Pay-if-Paid Terms in Subcontracts: Love, Hate & the *Transtar* Decision

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The Ohio Supreme Court recently issued its much-anticipated ruling in *Transtar Elec., Inc. v. A.E.M. Elec., Servs. Corp.*, 2014-Ohio-3095. The often-discussed case is popular due to the impact of decision. Pay-if-paid provisions affect the bottom line directly and inversely, for contractors and subcontractors. Thus, contractors love them and subcontractors hate them. Because the *Transtar* decision made enforcement of pay-if-paid provisions much easier, that decision will be viewed the same way.

By agreeing to a pay-if-paid provision, the subcontractor agrees that it will only be paid for its work if the owner pays the contractor for that work. Thus, a pay-if-paid provision can be one of the most effective risk-shifting provisions in a subcontract. Such language is often included in progress payment, final payment and claim liquidation provisions.

A handful of states flatly prohibit the enforcement of pay-if-paid provisions. Take California, for example, where I practiced for the first six years of my career. The law is so well-settled there that contractors typically do not raise the provision as a legal defense even if it is in the subcontract. Ohio, like the majority of states, takes its cue from *Thos. A. Dyer. Co., v Bishop Int'l. Eng. Co.*, 303 F. 2d. 655 (6th Cir. 1962). In that case, a federal court decided that such provisions were enforceable if they are "clearly and expressly stated in unequivocal terms."

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The battle in Ohio has been over the "magic language" required to create an enforceable pay-if-paid provision. Until *Transtar*, Ohio's courts have typically viewed pay-if-paid provisions with disfavor. A memorable assignment from my first years of practice in Ohio was researching this area of law for the appeal in *Chapman Excavating Co., Inc. v. Fortney & Weygandt, Inc.* (8th Dist.) 2004-Ohio-3867. In that case, Ohio's 8th Appellate District (which covers Cuyahoga County) reviewed language involving owner insolvency that is typically included in unequivocal pay-if-paid provisions.

Contractors should know how to use [pay-if-paid or pay-when-paid] language to protect their bottom line. Subcontractors should know how to spot the issue and assess the risk before they sign [an] agreement.

The subcontract provision at issue in *Transtar* did not include any reference to the risk of the owner's insolvency. It stated quite simply that owner payment to the contractor was a "condition precedent" to the contractor's obligation to pay the subcontractor. There, the owner did not pay the contractor, so the contractor did not pay the subcontractor. The subcontractor filed a lawsuit to get paid. The contractor sought enforcement of its pay-if-paid provision as a defense to payment. The trial court agreed with the contractor. The appellate court reversed. The subcontractor then sought the Ohio Supreme Court's review. After reviewing *Thos J. Dyer*, *Chapman Excavating* and other cases on point, the Supreme Court held that the use of the "condition precedent" language was sufficient. Currently, that is all the "magic language" needed in Ohio to enforce such a provision.

Contractors should know how to use this language to protect their bottom line. Subcontractors should know how to spot the issue and assess the risk before they sign the agreement.

It is one thing to take that risk when the project owner is a multi-billion dollar company. It is quite another when the project owner is a single-asset limited liability company. Love them or hate them, contractors and subcontractors must know how to handle these terms. P

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