

## Pay-When-Paid Clauses

General contractors are frequently faced with claims for extras or delay emanating from subcontractors but attributable to acts or omissions of the owner or consultant. In these cases the general contractor may want to “adopt” the claims, and attempt to pass them through to the owner, but if the owner resists, the general contractor may find itself in the uncomfortable position of simultaneously arguing in favour of the validity of the claim to the owner, but against it to the subcontractor.

General contractors sometimes try to avoid being stuck with liability for subcontractor claims which cannot be passed through by writing “pay-when-paid” clauses into their contract. These clauses attempt to pass the risk of the owner not paying on to the subcontractor. This is something that may be missed by the subcontractor and can work unfairly, especially where the subcontractor is in no position to assess the financial strength of the owner or where the subcontractor is precluded from calling on a Labour and Material Payment Bond because of the ability of the surety to assert the contractors “pay-when-paid” defence.

Because these clauses can operate in a way that appears “unfair”, it is no surprise that courts have struggled with them. From the cases, there appear two clear lines of argument. The first is that if a clause indicates that the subcontractor will be paid when the contractor is paid, that is a clear indication that unless and until the contractor is paid the subcontractor has no right to be paid and the risk of non-payment by the owner is borne by the subcontractor. The competing argument is that the “pay-when-paid” clause speaks to the timing of the payment but is not conclusive of the right to be paid. In other words, in the ordinary course the subcontractor will have to wait until the contractor is paid but does not give up their right to recover against the contractor in the event the owner never pays the contractor.

The competing lines of argument are best illustrated in *Timbro Developments Ltd. v. Grimsby Diesel Motors Inc. et al.*<sup>1</sup> and *Arnoldin Construction & Forms Limited v. Alta Surety Co.*<sup>2</sup>, the two

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<sup>1</sup> *Timbro Developments Ltd. v. Grimsby Diesel Motors Inc. et al.* (1988), 32 C.L.R. 32 (Ontario Court of Appeal)

<sup>2</sup> *Arnoldin Construction & Forms Limited v. Alta Surety Co.* (1995) 19 C.L.R. (2d) 1 (Nova Scotia Court of Appeal)

leading appellate court authorities in Canada dealing squarely with the meaning and enforceability of “pay-when-paid” clauses.

In *Timbro* the owner refused to pay the contractor who subsequently refused to pay the subcontractors. The standard form agreement between the contractor and each of the subcontractors contained the following clause:

**Payments will be made** not more than thirty (30) days after the submission date or **ten (10) days after the certification or when we have been paid by the owner**, whichever is the later.

The majority of the Ontario Court of Appeal (Blair and Cory JJ.A.) upheld the clause and dismissed the claims by the subcontractors. The majority of the court held at p.33:

... the clause clearly specifies the condition governing the contractor's legal entitlement to payment and not merely the time of payment. Under the clause, the subcontractor clearly assumes the risk of non-payment by the owner to the contractor. [our emphasis]

Finlayson J.A. in his dissenting view stated at p.33:

... the clause relates to the timing of payments due under the contract and in no sense puts the subcontractors at risk that they will not be paid if the contractor is not paid. They are not co-adventurers or partners in this construction contract. Having done the work as found by the trial Judge, they are entitled to be paid.

In *Arnoldin*, the payment clause stated:

**The balance** of the amount of the requisition as approved by the Contractor shall be **due to the Subcontractor on or about one day after receipt by the Contractor of payment by the owners....Final payment shall be made** on acceptance of the work by the Contractor, Architects and/or Engineers, and Owners, and **within 30 days after payment has been received by the Contractor.**

Despite the fact that these words appear to have a very similar meaning to those used in the clause at issue in *Timbro*, the Nova Scotia Court of Appeal found for the subcontractor, ruling as follows at p. 10:

In my opinion, in order for a general contractor to impose a term on a subcontractor pursuant to a standard form of contract, that payment for its work is conditionally on the contractor being paid by the owner the contract would require much clearer language than that contained in the subcontract between Gem and the appellant. An intention so important cannot be buried in obscure language that would not alert the subcontractor that payment for the subcontract work was conditional on the owner paying the contractor.

The court in this case was likely compelled to find for the subcontractor because there was a Labour & Material Payment Bond put in place by the contractor. The unexpected or unfair result the court was trying to avoid was the situation where the bond could not be called upon in the exact circumstance one would expect it to be called upon, that is, non-payment by the contractor. If the funds were found not due and owing by the contractor as a result of the operation of the pay-when-paid clause, the surety would have a complete defence to the subcontractors claim because there would be no default by the contractor.

Consider the cases in the following table following either the *Timbro* or the *Arnoldin* line of reasoning. They are difficult to reconcile and, for the most part, they conflict.

