PAGEL, DAVIS & HILL, P.C. BUSINESS INSIGHTS

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SUBCONTRACTOR AND SUPPLIER PAYMENT PROVISIONS

In this *Business Insights* issue we will provide an example of a payment provision from a builder customer contract form, and break this provision into parts for ease in understanding. However, when reviewing a builder's real contract form, the builder will not make it so easy on the reviewer. As with a number of provisions contained in the customer contract form, the payment provisions may be found in various places in the agreement form, schedules, attachments and exhibits.

Our sample payment provision begins with:

Contractor agrees to pay Supplier the sum of $100,000.00 (the "Purchase Price"), at the times and in the manner hereinafter set forth.

This provision is straightforward and should be acceptable as long as acceptable payment terms are set forth somewhere in the contract form, or added to the component manufacturer's addendum. The manufacturer will most likely find any of the following payment terms acceptable:

30 days from date of invoice or

Net 30 or

10th day of the month next following the month of the invoice.

Our sample payment provision continues with the following language:

Supplier represents and acknowledges that it relies primarily on the credit and ability of the Owner and not Contractor, and Supplier agrees that payment by the Owner to the Contractor, shall be an express condition precedent to any payment obligation that Contractor may have to Supplier.

A provision that is very similar to what we just read, and means essentially the same thing, is:

Supplier agrees that payment to Supplier is contingent upon Contractor's receipt of payment from Owner for the Material. Supplier accepts the risk of non-payment if Owner does not pay Contractor any progress payments and/or final payment for any reason.

Both of these provisions are referred to as pay-if-paid provisions. They exist in a number of general contractor customer contract forms. This is because general contractors rely on payments from project owners to pay their subcontractors and suppliers. What all pay-if-paid provisions have in common is that payment to the manufacturer is "subject to" or "conditioned on" some future event. This future event is usually the owner paying the general contractor. These provisions are not as problematic if the owner's credit is good, although that does not necessarily mean the supplier will get paid. Complications could interfere, such as the owner withholding payments due to some contract nonperformance on the part of the general contractor. These provisions are also less problematic if the general contractor has put up a payment bond for the project. However, even when a payment bond exists, this does not mean the manufacturer will be paid in a timely fashion. It may have to wait for payment from the surety under the bond.

Not all pay-if-paid provisions are enforceable—it will depend on state law. Further not all payment provisions that contain some kind of condition are pay-if-paid provisions. There is another type of payment provision which contains conditions—they are referred to as pay-when-paid provisions.

The difference with a pay-when-paid clause is that the general contractor customer is not absolved from paying, because the manufacturer is still entitled to payment within a reasonable time—even if the owner fails to pay the general contractor. This, of course, assumes the reason for non-payment is not the fault of the manufacturer.

The way to tell if a conditional payment provision is a pay-if-paid provision rather than a pay-when-paid provision is to carefully review the language used. If the clause clearly establishes:

- that the general contractor's receiving payment from the owner is a condition precedent,
- to the general contractor's obligation to pay,
- then that condition must be met before the general contractor's payment obligation ever arises.

It also must be remembered that not all pay-if-paid provisions are enforceable under state law—this varies state by state.

Our sample payment provision continues with the following language:

Ten percent (10%) of each of Supplier's invoice amounts shall be withheld as retention and shall be held in total, as accumulated, to be reduced when and to the extent the Contractor in its sole discretion deems proper.

This provision gives the customer the right to retain and hold ten percent of each invoice amount as long as the customer chooses to do so. While retainage is common in some markets, generally it is not common for retainage to be held by builders and general contractors from its suppliers. Note that it is common for retainage to be withheld from subcontractors however.

If retainage is agreed to, the supplier should make sure the retainage percentage is stipulated. It's even more important to stipulate when the retainage will be paid.

Our sample payment provision continues with the following language:

Supplier hereby waives and releases all liens or rights of liens now existing or that may hereafter arise for any and all work or labor performed or material furnished under this Agreement.

This provision states that the supplier is giving up its lien rights regardless of whether it is paid or not. As with pay-if-paid provisions, not all states will enforce a waiver of lien provision. It is also important to note that a waiver of lien provision is not the same thing as a partial lien waiver or final lien waiver, both of which waive lien rights after delivery of product to the jobsite, in exchange for payment.

Our sample payment provision ends with the following language:

Upon Contractor's request as determined in its sole discretion, Supplier shall pay for and furnish to Contractor, a good, sufficient and acceptable 100% Performance Bond and a 100% Payment Bond on Contractor's standard bond forms, written by a surety company acceptable to Contractor. The cost of the bonds required herein is included in the Purchase Price.

This provision gives the customer the right to require the manufacturer to provide both a performance bond and payment bond. Typically, neither of these bonds are something suppliers provide. In fact, most if not all manufacturers do not provide, and would not be able to provide, either of these.

Based on the problems with our sample payment provision, we would assign this provision a risk rating of F.

Here is an example of an alternate provision that a supplier could add to a customer contract form addendum to neutralize or counteract the payment provision we just discussed:

Contractor agrees to pay Supplier the sum of $100,000.00 (the "Purchase Price") at the times and in the manner hereinafter set forth. All invoices shall be payable on the 10th day of the month next following the date of the invoice. Invoices shall be issued immediately upon delivery of materials to the Contractor's jobsite. No contract retainage shall be permitted. Payment by Owner shall not be a condition precedent of payment by the Contractor to Supplier. Supplier shall release its liens only to the extent of payments received. Supplier's requirement to provide a performance or payment bond is deleted in its entirety.

This provision does a number of positive things for the supplier to neutralize the sample provision we have reviewed

- by stating the purchase price,
- setting the terms of payment,
- setting the date invoices will be issued, and

- eliminating the right to retainage.

It also does away with the pay-if-paid language, therefore making the general contractor responsible to pay—regardless of whether or not payment is received from the owner. Additionally, it converts the waiver of lien provision into an agreement to release lien rights when and if payments are received. Lastly, it eliminates the obligation to post either a performance or payment bond.

All of these things lower the risk to the supplier. Therefore, we assign this type of provision a risk rating of A—as long as the builder agrees to it following negotiation, because it completely counterbalances our sample payment provision.