SURETY TODAY PRESENTATION

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THE SURETY AND PAY-IF-PAID/PAY-WHEN-PAID CLAUSES

I. INTRODUCTION

In a typical construction scenario an owner contracts with a general contractor and the general contractor then contracts with various subcontractors and so on down the chain to lower tiers. In the absence of any contract language or statutory provisions to the contrary, the general contractor bears the risk of non-payment from the owner. So, for example, if the owner fails to pay through no fault of the subcontractor, the general contractor still remains liable to its subcontractor to pay for the work performed.

Contingent payment clauses like "pay-when-paid" and "pay-if-paid" typically provide that the contractor is not required to make payments to the subcontractor unless or until the contractor has received payment from the owner. Such clauses are utilized in subcontracts in an effort to prevent the general contractor from being required to pay the subcontractor before receiving payment for their work from the owner. Thus, changing the traditional allocation of the risk of non-payment by the owner from the general contractor down to the subcontractors and/or lower tiers. Numerous jurisdictions have addressed such clauses as to their enforceability between the contracting parties with varying results. Some uphold such clauses, other reject them, still others have enacted laws addressing such clauses. In addition, numerous jurisdictions have considered whether "pay-when-paid" and/or "pay-if-paid" clauses provide a valid defense to a surety in response to a payment bond claim. In some jurisdictions, the courts have reached

conflicting results. So, for example, states like Virginia uphold the enforceability of such contingent payment clauses as between a general contractor and a subcontractor, but proclaim that a surety cannot rely on a contingent payment clause as a defense to a payment bond claim. In other jurisdictions, the results are consistent with courts holding contingent payment clauses enforceable for the surety and its principal or conversely denying such clauses for both. Given the varying and seemingly anomalous treatment of such clauses, I thought it would be a good topic for discussion today.

II. CONTINGENT PAYMENT CLAUSES DEFINED

Let's start by defining what "pay-when-paid" and "pay-if-paid" clauses are and how they are different and why they are treated differently. First, it bears remembering that many courts over the years have mistakenly referred to these two types of contingent payment clauses interchangeably or have otherwise confused them, which has created a great deal of difficulty in interpreting various decisions. Accordingly, when you are looking at case law on this issue you really have to go into the decision and find the clause that is being discussed and review it to determine if the decision is really talking about a "pay-when-paid" or a "pay-if-paid" clause. Often times the decision will appear to stand for one proposition, but when you look at the clause the court was dealing with you realize the case doesn't really stand for what it appears. There are some good decisions where the court will undertake this kind of an exercise and look behind the first appearance of a case cited by the parties and will note the misapplication.

A. Pay-When Paid Clause.

A pay-when-paid clause governs the timing of a contractor's payment obligation to the subcontractor, usually by indicating that the subcontractor will be paid within some fixed time period after the contractor itself is paid by the owner. A typical clause of this type might read:

"Contractor shall pay subcontractor within seven days of contractor's receipt of payment from the owner." *See* Robert F. Carney & Adam Cizek, Payment Provisions in Construction Contracts and Construction Trust Fund Statutes, 24 CONSTRUCTION LAW, Fall 2004, at 5. Thus, generally, if a contingent payment provision simply requires the contractor to pay the subcontractor "upon receipt of payment from the owner" (or similar language), the clause will be considered to be a "pay-when-paid" clause that merely acts as a timing mechanism. The clause does not expressly excuse a contractor's ultimate liability if it does not receive payment by the owner, so the clause does not transfer the risk of insolvency from contractor to subcontractor and on down the chain. With such a clause, if the owner, for example, were to fail to pay, the general contractor would still be obligated to pay the subcontractor. As noted by one court, "pay-when-paid" provisions have been construed by the courts on numerous occasions to simply provide the contractor with a reasonable time within which to obtain payment from the owner and to make payment to the subcontractor.

