MANAGING CONSTRUCTION RISKS

Surety protection and conditional payment clauses

Brad C. Parrott

As subcontractors, you often rely on the existence of a payment bond in assessing the relative risks in taking on a project. Most governments require the general contractor to issue payment and performance bonds. In many instances, large private owners now require payment bonds on private projects. Generally, a surety's liability to a subcontractor, supplier, or laborer under the payment bond is co-extensive with the liability of the principal (in other words, the general contractor). Thus, as long as a claimant complies with notice requirements of the bond and any applicable statute, the surety's liability is generally the same as the general contractor's under either a private bond or a public-works bond.

However, a question arises when the claimant is a first-tier subcontractor (a subcontractor with a contract directly with a general contractor): Can the surety company refuse to make payment until its principal has been paid by the owner? In other words, does a conditional payment clause give the surety a basis to deny payment of an otherwise valid claim?

Most subcontract forms contain a conditional payment clause—often called a pay-if-paid clause—that provides that a subcontractor's right to receive any payment is conditioned upon the general contractor's receipt of such funds from the owner.

In the face of a claim by a first-tier subcontractor, it is common for a surety to deny paying a claim because the money is not "due." The surety argues that it is only obligated to pay monies that are due to the subcontractor, and monies are not due until the general contractor receives payment from the owner.

Whether a payment bond surety can raise a conditional payment clause as a defense to a claim depends on the circumstances and jurisdiction. Conditional payment clauses are enforceable in most states, so be sure to be familiar with the laws of the state in which you operate.

This article addresses three situations:

- public works payment bonds
- Miller Act bonds on federal projects
- private payment bonds

Public works payment bonds

Most, if not all, state and local governmental entities require a contractor to provide a payment bond to protect subcontractors (at least first-tier subcontractors and second-tier subcontractors, which are subcontractors or suppliers with contracts directly with first-tier subcontractors) supplying labor, materials, machinery, and equipment in the execution of the work provided in the public works contract.

These state statutes are often referred to as "little Miller Act" statutes. Be aware, though, that many little Miller Acts vary dramatically both in procedural requirements and application from the Miller Act.

As many readers know, a general contractor as principal is jointly liable with its surety to claimants under the bond and is also liable to its surety pursuant to its general indemnity agreement (GIA). Thus, a subcontractor can pursue a claim against a surety or jointly against a general contractor and its surety. Accordingly, it should be of keen interest to all claimants if the surety's liability differs from that of the principal, the general contractor.

To flesh out this point, consider the case law of the State of Virginia. In the 2000 case of *Moore Bros. Co. v. Brown & Root Inc. et al.*, the general contractor, Brown & Root, entered into subcontracts related to a Virginia road project. Brown & Root issued a payment bond as required by the Virginia Public Procurement Act. A subcontractor filed suit against Brown & Root and its surety seeking payment.

One of the defenses raised by Brown & Root and its surety was the pay-if-paid clause. If properly drafted, conditional payment clauses are enforceable in Virginia. The subcontractor argued that while Brown & Root may avail itself of the conditional payment clause, the surety could not raise such clause because the bond did not expressly incorporate the pay-if-paid condition precedent of the subcontract into the terms of the payment bond.

The court agreed, holding that "to suggest nonpayment by the owner absolves the surety of its obligation

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is nonsensical, for it defeats the very purpose of the payment bond. A surety who did not include an express pay-when-paid condition precedent in the contract payment bond may not assert the pay-when-paid clause contained in the subcontract."

The result is that the general contractor had a valid contract defense that the surety could not raise. Thus, the surety had liability where the general contractor did not. The bottom line is that the subcontractor was able to completely circumvent the conditional payment clause because such clause was not available to the surety in defense of a payment bond claim.

Other courts have reached the same result. A number of courts agree with the Brown & Root decision, including the following cases:

- In 2003, the court held in *Everett Painting Co. v. Padula & Wadsworth Construction* that where a bond is issued pursuant to the Florida public-works statute, the surety does not have the ability to create a conditional payment obligation because its liability is defined by the public-works act itself. The court further stated that the purpose of a public-works bond is to give subcontractors an alternative remedy to a mechanic's lien, which is not available on public projects.
- Although not part of the holding in *National Union Fire Ins. Co. of Pittsburgh v. Wadsworth Golf Construction Co.* in 2003, a Maryland court expressly approved the reasoning of the Brown & Root case that "to suggest nonpayment by the owner absolves the surety of its obligation is nonsensical, for it defeats the very purpose of the payment bond."
- In *Hartford Accident & Indemnity Co. v. Cochran Plastering Co. Inc.* in 2006, an Alabama court held that the surety "has neither cited, nor have we discovered, any authority for the proposition that the inability to proceed against the general contractor because of a pay-if-paid clause in the subcontract necessarily prevents recovery against [the Surety] under the payment bond. Indeed, such an argument runs counter to the underlying purpose of the payment bond, that is, the assurance of payment to subcontractors."

Unless you operate in one of the states where conditional payment clauses are illegal, conditional payment clauses will affect your business. Few subcontractors are able to persuade a contractor to eliminate conditional payment clauses. Thus, you should be aware of your state's law regarding a surety's right to raise a conditional payment clause in defense to a claim.

For state and local government projects, if your state follows the logic of the federal courts, you can recover against a surety even where the conditional payment clause prevents recovery against the general contractor.

