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Sure I Can or Sure I Can't?

By Michael Jay Rune II and Dana Chaaban – August 26, 2015

Under the law of contract formation, most aspects of transactions, services and/or liabilities may be negotiated and contracted for based upon the parties' "freedom to contract." In the field of construction law, such "freedom to contract" includes a recent trend where general contractors have begun to negotiate a shift in the distribution of risk away from the general contractor and to the subcontractor with the inclusion of contractual clauses that make the general contractor's receipt of payment from the owner a condition precedent to the general contractor's ultimate payment to the subcontractors. Such a shift is important because ordinarily a general contractor bears the risk of an owner's potential insolvency, and these clauses—informally termed "pay-if-paid" clauses—may be enforceable even though a subcontractor has fully performed its obligations under the subcontract. Contracts with such provisions typically consist of some variation of the following contractual language:

Subcontractor agrees that Contractor shall be under no obligation to pay Subcontractor for any work performed or materials or equipment furnished for this Project unless and until Contractor has been paid therefore by Owner, and the making of any and all progress and final payments and the amount thereof are expressly subject to this condition precedent. Subcontractor states that it relies primarily on the credit and ability of Owner to pay and not upon Contractor's credit or ability, and further, expressly accepts the risk that it will not be paid for work performed by it in the event that Contractor, for whatever reason, is not paid by Owner for such work.

Generally, contractual language that eliminates the general contractor's duty to pay a subcontractor for its completed work is disfavored in many states. In North Carolina, California, New York, and Wisconsin, such clauses are prohibited altogether. See N.C. Gen. Stat. § 22C-2; *Wm. R. Clarke Corp. v. Safeco Ins. Co. of Am.*, 15 Cal. 4th 882, 895 (Cal. 1997); *West-Fair Elec. Constr. v. Aetna Cas. & Sur. Co.*, 87 N.Y.2d 148, 158 (N.Y. 1995); and Wis. Stat. § 779.135(1). Other jurisdictions limit the scope of such clauses through legislative action and judicial interpretation. For instance, while Maryland recognizes "pay-if-paid" provisions as valid and enforceable, the Maryland Legislature has enacted a statute that provides: "[a] provision in an executory contract between a contractor and a subcontractor that is related to construction, alteration, or repair of a building, structure, or improvement and that conditions payment to the subcontractor on receipt by the contractor of payment from the owner or any other third party may not abrogate or waive the right of the subcontractor to: (1) claim a mechanic's lien; or (2) sue on a contractor's bond." Md. Real Property Code § 9-113 (2014) (emphasis supplied).

In Florida, the Florida Supreme Court has declared that ambiguous "pay-if-paid" clauses are unenforceable under the law. See *DEC Electric, Inc. v. Raphael Constr. Corp.*, 558 So. 2d 427, 429 (Fla. 1990); *J.J. Shane, Inc. v. Aetna Cas. & Sur. Co.*, 723 So. 2d 302 (Fla. 3d DCA 1998); *Robert F. Wilson, Inc. v. Post-Tension Structures, Inc.*, 522 So. 2d 79 (Fla. 3d DCA 1988), accord, *Everett Painting Co. v. Padula & Wadsworth Const. Inc.*, 856 So. 2d 1059, 1061 (Fla. 4th DCA 2003); *Dyser Plumbing Co. v. Ross Plumbing, Inc.*, 515 So. 2d 250, 252 (Fla. 2d DCA 1987).

Where a "pay-if-paid" provision is deemed unenforceable, courts will construe the provision as a "pay-when-paid" provision governing the timing of payment, not the complete bar of payment. Under a standard "pay-when-paid" provision, the general contractor must tender payment to the subcontractor within a *reasonable time*. A standard "pay-when-paid" contractual provision might read: "Contractor shall pay subcontractor within fifteen days of contractor's receipt of payment from the owner." Notwithstanding, where the general contractor and subcontractor have clearly expressed an intent conditioning payment to the subcontractor upon the owner's payment to the general contractor, the court, in construing such a provision, should give full force and effect to this clearly-expressed intent of the contracting parties.

Due to the prevalence of such clauses in recent years, subcontractors have sought to circumvent contractual "pay-if-paid" provisions by bringing claims against sureties who may guarantee payment. In such a scenario, a subcontractor would bring a lawsuit or demand payment from both the general contractor and its surety for failure to pay pursuant to the subcontract at the time of non-payment. The effectiveness of such a suit against the general contractor would be limited if the subcontract between the general contractor and subcontractor contained a valid and enforceable "pay-if-paid" provision

within the particular jurisdiction, as the general contractor could cite to the contractual provision as an affirmative defense where there has in fact been no payment made by the owner.

However, the effectiveness of such a defense by the general contractor's surety is still an open question. One issue is whether such a defense would be available to the surety not in privity-of-contract with the parties during the negotiation and formation of the subcontract. Courts are split on this question. In *OBS Co. v. Pace Constr. Corp.*, 558 So. 2d 404, 408 (Fla. 1990), the Florida Supreme Court explained that "[t]he payment bond is a separate agreement, and any liability to proceed against the general contractor does not necessarily prevent recovery against the sureties under the bond". In *OBS*, recovery under the payment bond was not conditioned on the owner making final payment to the subcontractor and the bond did not incorporate the subcontract's payment terms. *Id.* The Florida Supreme Court went on to note that "it would be inequitable to nullify the bonding company's liability because the owner has not paid the contractor" and "[w]hen a surety on a private construction project issues a bond that purports to protect against mechanic's liens, the bond must be construed and applied in accordance with the conditions of section 713.23, Florida Statutes". *Id.*

Similarly, in *U.S. ex rel. Walton Technology v. Weststar Engineering, Inc.*, 290 F. 3d 1199, 1203 (9th Cir. 2002), the court, in holding that the surety could not enforce a conditional payment clause contained in its principal's subcontract, found that such a provision, if extended to the surety, would negate the rights and obligations created under the Miller Act specifically intended to ensure protection for subcontractors. Although the court noted that general rules of suretyship law apply to extend the principal's rights to that of the surety, such is not the case wherein the Miller Act limits the coextensive liability between a surety and its principal.

Other courts have ruled alternatively on the theory that the surety stands in the shoes of the general contractor and thus is afforded all the contractual defenses of the general contractor. The United States District Court for the Southern District of Florida put this logic succinctly in *Great Am. Ins. Co. v. Sch. Bd. of Broward County*, 2010 U.S. Dist. LEXIS 120030, *45, 2010 WL 4366865 (S.D. Fla. July 30, 2010), by stating that once a surety has fulfilled its obligations under the bond, "the surety confers a benefit upon the obligee . . . That benefit relieves the obligee of the burden of completing the construction". *Id.*; see also *International Fid. Ins. Co. v. County of Rockland*, 98 F. Supp. 2d 400, 429, 2000 U.S. Dist. LEXIS 7454, *87 (S.D.N.Y. 2000). In short, these courts have interpreted the principal's rights as shifting to the surety.

It is unclear whether, absent clear and unequivocal language supplementing the subcontract to include this additional condition precedent, more courts will give credence to the surety's affirmative defense under the general contractor's "pay-if-paid" contractual terms. However, we can be certain of more litigation in the near future pertaining to the applicability and extension of "pay-if-paid" clauses. In the interim, general contractors have begun to supplement such "pay-if-paid" provisions to include terms extending the "pay-if-paid" condition precedent to the general contractor's surety, despite the fact that the surety is not privy to the original transaction, which may become another area for litigation.

Keywords: minority trial lawyer, litigation, pay-if-paid, construction, contract, condition, provision

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