Without express language clearly indicating an intent to shift the risk of non-payment from the owner to the subcontractor, courts will not typically construe "pay-when-paid" clauses as excusing the payment obligation of the general contractor. As one court stated, "[t]hese clauses are most often construed as simply affecting the timing of payments that the general contractor is required to make to the subcontractor, regardless of whether the owner performs or not." *Koch v. Constr. Tech., Inc.*, 924 S.W.2d 68, 71 (Tenn. 1996).

When dealing with a pay-when-paid clause, the question invariably becomes what is a "reasonable" time in which to make payment. The measure of a reasonable time for a contractor to withhold payment to its subcontractor while it is seeking payment from the owner will vary from case to case. For example, the court in *John F. Sanchez Plumbing Co. v. Aetna Cas. & Sur.*

Co., 564 So. 2d 1302 (La. Ct. App. 1990) held that a 22 month delay was too long. In *Sloan & Co. v. Liberty Mut'l Ins. Co.*, 2008 WL 3832519 (E.D. Pa. Aug. 15, 2008), pay-when-paid clause did not bar the subcontractor from filing suit before the limitations period expired, but the suit was stayed pending the result of a suit between the contractor and the owner. In *Havens Steel Co. v. Randolph Eng'g Co.*, 613 F. Supp. 514 (W.D. Mo. 1985), *aff'd*, 813F.2d 186 (8th Cir. 1987), the court felt that the contractor reasonably could only make its subcontractor wait three (3) months. The question of reasonableness will be determined on a case by case basis, so there is no hard and fast rule.

Because pay-when-paid clauses do not entirely preclude payment from the general contractor to the subcontractor, such clauses are generally held to be enforceable as between the general contractor and the subcontractor.

B. Pay-If-Paid Clause.

In contrast, a pay-if-paid clause, as the name suggests, provides that a subcontractor will be paid only if the contractor is paid. The intent of this type of clause is that if the owner does not pay the general contractor, the general contractor is not required to pay the subcontractor. A typical clause of this type might say: "Contractor's receipt of payment from the owner is a condition precedent to contractor's obligation to make payment to the subcontractor; the subcontractor expressly assumes the risk of the owner's nonpayment and the subcontract price includes the risk."

Thus, the key distinction between "pay-when-paid" and "pay-if-paid" provisions is the use of unequivocal language showing that payment from the owner is a "condition precedent" to the contractor's obligation to pay the claimant and that the risk of the owner's non-payment has been shifted down from the general contractor to the subcontractor.

A "condition precedent" is a legal term of art meaning: "[a]n act or event, other than a lapse of time, that must exist or occur before a duty to perform something promised arises." Black's Law Dictionary 334 (9th ed. 2009). The Maryland Court of Appeals similarly defines a condition precedent as: "a fact, other than mere lapse of time, which, unless excused, must exist or occur before a duty of immediate performance of a promise arises." *Chirichella v. Erwin,* 270 Md. 178, 182, 310 A.2d 555 (1973). The question whether a stipulation in a contract constitutes a condition precedent is one of interpretation dependent on the intent of the parties to be gathered from the words they have employed and, in case of ambiguity, after resort to the other permissible aids to interpretation. Although no particular form of words is necessary in order to create an express condition precedent, such words and phrases as "if," "provided that," "when," "after," "as soon as," or "subject to," have been held to commonly indicate that performance has expressly been made conditional. To determine whether the subcontract language is properly construed as a pay-if-paid clause the condition precedent language must clearly and unambiguously on its face demonstrate the parties' intent to shift the risk of non-payment to the subcontractor so that it would be clear to the subcontractor that it would not be paid unless the contractor was paid.

This express clarity is required because "conditions precedent are generally not favored, and courts will not construe stipulations to be a condition precedent when such a construction would result in forfeiture." Thus, the general rule is that if there is any ambiguity, a contingent payment clause will be construed as a timing provision rather than a condition precedent to payment. For example, the Virginia courts will not enforce contingent payment clauses if there is an ambiguity in the contract, which "exists when language is of doubtful import, admits of being understood in more than one way, admits of two or more meanings, or refers to two or

more things at the same time." *Universal Concrete Products v. Turner Const. Co.*, 595 F.3d 527, 529-530 (4th Cir. 2010).

