

Practice Update

Virginia Prohibits Pay-If-Paid Clauses and Limits Pay-When-Paid Language

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On April 27, 2022, Virginia Governor Glenn Youngkin ratified amendments to two Virginia statutes, prohibiting pay-if-paid clauses in construction contracts, and limiting the effectiveness of pay-when-paid clauses in certain agreements.

Pay-if-paid clauses generally provide that payment from a construction project owner to the general contractor is a condition precedent to the general contractor's obligation to pay the subcontractor. In other words, the contractor will pay the subcontractor only *if* it receives funds from the owner. If the owner fails to pay the contractor, the contractor will never have an obligation to pay the subcontractor. A pay-when-paid clause, on the other hand, provides that the general contractor will make payment to the subcontractor when it has received payment from the owner. While they sound similar, many courts have held that pay-when-paid clauses only allow the contractor a reasonable time to delay payment to the subcontractor, because the owner's payment to the contractor is not a true condition precedent to the contractor's obligation to pay the subcontractor.

For over twenty-five years, Virginia has expressly approved of pay-if-paid clauses in contracts between general contractors and subcontractors "where the

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language of the contract in question is clear on its face.” *Galloway Corp. v. S.B. Ballard Constr. Co.*, 250 Va. 493, 464 S.E.2d 349 (Va. 1995); *see also W. O. Grubb Steel Erection, Inc. v. 515 Granby, LLC*, 2009 WL 8618873 (Va. Cir. Ct. 2009). Virginia’s new law changes more than two decades of construction practice in the Commonwealth, by prohibiting these clauses and limiting the effectiveness of pay-when-paid language.

With respect to private construction projects, the amendment renders unenforceable any provision in a subcontract providing that payment from a higher-tier party is a condition precedent to the contractor’s obligation to make payment to the subcontractor. However, the amendment does not prohibit retainage provisions. Another exception is where the higher-tier party contracting with the contractor is insolvent or a debtor in bankruptcy.

As for pay-when-paid clauses, the amendment requires a contractor to pay a subcontractor within the earlier of (a) 60 days of the satisfactory completion of the work for which the subcontractor has invoiced, or (b) seven days after receipt of amounts paid by the owner to the general contractor or by the higher-tier contractor to the lower-tier contractor for work performed by a subcontractor. In other words, contractors can no longer indefinitely rely on pay-when-paid language to delay payment to a subcontractor, as such payment will be due no later than 60 days after completion of the work at issue – regardless of whether the owner has made payment.

This amendment does not prohibit withholdings in accordance with the subcontract, but if a contractor withholds some or all of the amount invoiced by a subcontractor, it must notify the subcontractor in writing of the withholding, with the reason for nonpayment and the amount being withheld. A general contractor’s failure to comply with the new amendment may result in interest penalties under Virginia law.

The same amendment also requires project owners to pay the general contractor within 60 days of receipt of an invoice following satisfactory completion of the work for which the general contractor has invoiced. Owners may also withhold amounts when permitted by the prime contract, but the owner must notify the general contractor in writing of the withholding and the reason for nonpayment. An owner's failure to comply may also result in interest penalties under Virginia law.

With respect to public projects in Virginia, a separate amendment similarly makes unenforceable any provision providing that payment from a higher-tier party is a condition precedent to the contractor's obligation to make payment to the subcontractor. For public projects however, there is no exception where the higher-tier party contracting with the contractor is insolvent or a debtor in bankruptcy. This amendment does not limit the use of pay-when-paid clauses, but existing law for contracts that are subject to the Virginia Public Procurement Act, at Virginia Code Ann. § 2.2-4354, already requires a contractor, within seven days of payment from the government, to either make payment to subcontractors or notify them of the withholding and the reasons for withholding. This amendment effectively restates that notice requirement.

The amendments to Virginia law create additional risk for general contractors related to non-payment by an owner, in that the general contractor no longer has the option of shifting such payment risks to a subcontractor with a strict pay-if-paid clause, or indefinitely delaying payment to the subcontractor under a pay-when-paid provision. General contractors on projects in Virginia may consider modifying their subcontracts to account for this change in law. Owners should also ensure that prime contracts provide for a payment cycle in accordance with Virginia law. Owners and contractors have time to make any needed changes. All of the foregoing amendments become effective, and apply to

construction contracts executed on or after January 1, 2023.

Akerman construction attorneys can assist with understanding and navigating these amendments to Virginia law.

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