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CONSTRUCTION LAW

Pay-When-Paid Clauses In Construction Contracts

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In the construction industry, it is common for a general contractor to avoid paying a subcontractor unless and until it has received payment from an owner for the subcontractor's work. This practice, however, had been rejected by the New York Court of Appeals in the 1995 landmark case West-Fair Elec. Constrs. v. Aetna Cas. & Sur. Co., 87 N.Y. 148 (1995). In that case, the Court of Appeals invalidated pay-when-paid clauses in construction contracts. Since then, relying on West-Fair, subcontractors have prevailed against general contractors who refused to pay a subcontractor because the owner had not paid the general contractor. In those situations, the general contractor bears the economic loss for the subcontractor's work, which may turn a profitable job into a non-profitable one.

This does not have to occur. General contractors have a tool available that they, or their counsel, may not have considered. An overlooked section of the Prompt Payment Act provides an alternative to invalid pay-when-paid clauses. In 2002, the New York Legislature enacted Article 35-E of General Business Law, otherwise known as the Prompt Payment Act. Most of the focus of this statute is the default deadlines it establishes by which an owner must pay a general contractor and a general contractor pay a subcontractor. However, a little explored section of the statute, §756-a(3)(b)(i), exculpates a general contractor from personal liability to a subcontractor where the subcontract discloses that the general contractor is entering into the agreement as an agent for a disclosed owner.

How does the Prompt Payment Act interact with West-Fair? (Note: Throughout the remainder of this article, the Prompt Payment Act and GBL §756-a(3)(b)(i) are referred to interchangeably even though there are other provisions of the Prompt Payment Act.) Even though the Prompt Payment Act has been on the books for approximately 20 years, no court has addressed this. Thus, the question exists: Does the Prompt Payment Act revive pay-when-paid as a valid way for a general contractor to avoid paying a subcontractor?

The Prompt Payment Act

GBL §756-a(3)(b)(i) states, in full: "Unless the provisions of this article provide otherwise, the contractor or subcontractor shall pay the subcontractor strictly in accordance with the terms of the construction contract. Performance by a subcontractor in

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accordance with the provisions of its contract shall entitle it to payment from the party with which it contracts. Notwithstanding this article, where a contractor enters into a construction contract with a subcontractor as agent for a disclosed owner, the payment obligation shall flow directly from the disclosed owner as principal to the subcontractor and through the agent."

The juxtaposition of the second and third sentences of GBL §756-a(3)(b)(i) demonstrates the Legislature's intent to absolve a general contractor from personal liability to the subcontractor in certain circumstances. The second sentence of the statute states that the subcontractor is entitled to payment from the party with whom it contracts. The third sentence states the payment obligation shall "flow" directly from the disclosed owner to the subcontractor and "through" the agent contractor. Connecting the two sentences together is the introductory clause "Notwithstanding this article" at the beginning of the third sentence.

By selecting that language, the Legislature intended the payment obligation mentioned in the second sentence does not apply when the contractor is an agent for a disclosed owner. Since the payment obligation flows directly from the disclosed owner to the subcontractor through the agent, the general contractor is a conduit for payment and nothing more. It absolves the general contractor from personal liability to the subcontractor when the general contractor does not receive payment from the owner.

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The next subsection of the statute reinforces this. GBL §756-a(3)(b)(ii) states: "When a subcontractor has performed in accordance with the provisions of its construction contract, the contractor shall pay to the subcontractor … the full or proportionate amount of funds received from the owner for each subcontractor's work and materials … ."

If the general contractor (as agent) is to be anything more than a conduit for payment, GBL §756-a(3)(b)(ii) would not have limited the general contractor's payment obligation to the funds it received from the owner. The Legislature would have required the general contractor to use its own funds if those received from the owner were insufficient.

Thus, the Prompt Payment Act does, in certain circumstances, exculpate a general contractor from personal liability. This may appear to be novel, but it is not. It is simply the extension of the well-established common law rule that an agent who acts on behalf of a disclosed principal will not be liable for breach of contract unless there is clear and explicit evidence of the agent's intention to be bound for the failures of the agent's principal. See, e.g., *Savoy Record Co. v. Cardinal Export*, 15 N.Y.2d 1 (1964); *Mencher v. Weiss*, 306 N.Y. 1 (1953); *Brasseur v. Speranza*, 21 A.D.3d 297 (1st Dep't 2005)

The Act and 'West-Fair': Are They at Odds?

The Prompt Payment Act allows, in certain circumstances, pay-when-paid. *West-Fair* invalidated such clauses. How can the statute and the judicial doctrine be reconciled? Currently, there is no reported case that discusses how the Prompt Payment Act interacts with the *West-Fair* doctrine. There appears to be only one reported case that even mentions both the Prompt Payment Act and West-Fair. In *Hugh O'Kane Elec. Co. v. MasTec North America*,

19 A.D.3d 126 (1st Dept. 2005), the First Department noted that GBL §756-a(3)(b)(i) was not applicable because it was enacted after the parties had entered into the subcontract at issue. The appellate court then went on to interpret a subcontract that contained the disfavored pay-when-paid clause, but ultimately ruled that the parties' choice of law took precedent over the prohibition on pay-when-paid clauses. Thus, *Hugh O'Kane* provides no guidance on how the Prompt Payment Act interacts with *West-Fair*.

Despite the lack of judicial guidance, the Prompt Payment Act and *West-Fair* can be reconciled by examining the rationale behind the *West-Fair* decision. In *West-Fair*, the Court of Appeals rejected the pay-when-paid clause because it imposed a condition precedent upon the contractor's obligation to pay the subcontractor, receipt of payment from the owner. No debt was due to the subcontractor until the owner paid the general contractor.

Since that may never occur, the subcontractor had waived the right to file a mechanic's lien, which is expressly prohibited by Lien Law §34. (As the Court of Appeals stated, "the pay-when-paid provision here extinguishes plaintiff subcontractor's ability to enforce a lien against the owner." *West-Fair*, supra, 87 N.Y.2d at 159.)

The Prompt Payment Act does not violate the Lien Law concern that was the basis for the West-Fair decision. The Prompt Payment Act does not impair a subcontractor's lien rights because it does not delay indefinitely when payment to a subcontractor becomes due, as a true pay-when-paid clause does. The subcontractor can still file and enforce a mechanic's lien when its deadline to receive payment has passed.

The Prompt Payment Act merely establishes who—as between the general contractor and owner—is financially responsible to pay the subcontractor when the subcontract discloses a principal-agent relationship between the owner and general contractor. In this circumstance, the general contractor has no obligation to pay the subcontractor with its own funds, and has a defense to a subcontractor's claim.

In turn, the subcontractor should also be able to sue the owner directly, in addition to asserting its lien rights, since the payment obligation flows directly from the owner through the general contractor to the subcontractor. Thus, the Prompt Payment Act does not impair a subcontractor's lien rights and is compatible with *West-Fair*.

Conclusion

Many general contractors continue to use pay-when-paid clauses in New York, even though West-Fair rejected them 20 years ago. General contractors, and their counsel, should instead be aware of the benefits of the Prompt Payment Act and draft subcontracts that provide the protection available under that statute. Furthermore, in these circumstances, subcontractors and their counsel should be aware that the Prompt Payment Act does not impair their lien rights and can provide them with a direct claim against an owner.