So, what are some actual examples of a valid pay-if-paid clause. In Louisiana a court held that the following language constitutes a valid "pay-if-paid" provision:

> Subcontractor shall not be entitled to receive any progress payment or final payment prior to [Contractor's] actual receipt of that payment from Owner. Subcontractor agrees that [Contractor's] actual receipt of full payment from Owner shall be a condition precedent to the bringing of any action by Subcontractor hereof against [Contractor] or its surety, if any, relating to Contractor's failure to make payment.

Imagine Const., Inc. v. Centex Landis Const. Co., 707 So. 2d 500, 502 (La. App. 1998).

Similarly, a Maryland court found the following language to sufficiently create a pay-if-paid clause: "It is specifically understood and agreed that the payment to the trade contractor is dependent, as a condition precedent, upon the construction manager receiving contract payments, including retainer from the owner." *Gilbane Bldg. Co. v. Brisk Waterproofing Co.*, 585 A.2d 248, 250 (Md. App. 1991).

Some courts have taken the position that to create a pay-if-paid clause the provision must expressly use specific language or terms to state that the risk of non-payment is being shifted and that the subcontractor will not be paid unless the owner pays the general contractor. The decision of the Sixth Circuit in *Thos. J. Dyer Co. v. Bishop Int'l Eng'g Co.*, 303 F.2d 655, 661 (6th Cir.1962) has been cited for this proposition. The majority of courts do not follow this approach and will treat normal condition precedent language as sufficient to create a pay-if-paid provision. *See BMD Contractors, Inc. v. Fid. & Deposit Co. of Maryland*, 679 F.3d 643, 649–51 (7th Cir. 2012), *as amended* (July 13, 2012).

III. CAN THE SURETY RELY ON A CONTINGENT PAYMENT CLAUSE AS A DEFENSE TO A PAYMENT BOND CLAIM?

Case law is clear that a surety is entitled to assert the defenses of its principal and that a surety's liability can be extended no further than the principal's. Courts have long held that a surety "stands in the shoes of the principal contractor," and therefore has the right generally to assert any defense which its principal might assert if sued. Moreover, the natural limit of the obligation of the surety is to be found in the obligation of the principal. The underpinning of this maxim is that a surety's liability is derivative of the principal's obligation. "[A] surety's obligation is derived from its principal and the liability of the surety is measured by the liability of the principal." *Waukesha Concrete Products Co. v. Capitol Indem. Corp.*, 379 N.W.2d 333, 336 (Wis. App. 1985). Thus, under traditional suretyship jurisprudence a surety should be entitled to rely on a contingent payment provision like a pay-if-paid or pay-when-paid clause to the same extent as its principal.

Most courts will allow reliance on a "pay-when-paid" provision by a surety and hold that payment of a payment bond claim must be made in a reasonable time. *See Allen Elec. Co. v. Fidelity & Deposit Co. of Md.*, No. 15, 1989 W.L. 54791, at *3-7 (Tenn. Ct. App. May 24, 1989); *St. Paul Fire & Marine Ins. Co. v. Georgia Interstate Elec. Co.*, 370 S. F. 2d 829 (Ga. Ct. App. 1988); *Pacific Lining Co. v. Algernon-Blair Constr. Co.*, 812 F. 2d 237, 241 (5th Cir. 1987). However, the jurisdictions are split on whether a surety may be allowed to assert a "pay-if-paid" provision as a defense to a payment bond claim.

A. Jurisdictions That Allow Surety's to Assert the Defense

Numerous courts have held that a surety may assert the pay-if-paid clause in the principal's contract with the subcontractor as a defense to a payment bond claim if the conditions give rise to the defense. In so doing, some courts reason that the bond or statute generally

requires the claimant to show that there has been a default and that a sum is "justly due" for labor and materials before the surety is obligated to pay. It therefore follows that no sum is justly due and there is no default if the contractor has a valid paid when-paid defense to the subcontractor's demand for payment.

