# Ask an Attorney

*The Legal Rights Committee expresses its appreciation to* ***Tim Woolford, Esq.,*** *of* ***Stevens & Lee, P.C.,*** *Lancaster.*

**Q: What is a "pay-when-paid" or "pay-if-paid" clause, and can a General Contractor refuse to pay a subcontractor on this basis?**

A: General contractors (GCs) often include "*pay-when-paid*" or "*pay-if-paid*" clauses in their standard form subcontracts. GCs attempt to rely on these clauses to withhold payment from subcontractors until they are paid by the owner for the subcontractor's work. In the past few decades, the question of whether these clauses give the GC the right to indefinitely withhold payment from subcontractors if they are not paid by the owner has been strenuously contested. A typical pay-when-paid clause contains some version of the following:

**Payment will be made to the subcontractor upon approval by the architect and receipt of payment from the owner.**

The most recent pronouncement from a Pennsylvania appellate court on pay-when-paid clauses is that *they do not permit the GC to withhold payment from the subcontractor indefinitely.* Instead, many courts have interpreted them as mere timing mechanisms to indicate when the GC was to pay the subcontractor, and that they do not permit the GC to withhold payment indefinitely. *See* United Plate Glass Co. v. Metal Trims Industries, Inc., 525 A.2d 468 (Pa. Cmwth 1987); Diaz Contracting, Inc. v. Lisbon Contractors, Inc., 1991 U.S. Dist. LEXIS 4604 (E.D. Pa. 1991). State and federal courts interpreting pay-when-paid provisions generally conclude that the GC must pay the subcontractor despite non-payment from the owner. So, pay-when-paid clauses are often interpreted so that payment to the GC from the owner is not a condition precedent to the obligation to pay the subcontractor. Eventually, the GC must pay the subcontractor even if the owner never pays the GC. The reasoning behind this is that "ordinarily, the party directly involved with the owner bears the risk of the owner's failure to pay." O'Brien & Gere Engineers v. Talegheni, 540 F. Supp. 1114 (E.D. Pa. 1982). Pennsylvania courts' interpretation that pay-when-paid clauses typically do not defeat a subcontractor's demand for payment is consistent with the interpretation applied by courts in most states.

Irrespective of whether pay-when-paid clauses are timing provisions or conditions precedent, if the owner's failure to pay is the result of the GC's own misconduct or mismanagement of the project, the GC will probably not be entitled to the protection of the clause. *See e.g.*, Moore Bros. Co. v. Brown & Root, Inc., 207 F.3d 717 (4th Cir. 2000). Since a GC's misconduct was the cause of an

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owner's failure to pay, it could not avoid paying subcontractors.

A close corollary of the pay-when-paid clause is the *pay-if-paid* clause. Pay-if-paid clauses expressly state that payment from the owner is a condition precedent to the GC's duty to pay the subcontractor. In some states, pay-if-paid clauses are not enforced because they are deemed to violate public policy. Other states will enforce the clauses, but only if the language is very clear that payment from the owner is a condition precedent to the duty to pay the subcontractor. Pennsylvania appellate courts have not addressed the enforceability of pay-if-paid clauses in the context of whether a GC can rely on it to indefinitely deny payment to a subcontractor. However, in light of their interpretation of pay-when-paid clauses, it seems likely that Pennsylvania courts would not enforce them unless the language of the clause very clearly established that payment from the owner is a condition precedent to the duty to pay the subcontractor.

A closely related issue is whether a surety or bonding company can claim the protection of a pay-when-paid or pay-if-paid clause. Usually, sureties can avail themselves of any defense that the principal has. In other words, they "stand in the shoes of the principal." While Pennsylvania courts have not addressed this precise issue, courts in several other states have held that the surety cannot invoke this defense unless the bond itself clearly states that the pay-when-paid or pay-if-paid clause is incorporated into the bond. *See e.g.*, Moore Bros. v. Brown & Root, *supra*. Thus, if the general contractor for whom you are working has a payment bond and is claiming that he does not have to pay you because he has not been paid by the owner, the bonding company might not be permitted to assert the defense.

In summary, if you are a subcontractor or supplier, and the GC or higher-tiered contractor informs you that he has no duty to pay you because he has not been paid by the owner, contact legal counsel to get advice on whether the GC's claim is legally valid.

