



## Pay-if-Paid Clauses: A Surety's Defense for Payment Bond Claims?

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A construction project can be a breeding ground for general contractor versus subcontractor payment disputes. Whether it is payment for extra work subject to the project owner's approval, slow pay or no pay by the project owner, and the general contractor has provided a payment bond, the payment bond surety is often the target of a subcontractor's lawsuit for payment. When the general contractor's subcontract includes a pay-if-paid clause, however, and the project owner has not paid the general contractor the monies the subcontractor claims to be due, may the payment bond surety rely on that conditional payment clause as a defense to the subcontractor's lawsuit?

The answer is probably yes, but depending on the jurisdiction it is not always yes.

### The Surety and Its Principal

A basic principle of suretyship law holds the traditional payment bond surety to be a secondary obligor with the defenses available to its principal (often the project's prime contractor) likewise available to the surety. This principle is often generalized by characterizing the surety as standing in the shoes of its principal for its rights and obligations under the payment bond. (Of course, there may also be defenses unique to the payment bond surety arising from the specific terms of the payment bond, such as timely notice of a claim.)

This Construction Alert focuses on the subcontract that includes a pay-if-paid clause and whether the payment bond surety can rely on that subcontract clause as a defense to a subcontractor's lawsuit for payment under the payment bond.

### The Pay-if-Paid Defense for the Surety

In an often cited case from the U.S. Court of Appeals for the Fourth Circuit, Moore Brothers Company v. Brown & Root, Incorporated, 207 F. 3d 717 (4<sup>th</sup> Cr. 2000), subcontractors on a private toll road construction project in Northern Virginia sued the general contractor and its payment bond surety for payment after performing additional change in scope work. The project owner did not have funds to pay the general contractor for the added work; consequently, the general contractor did not pay its

subcontractors for the added work, citing to its subcontracts? pay-if-paid clauses. In defense of the subcontractors? lawsuit for payment, the general contractor?s payment bond surety likewise cited to the subcontracts? pay-if-paid clauses contending the general contractor had no obligation to pay until the project owner paid the general contractor, therefore the surety, standing in the shoes of its principal, was under no obligation to pay the subcontractors under the payment bond.

The federal circuit court, finding there to be no Virginia law on the validity of the surety?s defense, ruled the payment bond surety could not rely on the subcontracts? pay-if-paid clauses as a defense to the subcontractors? payment bond claims. Even though the payment bond incorporated the subcontracts containing the pay-if-paid clauses, the federal court found two bases to hold the surety liable: 1.) there was no indication in the payment bond language that the surety?s obligation to pay ?sums justly due? incorporated the contingency of payment first by the project owner to the general contractor, and 2.) three other jurisdictions had rejected a payment bond surety invoking a conditional payment clause defense otherwise available to the surety?s principal. The federal court held ?[a]s a surety who did not include an express ?pay when paid? condition precedent in the contract payment bond, [surety] may not assert the ?pay when paid? clause contained in the subcontract between the claimants and the principal as a defense to its liability to pay on the bond.? 207 F.3d at 723-24.

Other federal and state courts considering the same issue have not followed the Fourth Circuit Court?s ruling in Moore Bros. For example, in Wellington Power Corporation v. CNA Surety Corporation, 217 W.Va. 33, 614 S.E. 2d. 680 (2005), West Virginia?s Supreme Court of Appeals held that a pay-if-paid subcontract clause did not violate West Virginia?s public bond statute for public construction projects, and a pay-if-paid clause that prevents a subcontractor from proceeding against the general contractor in the absence of the project owner?s payment also prevents the subcontractor from proceeding against the general contractor?s payment bond surety. See also, Travelers Casualty & Surety Company of America v. Sweet?s Contracting, Inc. 2014 Ark. 484, 450 S.W. 3d. 229 (2014) (Principal?s subcontract incorporated into bond included a pay-if-paid clause, and in suretyship the principal?s contract and the bond are to be constructed together as one instrument; thus the surety may invoke all defenses available to the principal.).

In BMD Contractors, Inc. v Fidelity and Deposit Company of Maryland, 679 F. 3d. 643 (7<sup>th</sup> Cir. 2012), the federal appellate court, citing Indiana law, ruled a surety must only answer for the debts of the principal and cannot be liable where the principal is not. The federal court specifically addressed the Fourth Circuit?s ruling in Moore Bros. and rejected the reasoning, noting Moore Bros. mistakenly assumes that the purpose of a payment bond is to insure subcontractors against nonpayment under any circumstances, rather than when payment is in fact due under the contract.

Similarly, in Great Lakes Travel Hotel Supply Company v. Travelers Casualty and Surety Company of Americas, 2013 WL 12122069 (E.D.MI. 2013), the federal district court, relying on Michigan law and general suretyship principles, held that a surety can assert any defense that its principal can assert; including a subcontract pay-if-paid clause in defense of a subcontractor?s payment bond claim. In so ruling, the federal court did note that Miller Act cases can be the exception and cited to several cases holding sureties cannot assert pay-when or pay-if subcontract clauses in defense of subcontractors? Miller Act payment bond claims. See also, United States for Use and Benefit of Walton Technology, Inc. v Weststar Engineering, Inc

, 290 F.3d 1199 (9<sup>th</sup> Cir. 2002) (?When and if paid? terms did not amount to a clear and explicit waiver of subcontractor?s Miller Act rights, and payment bond surety could not rely on the contingent payment terms as a defense.).

More recently, a Virginia state trial court has considered the issue whether a payment bond surety can rely on the pay-if-paid clause in its principal?s subcontract to defend against a subcontractor?s payment bond claim. The Virginia trial court answered ?yes? to the issue, and, in so ruling, wrote, ?In sum, the Court does not find any provision of Virginia statutory or case law which reveals a public policy that condemns or restricts a surety?s reliance on a pay-if-paid clause negotiated by its principal.?

IES Commercial Inc. v The Hanover Insurance Company (Roanoke City Case No. CL 16-108, May 3, 2016) The trial court found ?no compelling reason? to single out the pay-if-paid defense from other defenses available to the surety by adding a requirement that it be expressly stated in the subcontract and the payment bond as Moore Bros. commanded.

### **Conclusion**

Those courts allowing the surety to plead the pay-if-paid clause as a defense, assuming there is no waiver or other legal excuse against the defense, rely upon the traditional suretyship principle that in general, a surety may plead any defense available to its principal, and the liability of the surety is co-extensive with the liability of the principal on the bond and can be extended no further. To single out the pay-if-paid defense, as a defense that must be spelled out in the bond in order to preserve it, as in Moore Bros., while not requiring the same of all other surety defenses defies logic and the traditional principles of suretyship.

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