Other courts, in upholding a pay-if-paid clause in favor of a surety, have reasoned that the surety's liability can be no greater than that of its principal. In other words, if the principal is not liable, neither should the surety. *See, e.g., Travelers Cas. & Surety Co. of Am. v. Sweet's Contracting, Inc.*, 450 S.W. 3d 229 (Ark. 2014); *Wellington Power Corp. v. CNA Sur. Corp.*, 614 S. E. 2d 680 (W. Va. 2005).

In *BMD Contractors, Inc. v. Fid. & Deposit Co. of Maryland*, 679 F.3d 643, 649–51 (7th Cir. 2012), *as amended* (July 13, 2012), the Seventh Circuit in holding that the surety was entitled to assert a pay-if-paid defense noted that "(1) sureties are generally liable only where the principal itself is liable; and (2) concurrently executed bonds and the contracts they secure are construed together." Of chief importance to the court was the proposition that the surety is only liable if the principal is liable. The court further noted that the purpose of a payment bond is to insure subcontractors against nonpayment when payment is in fact due under the relevant contract.

Similarly, a federal court in New Jersey pointed to the "unique" nature of suretyship, noting that "a surety's liability is triggered only when the principal's debt matures." *Fixture Specialists, Inc. v. Global Constr., LLC*, 2009 WL 904031 (D.N.J. March 30, 2009). The Court further noted that freedom to contract permits a shifting of the risk of nonpayment to subcontractors when clearly bargained for. The decisions permitting a surety to assert a pay-if-

paid defense are rooted in observance of the nature of suretyship and a strict enforcement of the bonded contract terms.

B. Jurisdictions That Do Not Allow a Surety to Assert the Defense

In stark contrast to the decisions referenced above, many states, by either statute or case law, have prohibited sureties from relying upon "pay-if-paid" provisions.

(1) Public Policy – Fairness/Equity

Some courts analyze the issue of enforceability of pay-if-paid clauses on public policy grounds relying on concepts of fairness and equity. These courts reason that the general contractor has a direct contractual relationship with the owner and has more control over ensuring that payment is received for services performed. The general contractor also controls the entire project and is in the best position to resolve any disputes that might relate to the owner's refusal to pay. Further, generally speaking, a general contractor is better able to bear the risks of nonpayment than a subcontractor. This is so because subcontractors are typically smaller with less capital than general contractors. As a consequence, subcontractors are not well equipped to incur the credit risk of an insolvent or unwilling owner. *See* 3 Bruner & O'Connor Construction Law § 8:49.

(2) Public Policy – Violation of Statutory Purpose

Various courts have disallowed a surety from invoking "pay-if-paid" provisions because failing to do so, the courts believe, would defeat the alleged purpose of some governing statute. A Louisiana court stated:

> The application of traditional suretyship law principles in this scenario is contrary to the [Public Work Act's] avowed purpose of providing a source of security to those performing work and furnishing materials on public projects. Because the contractual provision on which [the surety] relies is contrary to the purpose of the Public Works Act, we hold that [the surety] may not assert the "pay if paid"

> provisions of the [principal's] subcontracts to defeat its liability to pay subcontractors pursuant to the terms of the statutory bond.

Many other decisions cite a conflict between pay-if-paid clauses and their jurisdiction's prohibition on lien waivers unless actual payment had been made. In *Wm. R. Clarke Corp. v. Safeco Ins. Co.*, 938 P.2d 372 (Calif. 1997), the subcontracts contained a clear pay-if-paid provision which stated that regardless of the reason for the owner's nonpayment, whether attributable to the fault of the owner, contractor or subcontractor, the owner's payment was a condition precedent to the contractor's obligation to pay the subcontractor. Safeco issued a payment bond for the project. The owner became insolvent and failed to pay the general contractor, and the general contractor refused to its subcontractors relying on the pay-if-paid clause. The subcontractors filed mechanics' liens against the property and filed claims against Safeco's payment bond. Safeco defended on the grounds that, as a surety, its obligation under the payment bond never matured because its principal, the general contractor, never became obligated to pay Clarke by operation of the pay-if-paid provision. The California Supreme Court rejected the surety's argument and the "freedom to contract" policy on which it was grounded because the Court believed that to enforce the clause would undermine the strong state policy of preserving the mechanics' lien rights of those who supply labor and materials for the improvement of property. The Court stated:

