When Must Contractors Pay Subcontractors?

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Ohio courts are taking a strict stance on when contractors must pay subcontractors. It is common for subcontract agreements to tie contractor's payment to subcontractors to the contractor's receipt of payment from the owner. Two common methods for dictating the payment of subcontractors are "pay-when-paid" and "pay-if-paid" clauses. Pay-when-paid clauses provide that payment to subcontractors should be within a certain amount of time after the owner pays the contractor. Courts interpret these as a timing mechanism for payment, rather than a defense to nonpayment if the owner has not paid the contractor. In practice, these clauses merely delay payment to subcontractors for a reasonable time.

Pay-if-paid clauses, on the other hand, provide that payment from owner to contractor is a condition precedent to the contractor's duty to pay subcontractors. In other words, the contractor has no duty to pay the subcontractor until the owner pays the contractor.

A typical payment clause might expressly state that the owner's payment to contractor is a condition precedent to the contractor's duty to pay subcontractors. The majority of courts, including Ohio, hold that condition precedent language alone is not enough to constitute a pay-if-paid clause. A condition precedent is an event that must occur before a duty or right arises. This means that, if a certain event does not occur, a party's obligation under the contract is not necessary. One might wonder, then, why such language does not create a pay-if-paid clause. Ohio courts strongly disfavor condition precedents. Whether language creates a condition precedent is a question of intent. If the parties' intent to create a condition precedent is at all ambiguous, the courts will not consider an event a condition precedent. Consequently, Ohio courts hold that bare "condition precedent" language does not protect a contractor who withholds funds because the owner has not paid the contractor. And the contractor must pay its subcontractors within a reasonable time even if the owner has failed to pay.

Common sense supports the majority view. The general contractor of a project contracts directly with the owner. Thus, contractors stand in better position to know the owner's financial stability than subcontractors.

A successful pay-if-paid clause must expressly provide that the subcontractor will bear the risk of the owner's nonpayment. If the parties do not expressly shift the risk of the owner's nonpayment to the subcontractors, the courts will interpret the clause to be a pay-when-paid clause.

Timing of payments can be critical to the success of a company. Whether you are a contractor or subcontractor, it is important to have legal counsel review this and other contract language.