**Q: What is the *Eichleay* formula, and how does it relate to my delay claim?**

A: The *Eichleay* formula is a method of calculating damages when a construction project is delayed past the contract completion date. Many courts and arbitrators recognize the *Eichleay* formula as an appropriate measure for computing unabsorbed home office

general and administrative expense incurred by a contractor when a project is delayed. Home office overhead is the general and administrative expense (G&A) a business spends to support its revenue-generating activities. Typically, these costs cannot be directly allocated to any particular project. They include rent and depreciation costs, licenses and fees, taxes, utilities, salaries of directors, officers, managers and administrative personnel, as well as other general administrative expenses.

The theory behind the *Eichleay* formula is that when a project is delayed, it is unable to absorb as much overhead as expected. Therefore, a delayed project often results in a disproportionately higher allocation of overhead to other projects. Recovery of unabsorbed home office overhead compensates the contractor for the G&A costs that the contractor was expected to absorb as part of the bid price. The inability to absorb these costs, due to the owner's delay, results in a loss.

The *Eichleay* formula establishes a formula for recovering this loss in the form of a daily overhead rate approximating the amount of G&A that the contract was expected to absorb during the contract period. It does so by using the ratio between the contract billings for the delayed project and the contractor's total corporate billings for the actual contract period. The formula is as follows:

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|---|---|---|---|---|
| Contract billings Total Billings for Actual Contract Period | X | Total Overhead Incurred during Contract Period | = | Overhead Allocable to Contract |
| Overhead Allocable to Contract Actual Days of Contract Performance | = | Contract Daily Overhead | | |
| Contract Daily Overhead | X | No. of Days of Delay | = | Unabsorbed Overhead |



As a technical matter, recovery of so-called *Eichleay* damages may require that the contractor prove that the work was actually suspended for a period of time, and that the contractor was "on standby."[1] Many owners, mediators and arbitrators are either unaware of this requirement or fail to enforce it, and permit recovery of *Eichleay* damages despite the fact that there was no suspension of work. Thus, when calculating a delay claim, it is recommended that you include an unabsorbed home office overhead component in the claim, as it will often be recognized even though the work was not suspended.

Like many states, Pennsylvania courts have not expressly adopted the *Eichleay* formula as the proper method of calculating unabsorbed home office overhead. Nevertheless, in resolving delay claims through informal settlement negotiations, mediations and arbitrations, the *Eichleay* formula is often recognized. The Pennsylvania Board of Claims has not adopted the *Eichleay* formula, but has instead expressed approval for the so-called *Manshul* formula which involves a more complex method of computing unabsorbed home office overhead. Thus, contractors on DGS, PennDot, State System of Higher Education, and certain other state projects should consult with

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counsel to ensure that their claims are computed pursuant to the methods preferred by the Board.

**Q: How can contractors protect themselves against construction contracts heavily favored toward the other party?**

A: Construction contracts are not always fair and are not always the result of equal bargaining power. In many cases, they are presented on a "take it or leave it" basis. However, this does not mean that the contractor must simply surrender and sign the one-sided contract. The greatest protection in evaluating and negotiating contracts is to know the landmines to look out for, to understand the handful of critical contract provisions that are commonly used, and to know what the exceptions and loopholes are. The prudent contractor knows which provisions can be negotiated so that both parties are satisfied. He also knows what to do after the project begins in order to manage the risks created by the contract provisions he was constrained to accept.

By understanding what the other party is trying to accomplish with the inclusion of certain clauses, you can often reach an acceptable compromise. If the clause cannot be negotiated, the risk of it should be allocated to a lower-tier subcontractor. You do not want to be exposed to the owner to a greater extent than your lower-tiered contractors are exposed to you.

In attempting to negotiate a few key provisions, you may very well succeed in having your proposed changes accepted. On the other hand, you should avoid attempting to negotiate every provision of the contract because you will likely frustrate and/or alienate the other party. Moreover, all your changes will likely be rejected out of hand. The prudent contractor employs a milder approach by knowing and identifying the provisions that can harm him, understanding how they operate, and attempting to negotiate them. Once he has accepted what he must, he prepares to deal with the risks during performance.

Some of the key provisions that the prudent contractors focus upon include the following: flow-down or pass-throughs, review and site inspection, scheduling, changes and change orders, claims and disputes, differing site conditions, delay claims, extensions of time, no damages for delay, pay-when-paid, indemnification, resolution of claims and disputes, attorneys' fees, waivers of liens and termination.

Whether the provisions can be negotiated or not, you should carefully study the contract before signing it with an understanding of the key provisions. Then, you should prepare to perform with a keen understanding of the risks which the contract allocates to each party.

[1] Interstate Gen. Gov't Contractors, Inc. v. West, 12 F.3d 1053, 1057 (Fed. Cir. 1993)



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