Another item to consider is that in some instances, public payment bonds only cover a limited number of tiers. If you are considering a job where you will be a third-tier or lower subcontractor, be certain to check the applicable bond and related law to determine whether you will be a covered claimant under the Little Miller Act bond.

Miller Act bond on federal projects

The Miller Act requires that all construction on federal property be accompanied by appropriate payment and performance bonds securing both performance and payment of subcontractors and suppliers. In the federal contracting arena, the courts have been clear that the surety's liability depends entirely on whether a claim falls within the language of the Miller Act, interpreted in light of its protective purposes. See the 1991 case of *U.S. Xrail T.M.S. Mechanical Contractors v. Miller Mutual Fire Insurance Co. of Texas*.

In *T.M.S. Mechanical*, the court held that a pay-when-paid clause does not preclude a subcontractor's recovery under the Miller Act payment bond. This is because the federal legislation conditions payment to the subcontractor not upon payment by the government to the contractor but rather on the passage of time from completion of the work or provision of materials.

For similar cases, see *Walton Technology Inc. v. Westar Engineering* in 2001 (following the T.M.S. precedent in Miller Act claim in California), *M&T Elec. Contractors Inc. v. Capital Lighting & Supply Inc.* in 2001, *Brown & Kerr Inc. v. St. Paul Fire & Marine Ins. Co.* in 1995, and *DDC Interiors Inc. v. Dawson Constr. Co. Inc.* in 1995.

Many state public works acts, such as the little Miller Acts, also condition the right of a subcontractor to bring an action only upon the passage of 90 days (or some other amount of time) and not having been paid in full for labor and materials furnished. Most, if not all, little Miller Acts make no reference to any payment being made by a third party or owner.

Further, most state courts find federal case law interpreting the Miller Act persuasive when they are faced with similar little Miller Act issues. Accordingly, the logic of Miller Act cases may prove useful if your state does not have any precedent on a public project payment bond surety's right to raise a conditional payment clause as a defense.

Private payment bonds

In most states, private payment bonds are simply contracts. This means that the subcontractor's rights and remedies under a private project payment bond are only those expressly stated within the bond itself.

Accordingly, if a payment bond states that it will make payments of amounts due to all subcontractors, then the conditional payment clause may be available as a defense to the surety. The 1997 American Institute of Architects' (AIA) Form Payment Bond provides that the surety will make payment of sums due.

However, if the payment bond does not in any way incorporate the terms of a subcontract containing a conditional payment clause nor is any sort of conditional payment language contained within the bond itself, then a subcontractor has a good argument that recovery on the bond is not conditioned upon or in any way related to payment by the owner. In short, where the bond does not, in some manner, incorporate the conditional payment clause, the surety should not be able to raise it in defense to a claim.

Remember, under the GIA between the surety and the general contractor, a solvent general contractor will actually be the party paying a successful surety bond claim. Thus, it is in the general contractor's interest to have the conditional payment clause available to the surety in defense of a payment bond claim. To protect this interest, some general contractors are now taking the clever approach of making the surety an intended third-party beneficiary of the conditional payment clause (incorporation in the subcontract rather than in the bond).

First, parties to a contract can agree that one or more of the terms or obligations are intended to benefit a third party (in other words, the intended third-party beneficiary). Where an intended third-party beneficiary is created, that third party has the right to enforce the contract relative to the benefit or benefits it is to receive.

Set in context, if a surety is made an intended beneficiary of the conditional payment clause, the surety then has the right to the benefit of such clause. By essentially incorporating the surety into the subcontract, the general contractor has sidestepped one of the principal holdings of the Brown & Root court—that the surety could not avail itself of the protections of a conditional payment clause because the bond does not incorporate the conditional payment clause (incorporation in the subcontract rather than in the bond).

On private jobs where no statute governs the payment bond, this third-party beneficiary approach may well protect the surety. I am unaware of any case law interpreting a subcontract making a surety an intended third-party beneficiary.

Courts have long held, however, that third-party beneficiaries are entitled to enforce the rights bestowed upon them. Accordingly, when you are negotiating subcontracts, it is important that you reject language making the surety an intended third-party beneficiary of the subcontract.

So what does all of this mean for a precaster?

- First, know the law on this subject in the jurisdictions in which you operate.
- Be certain to meet all procedural requirements necessary to preserve bond claims.
- If the surety cannot raise a pay-when-paid clause as a defense to a claim, then your risk in accepting such a clause decreases significantly.
- A direct right of payment against a surety may give a precaster the strength to compel payment from the general contractor without litigation or arbitration.

About the author

Brad C. Parrott, Esq., is a partner in the construction law firm of Shapiro Fussell Wedge & Martin LLP, based in Atlanta, Ga. He represents precast concrete producers throughout the United States and is a frequent lecturer at PCI-sponsored events.

Synopsis

Most subcontract forms contain a conditional payment clause—often called a pay-if-paid clause—that provides that a subcontractor's right to receive any payment is conditioned upon the general contractor's receipt of such funds from the owner. Concerns arise about whether the surety company can refuse to make payment until its principal has been paid by the owner. This article addresses public works payment bonds, Miller Act bonds on federal projects, and private payment bonds.

Keywords

Contracts, legal issues, payment bonds, subcontracting.

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