

Pay-When-Paid: Courts Hold a 'Reasonable Time' Now Has to Be Reasonable



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A new and significant California Court of Appeal decision that will have substantial financial impacts on direct contractors, their sureties and subcontractors was published on Apr. 17, 2020, called *Crosno Construction, Inc. v. Travelers Casualty and Surety Company of America*. This case, which focuses on "pay-when-paid" language in a public works subcontract, substantially impacts the timing of a payment bond surety's obligation to the subcontractor, and has the potential to be applied to the timing for payment by a general (direct) contractor to a subcontractor. In essence, *this case holds that a "pay-when-paid" provision in a subcontract is void and unenforceable against a subcontractor's payment bond claim when the provision purports to delay payment for as long as necessary for the direct contractor to pursue its claim against the project owner.*

It is well-settled that "pay-if-paid" clauses are unenforceable as contrary to public policy in California pursuant to the landmark California Supreme Court decision in *Wm. R. Clarke Corp. v. Safeco Ins. Co.* (1997) 15 Cal.4th 882. In that case, the Supreme Court distinguished an unenforceable pay-if-paid provision from a pay-when-paid provision, by explaining that a pay-when-paid provision does not establish a true condition precedent, but "merely [fixes] the usual time for payment to the subcontractor, with the implied understanding that the subcontractor in any event has an unconditional right to payment within a **reasonable time.**" *Wm. R. Clarke, supra*, 15 Cal.4th at p. 885 (emphasis added). Subsequent to the *Wm. R. Clarke* case, general contractors

throughout the state of California amended their form subcontract agreements so that the parties would agree to the definition of what constitutes a "reasonable time." In most sophisticated subcontract agreements, that "reasonable time" is defined as the length of time it takes the general contractor to pursue its remedies against the owner.

In *Crosno*, the general contractor (Clark Bros., Inc.) used that now-commonplace language, requiring the subcontractor (Crosno Construction) to wait a "reasonable time" for payment if Clark was not paid by the owner, and defining what a "reasonable time" meant. Specifically, the subcontract contained the following pay-when-paid provision in the event the public entity owner delayed making payments to Clark:

"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."

In accordance with the subcontract, Crosno was almost finished with the fabrication, erection and coating of two 250,000-gallon welded steel water reservoir tanks for a

public work of improvement when Crosno was ordered to suspend work after a dispute had arisen between Clark and the public entity and, the next day, served a stop payment notice on the public entity. Approximately 45 days later, Crosno made a claim upon Clark's payment bond and provided notice of such claim to Travelers. After Travelers denied the payment bond claim as premature by invoking the pay-when-paid provision in Crosno's subcontract, Crosno filed suit to enforce its stop payment notice and claim on the payment bond. Roughly one year later, Crosno filed a motion for summary judgment/adjudication as to its payment bond cause of action against Travelers, arguing that the pay-when-paid provision in the subcontract was void and unenforceable. The trial court agreed and granted Crosno's motion, awarding judgment in the amount of \$562,435 in favor of Crosno and against Travelers, plus almost 3½ years of interest on that amount, in addition to attorneys' fees.

The Fourth Appellate District of the California Court of Appeal affirmed the trial court's summary judgment in favor of Crosno. The appellate court, "agree[ing] with the trial court's sound analysis," held that the pay-when-paid provision in the Crosno subcontract, which delayed the subcontractor's right to payment for an indefinite time period until the general contractor's litigation against the owner concluded, "would unreasonably affect or impair [the subcontractor's] statutory payment bond remedy (Civil Code Section 8122) and is unenforceable for the same reasons expressed in *Wm. R. Clarke ...*"

The appellate court rejected Travelers' argument that Section 8122 was not implicated because the pay-when-paid clause only set the time for payment and did not waive Crosno's bond rights. Emphasizing that California's statutory scheme devoted to resolution of payment disputes on construction projects protects against *both waiver and impairment* of payment rights, the court held that the definition of a "reasonable time" set forth in the subcontract provision at issue includes an indefinite timeframe that is *unreasonable*. The court highlighted several times that while a pay-when-paid provision "might properly allow payment to be delayed for a *reasonable* period of time after completion of work,

enforcing the provision here 'does not provide for payment within a reasonable time.'" Invoking this particular pay-when-paid provision to delay Travelers' obligation under the payment bond until an undetermined time in the future when Clark's litigation with the public entity concluded "would unquestionably and unreasonably affect or impair Crosno's right to recover under the payment bond without either an express waiver or full payment required by [Civil Code] Sections 8124 and 8126. Accordingly, the specific pay-when-paid provision before us is 'void and unenforceable' (§§ 8122, 8126) against Crosno's payment bond claim."

It should be noted that a key fact in this case was that there was no dispute regarding whether Crosno was entitled to payment. The only issue was timing. When a claim (bond or otherwise) involves the determination of entitlement to payment, the surety or direct contractor will have defenses to payment. The court stated that its decision "does not ... allow subcontractors whose work is disputed to recover from [a] surety before merit is finally determined by the owner and the general contractor." Therefore, if Crosno's work had been implicated in Clark's dispute with the public entity, Traveler's obligation would not have been triggered until liability had been resolved.

In sum, *the key to the court's decision was the particular language used in the subcontract, which defined a "reasonable time" as an unreasonable indefinite period.* The court determined that such a definition was unacceptable because that provision "has the effect of the delaying payment to the subcontractor for what may be—and in this case was—an unreasonably long period of time." *And while this case concerned a payment bond claim and the surety's obligations, the court's reasoning seems easily translatable to a subcontractor's claim against a direct contractor.* As a result of the *Crosno* case, direct contractors should amend their subcontract form agreements to redefine a "reasonable time" as something that is not indefinite and unreasonably long. Although the court did not articulate what an "unreasonably" long time is, the court did twice repeat the policy of California law was to ensure "*quick*" payment to subcontractors and suppliers

who are proper mechanics lien, stop payment notice, and payment bond claimants. Moreover, subcontractors that have been caught in a holding pattern due to a pay-when-paid clause should now consider making a final demand for payment on current projects, and look to specifically negotiate pay-when-paid provisions in the future subcontract agreements. Finally, suppliers should run into fewer justifiable excuses for delayed payment from their customers and stand to benefit from enhanced cash flow as a result of the *Crosno* decision. ■■■■■

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