> We may agree with Safeco that a pay if paid provision is not precisely a waiver of mechanic's lien rights and yet conclude that a pay if paid provision is void because it violates the public policy that underlies the anti-waiver provisions of the mechanic's lien laws. The Legislature's carefully articulated anti-waiver scheme would amount to little if parties to construction contracts could circumvent it by means of pay if paid provisions having effects indistinguishable from waivers prohibited under [California law].

See 3 Bruner & O'Connor Construction Law § 8:49

(3) Contractual Arguments

In addition to the public policy arguments, some courts prohibit a surety from asserting a "pay-if-paid" provision on alleged contractual grounds. For example, the Supreme Court of Alabama noted that, while the underlying contract contained a contingent payment clause, the payment bond and the subcontract are separate contracts, and neither references nor incorporates the terms of the other. More specifically, the payment bond does not condition payment to the claimant on the owner's making a final payment to the principal." A court in Massachusetts refused to allow a surety to assert the defense, stating that the payment bond itself did not reference or incorporate any conditional payment language. Similarly, the Fourth Circuit Court of Appeals (interpreting Virginia law) stated that a surety could utilize a "pay-if-paid" defense only if such condition precedent was expressly stated in the bond.

At least one court has taken the dangerous position that the surety's obligation under the payment bond to a claimant is an independent promise, such that the surety can be liable even if the principal is not liable. Thus, under the terms of the payment bond when the surety is unqualifiedly obligated to pay when the principal fails to pay, the surety was held to be liable even if the principal was not obligated to pay. *Moore Bros.*, *supra*. Of course, this approach completely ignores established surety law and the well-recognized purpose of a payment bond.

(4) State Statutes

Several states have enacted statutes providing that contingent payment clauses are void or unenforceable. These statutes sometimes prohibit such clauses entirely and sometimes only prevent "pay-if-paid" provisions from abrogating the right to a bond claim. A Massachusetts statute provides that a "pay-if-paid" clause is not enforceable by the surety on private construction projects, except when the claimant's defective performance caused or contributed to

the non-payment by the owner. Some state statutes state that a contingent payment clause is ineffective as a waiver of lien and bond rights. *See* Md. Code Ann. § 9-113(b) (1963); Ga. Code Ann. § 44-14-361.1(4) (Supp. 1997); 770 Ill. Comp. Stat. 60/21 (West. 1996); Utah Code Ann. § 13-8-4 (Supp. 1997). Under Florida law a contingent payment provision may be enforceable by a surety if the bond is listed in the notice of commencement for the project as a conditional payment bond and is recorded together with the notice of commencement for the project prior to commencement of the project, the words "conditional payment bond" are contained in the title of the bond at the top of the front page and the bond contains on the front page, in at least 10-point type, the statement:

> THIS BOND ONLY COVERS CLAIMS OF SUBCONTRACTORS, SUB-SUBCONTRACTORS, SUPPLIERS, AND LABORERS TO THE EXTENT THE CONTRACTOR HAS BEEN PAID FOR THE LABOR, SERVICES, OR MATERIALS PROVIDED BY SUCH PERSONS. THIS BOND DOES NOT PRECLUDE YOU FROM SERVING A NOTICE TO OWNER OR FILING A CLAIM OF LIEN ON THIS PROJECT.