Because *Timbro* and *Arnoldin* are in conflict, where one encounters a “pay-when-paid” clause that is not crystal clear, there is room for both sides to argue and to litigate and there will be a significant degree of uncertainty for both with respect to the outcome of legal proceedings. That said, how far can the arguments be taken?

The cases that follow the *Arnoldin* line of reasoning do not go so far as to displace entirely the principal that where there is no ambiguity, the words of the contract are to be given their plain and ordinary meaning. So, a “pay-when-paid” clause which clearly and plainly alerts the subcontractor to the issue of its assumption of the risk of non-payment by the owner is going to be given effect and a subcontractor agreeing to such a clause will likely be stuck if the owner

does not pay and will also likely have no recourse under an L&M Payment Bond where the contractor is the principal.

An example of a “pay- when-paid” clause that should have this effect is:

Payment by Owner to Contractor is a condition precedent to Contractor paying Subcontractor. Subcontractor understands and agrees that it will be paid if, and only after, Contractor is paid by Owner for that portion of the Work for which Subcontractor is seeking payment. Subcontractor fully understands that it bears the risk of non-payment by the Owner.

On the other hand, and as one would expect, the cases that follow *Timbro* still require there to be some relatively clear expression of the pay-when-paid concept. Such a term will not likely be implied by custom or past practice. In *Pro Star Mechanical Contractors Ltd. v. Farmer Construction Ltd.*, S.C.B.C., Victoria Registry No. 94/1540, July 6, 1994, a decision of the B.C. Supreme Court, a contractor argued that a pay-when-paid provision should be implied in its subcontract. When the subcontract was awarded, the contractor wrote to the subcontractor saying, “We will forward our form of Contract to you for signature immediately after the Prime Contract is formally executed.” The form of subcontract in use by that Contractor contained a “pay-when-paid” clause. Although the parties had previously contracted using that contractors standard contract, the subcontractor in this case had not been questioned on the topic in this instance and never did sign the form of subcontract with the “pay when paid” clause. When the contractor was not paid by the owner and in turn the contractor failed to pay this subcontractor, the subcontractor sued and recovered on the basis that he had never agreed to the clause.

Mr. Justice Cowan found that the “pay when paid” clause could not be imported into the agreement by implication as the subcontractor had never agreed and one payment had been made by the general contractor without protest. The subcontractors invoices had stipulated payment within 30 days and the judge found payment to have been due on that basis. One qualification that must be given is that, even where an otherwise valid pay-when-paid clause is contained in the subcontract, it may not protect the contractor from the subcontractors claims where the reason for non-payment is the contractors own default under its contract with the

owner. The Ontario Court of Appeal dealt with this scenario in *McBrien v. Shanly*,<sup>3</sup> In that case the defendant contractor failed to pay the plaintiff subcontractor for work performed and accepted by the defendant under the contract. The defendant relied upon a clause that read:

**All payments to be made** monthly to the party of the first part [the plaintiff], by cheque or draft on some one of the chartered banks on the Provinces, payable at the Toronto or elsewhere, as agreed upon, and within ten days **after the party of the second part shall have received the amount due to him** for the said work from the said Midland Railway Company [the party that commissioned the construction under the prime contract].

It was not disputed that the prime contract was terminated by the Midland Railway Company because of a default by the defendant. The Ontario Court of Appeal allowed the Plaintiff to recover to full amount owing to him.

Haggarty C.J. stated the applicable principles for interpretation of such provisions at p.35:

I think the true intent and meaning of such a contract must be that at best the defendant can say: "If I duly perform my contract with the company, and though I am entitled to the money from them, if from any cause, not arising from any act or default of mine, they do not pay, you cannot call on me to pay.

.....

I think in every bargain, like that between the plaintiff and the defendant, when payment for work actually done is to be postponed till payment by a third party, for whom, as the paymaster in chief, the whole work has to be done, there is a clear, implied condition lying at the root of the bargain, that nothing shall be done or omitted on the defendant's part to intercept or prevent payment by the third party.

And finally at p. 37:

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<sup>3</sup> *McBrien v. Shanly* (1874), 24 U.C.C.P. 28 (Ont. C.A.)

It is a principle very well established at common law, that no person can take advantage of the non-fulfilment of a condition, the performance of which has been hindered by himself.

In summary, a pay-when-paid clause is a useful means of transferring risk of non-payment by the owner from the contractor to a subcontractor. Subcontractors should be wary of accepting this risk, especially where they do not know or are unable to ascertain the financial viability of the owner. To be effective, the clauses must be worded very clearly. Even when the wording is clear, a contractor may have difficulty relying on a pay-when-paid clause if the reason for non-payment is its own default under its contract with the owner.