

ANTONIA M. POWELL

ATTORNEY AT LAW

9440 SANTA MONICA BLVD. - SUITE 301
BEVERLY HILLS, CA 90210
TEL. (310) 913-5611
TEL. (310) 392-9004

antoniapowell@ca.rr.com

M E M O R A N D U M

TO: Deveney Pula, Exec. Director

DATE: July 20, 2020

RE California Appeals Court Rules Open-Ended Pay-When-Paid Clauses Unenforceable

I believe our contractors will be interested in the recent case of **Crosno Construction Inc. v. Travelers Casualty & Surety Co.**, (No. D0755561, 2020 WL 1899278) in which the Fourth District California Court of Appeals decided that an industry standard "pay-when-paid" contract clause (part of the *AGC Short Form Subcontract*) was ruled void and unenforceable. The ruling was based on the grounds that the pay-when-paid clause violated state public policy because it did not provide for payment to the subcontractor within a reasonable time since payment was delayed indefinitely for as long as it took the general contractor to pursue its claim against the project owner. (A copy of the **Crosno** decision is attached.)

Brief Case Summary

The case involved a 2014 public works project for construction of an arsenic removal water treatment plant. The Water District owner entered into a contract with Clark Brothers as the general contractor. Crosno Construction was hired by Clark to fabricate and coat two steel reservoir tanks. After Crosno completed most of its work, a dispute arose between the District and Clark. Crosno was ordered to suspend work. Crosno sought to recover the payments owed under Clark's public works payment bond issued by Travelers Casualty and Surety ("Surety").

The Surety denied the payment bond claim as premature arguing that pursuant to the pay-when-paid clause in its subcontract, Crosno was required to wait a "reasonable time" for payment if Clark was not paid by the owner. The subcontract defined such reasonable time as the length of time it takes the general contractor to pursue its remedies against the owner.

Specifically, the subcontract contained the following pay-when-paid language in the event the owner delayed making payments to the general contractor:

"If owner or other responsible party delays in making any payment to contractor from which payment to Subcontractor is to be made, Contractor and its sureties shall have a reasonable time to make payment to Subcontractor. "Reasonable time" shall be determined according to the relevant circumstances, but in no event shall be less than the time Contractor and Subcontractor require to pursue to conclusion their legal remedies against Owner or other responsible party to obtain payment, including (but not limited to) mechanics' lien remedies."

Deveney Pula, Exec. Director
July 20, 2020

The issue on appeal was whether the above "pay-when-paid" provision in the contract blocked Crosno from recovering under the payment bond while the general contractor's lawsuit against the District (owner) was still pending.

The court found that the definition of "reasonable time" in the contract's pay-when paid provision was unenforceable because it impaired the subcontractor's right to timely payment under the bond and required the subcontractor to wait an "indefinite time" until the general contractor and the owner resolved their disputes. The court also found that there was no dispute regarding the amount owed or the work performed by Crosno and also that Crosno had never executed a statutory waiver and release of its payment bond rights.

Surety May Not Use the Subcontract's Pay-when-Paid Provision to Deny Subcontractor's Bond Payment Claim

The court noted that the primary focus of the Surety should have been on whether the subcontractor furnished material and performed labor that was used in construction and not on the rights of the general contractor or owner. The Court further stated that the statutory aim of the payment bond is to give subcontractors a quick, reliable and sufficient means of payment and that a Surety may not "prioritize the general contractor's litigation rights over the subcontractor's payment bond rights". (at pp 26-27)

What Is The Extent Of The Crosno Ruling

Looked at narrowly, the ruling only applies to public works payment bonds where there is no dispute regarding the work performed by the subcontractor. However, the court's reasoning and holding seem easily transferable to a subcontractor's claim against a general contractor and should apply with equal force to private works projects. Additional litigation however will be needed to answer the question as to whether courts will extend Crosno's holdings and remedies to private works and to payment claims against the general contractor.

Another unanswered question is whether bond sureties can be successfully sued while change order requests are pending. Since processing change orders is often held until the end of the job, subcontractors complain they have no way to bill for the work. Under the rationale of Crosno, subcontractors can argue that they performed the work at the general contractor's instruction, the general contractor accepted the work and should now pay for the work and if it refuses, the bond Surety should be required to pay. Again additional litigation will be needed to answer this question.

Also important to remember is that the court did not find that all pay-when-paid clauses are unenforceable, just that the time period for payment had to be specified and reasonable. The court however, did not offer any guidance as to what might be deemed a "reasonable" period for non-payment except to suggest that payment more than 3 years later is not reasonable. Unfortunately the answer to this question will also have to be the subject of a future court ruling.

Practical Considerations

Many current subcontracts with language identical to or similar to that in the Crosno subcontract may now include unenforceable pay-when paid provisions. I encourage and recommend that both general and subcontractors closely review their current pay-when-paid provisions to determine if revisions are required as a result of the Crosno ruling.

Deveney Pula, Exec. Director
July 20, 2020

General Contractors - Pay-when-paid language in subcontracts must be revised to include a definite, clearly defined time frame. Contract language delaying payment to some indefinite, unspecified time period will be seen as "unreasonable" and will not be enforceable.

Subcontractors - Subcontractors of public works projects should also review their existing subcontracts to determine whether pay-when-paid provisions in their contract complies with the Crosno ruling.

If subcontractors on public works projects have been waiting for payment for an extended period of time due to nonpayment by the owner, recovery on a payment bond claim prior to the resolution of the dispute between the general contractor and the owner may be a feasible option. Subcontractors in this situation may wish to first send a demand for payment to the general contractor citing the Crosno case.

Before taking action, it is recommended that public works subcontractors consult with their firm's attorney to ask about their remedies under Crosno and what avenues to payment may be available to them.

Toni Powell