Fla. Stat. Ann. § 713.245 (West)

IV. THE MILLER ACT

As a general rule, federal courts have rejected the surety's attempt to enforce a contingent payment clause against a subcontractor on grounds that the clause is effectively an implied waiver of the subcontractor's Miller Act rights. *See United States ex rel. Walton Tech., Inc. v. Weststar Eng'g., Inc.*, 290 F.3d 1199 (9th Cir. 2002); *United States ex rel. Tusco, Inc. v. Clark Constr. Group, LLC*, 2016 WL 4269078, at *9 (D. Md. Aug. 15, 2016). Implied waivers are unenforceable under the Miller Act. *See United States ex rel. W.W. Gay Mech. Contractor, Inc. v. Walbridge Aldinger Co.*, 2012 WL 12895044 (M.D. Fla. Aug. 23, 2012). The Miller Act, specifically provides that a subcontractor's waiver of its right to sue on a payment bond is void unless it is in writing, signed, and executed after the subcontractor has already furnished the

labor or materials under the contract. 40 U.S.C. § 3133(c). Thus, a contract provision that would deny the subcontractor its federal remedy under the Miller Act cannot be used as a defense. *United States ex rel. McKenney's, Inc. v. Government Tech. Servs., LLC*, 531 F. Supp.2d 1375 (N.D. Ga. 2008). The Court in U.S. v. Zurich Am. Ins. Co., 99 F.Supp. 3d 543 (E.D. Pa. 2015) noted that on federal contracts the principal's and the surety's liability are only coextensive to the extent permitted by the terms of the Miller Act. The Court further observed that the Miller Act gives a subcontractor the right to sue a payment bond surety based on the passage of time, not on the payment from the federal government to the prime contractor.

V. FACTUAL UNENFORCEABILITY

Even if the contingent payment clause is enforceable in a particular jurisdiction as a general matter, there still may be factual defenses to its application. Courts have recognized that the "credit risk" that an owner will be unable to pay is different from the risk of nonpayment arising because of defenses to payment that the owner may possess. Such defenses of the owner may include untimely performance or poor workmanship. The general contractor is responsible for coordinating the work of its subcontractors and the overall performance of the project. Accordingly, many states recognize that if the general contractor or another contractor for whom the general contractor is responsible is the reason that the owner is refusing to pay, and the claiming subcontractor is without fault, the contingent payment clause may not be enforceable. In one case the Court applied the prevention doctrine to deny application of the pay-if-paid clause. *Moore Bros. Co. v. Brown & Root, Inc.*, 207 F.3d 717 (4th Cir. 2000). In that case the Court found that Brown & Root, the general contractor, through its own actions contributed to the non-occurrence of the condition precedent i.e.: non-payment by the owner. Under the prevention doctrine if a promisor hinders or prevents fulfillment of a condition to his

performance, the condition may be waived or excused. Because the general contractor caused the owner's failure to pay, neither it nor its surety could rely on the pay-if-paid clause as a defense to payment of the subcontractor.

VI. CONCLUSION

The question of whether a surety may rely on a contingent payment clause like a "pay-when-paid" or a "pay-if-paid" clause varies from jurisdiction to jurisdiction and depends on the applicable language of the clause, terms of the bond, applicable case law and applicable statutes.

Recommended Resources (the author gratefully acknowledges and gives credit to the following):

1. *BMD Contractors, Inc. v. Fidelity and Deposit Company of Maryland*, 679 F.3d 643 (7th Cir. 2012).
2. 28th Annual Southern Surety and Fidelity Claims Conference, *Payment Bond Defenses: Pay-When-Paid and other Conditional Payment Terms in Contracts*, T. Selden, A. Whillock, S. Hipsak Goetz (2017) https://www.forcon.com/conferences/southern-conference/.
3. 27th Annual Northeast Surety and Fidelity Claims Conference, *The Continued Viability of the "Pay-If-Paid" Defense for the Surety*, T. Asikainen, O. Harb (2016). https://www.forcon.com/conferences/northeast-conference/
4. 3 Bruner & O'Connor Construction Law § 8:48-8:50