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The Elusive Permissibility of Pass-Through Claims in Virginia

by Melisa A. Roy

Pass-through claims have become an instrument in construction contract litigation for the efficient resolution of subcontractor claims against an owner. Indeed, refusing to allow pass-through claims would result in a waste of resources, greater expense, and duplicative litigation where a contractor would be required to sue the project owner and separately defend against the same claims by one or more subcontractors.

Federal courts (and several states) have long allowed pass-through claims, given their practical and administrative benefits.[1] The allowability of pass-through claims in Virginia is less clear, however. The Supreme Court of Virginia has never opined on the permissibility of pass-through claims in the commonwealth, and the state legislature has only permitted them with respect to contracts with the Virginia Department of Highways and Transportation (VDOT). Nevertheless, pass-through claims may be permissible in Virginia if certain conditions are satisfied. There appears to be an opening to pass-through claims where a contractor presents the claims in its own name and as its own damages based on potential future liability.

What Are Pass-Through Claims?

A typical construction project involves the project owner, the prime contractor, and various subcontractors hired by the prime contractor to perform portions of the work. Disputes on construction projects often arise over claims for additional costs incurred by a contractor or subcontractor as a result of a defective design, changes to the work, and delays to the job, among other possibilities,

attributable to the owner. A subcontractor, however, generally cannot bring a claim directly against an owner due to the lack of contractual privity between the subcontractor and owner.

Pass-through claims address the lack of privity that prevents the subcontractor from claiming directly against the owner for damages, while also avoiding the gross inefficiency that would result by requiring separate lawsuits between only those parties that do maintain privity (i.e., subcontractor-contractor and contractor-owner). Specifically, because the subcontractor has no contract with the owner, the prime contractor "passes through" the subcontractor's claim to the owner in the contractor's name.

Pass-Through Claims in Federal Government Contracting

The United States Supreme Court long-ago affirmed the use of pass-through claims in federal government contracting as set forth in *United States v. Blair*[2]:

> But it does not follow that [the contractor] is barred from suing for this amount. [The contractor] was the only person legally bound to perform his contract with the Government and he had the undoubted right to recover from the Government the contract price for the…work **whether that work was performed personally or through another**…. [The contractor]'s contract with the Government is thus sufficient to sustain an action for extra costs wrongfully demanded under that contract. (emphasis added)[3]

The Severin Doctrine

The prosecution of pass-through claims in federal government contracting was, for a time, significantly limited by what has come to be known as the *Severin* Doctrine. The *Severin* Doctrine, which arose out of the 1943 decision in *Severin v. United States*,[4] applies only to breach of contract actions and states that a contractor has no standing to sue the federal government for actual losses incurred by one of its subcontractors unless the contractor has some obligation to the subcontractor for the amount claimed. In *Severin*, the subcontract stated that the contractor was not "responsible for any loss…or delay caused by the Owner…." The contractor was able to recover its delay damages against the government, but not its subcontractor's damages because the contractor was unable to prove that it suffered any actual damages as a result of the subcontractor's damages arising from the government's breach.

Liquidating Agreements

Federal courts have allowed contractors to bypass the *Severin* Doctrine through properly drafted liquidating agreements. Liquidating agreements are a favored risk allocation tool among contractors in which a contractor and subcontractor agree that the contractor is liable to the subcontractor for the owner's acts, omissions, and responsibilities to the extent that the contractor is able to recover from the owner for the same.

In *J.L. Simmons v. United States*,[5] for example, the Court of Federal Claims allowed a contractor to pass through the claims of twelve subcontractors, including nine that had executed a release discharging all claims against the contractor "with the exception of [their] claim for losses because of engineering errors in design committed by the [owner]."[6] Notably, the court allowed the pass-through claims even though the contractor's obligations to the subcontractors regarding the amount in dispute would be extinguished if the court denied the claim against the owner, finding that the contractor's liability was not negated by the releases.

Pass-Through Claims in Virginia

Pass-through claims in Virginia, however, have been denied except where allowed by statute or where the contractor has asserted its own damages independent of the subcontractor's damages. Moreover, unlike in federal government contracting, the use of liquidating agreements in Virginia could result in a denial of the pass-through claim if the contractor's liability is made contingent on recovery from the owner. One Virginia statute expressly allows pass-through claims, but the statute applies only to VDOT contracts. As explored below, however, a more general Virginia statute may allow a contractor to claim against an owner for its subcontractor's damages if the claims are presented as the contractor's own damages.

The Supreme Court of Virginia has never opined on the permissibility of pass-through claims in the commonwealth, and the state legislature has only permitted them with respect to contracts with the Virginia Department of Highways and Transportation (VDOT).

In *George Hyman Construction Company v. McLean Hotel Associates Limited Partnership*,[7] Judge Griffith of the Fairfax Circuit Court allowed a contractor's pass-through claim brought in the contractor's own name against a private owner under Virginia Code § 8.01-281(A), which provides that a claim asserted

> …**may be based on future potential liability**, and it shall be no defense thereto that the party asserting such claim, counterclaim, cross-claim, or third-party claim has made no payment or otherwise discharged any claim as to him arising out of the transaction or occurrence. (emphasis added)[8]

The court reasoned that, under the statute, the contractor could maintain suit against the owner on behalf of its subcontractors without yet having paid those subcontractors. To recover, the contractor would have to prove damages allegedly suffered by each subcontractor that can be directly recovered by the subcontractor as well as evidence as to the damages, which may have been suffered by [the contractor] as a result of [the owner's] breach of contract and the subsequent obligations [the contractor] incurred to their subcontractors due to this breach.

It seems fitting that the court relied upon Virginia Code § 8.01-281(A), the primary procedural purpose of which, to "promote judicial economy by having all claims, actual or potential, arising from the same transaction or occurrence determined in one proceeding,"[9] echoes a primary purpose for allowing pass-through claims as well.[10]

Two years after *Hyman*, the Court of Appeals of Virginia did not allow a contractor to bring a pass-through claim against VDOT in *APAC-Virginia, Inc., ex rel., etc. v. VDOT*.[11] In *APAC*, the court rejected the contractor's argument that, under VA. CODE ANN. § 33.1-192.1,[12] the commonwealth waived sovereign immunity[13] and, with it, waived privity of contract. The court stated that privity of contract is a prerequisite in Virginia for an action based solely upon economic loss, and held that a contract action "must be brought in the name of the party in whom the legal interest is vested." The opinion in *APAC* makes no mention of *Hyman* or VA. CODE ANN. § 8.01-281(A), but is distinguishable from *Hyman* nevertheless. Importantly, the contractor alleged damages that only the subcontractor sustained. In addition, the contractor brought the action "*ex rel.*" or "on behalf of" its subcontractor, whereas in *Hyman*, the contractor alleged its own damages and brought suit only in its own name. [14]

As a result of the holding in *APAC*, the legislature responded by amending the Virginia Code in 1991 to expressly permit subcontractor pass-through claims on VDOT projects.[15] To date, however, Virginia has not yet expanded the statute to permit pass-through claims in connection with other non-highway state construction projects.[16]

Soon after *APAC*, in *Marriott Corporation v. Thomas P. Harkins, Inc.*,[17] Judge Griffith distinguished his previous decision in *Hyman* and denied the contractor's pass-through claims.The court relied on *APAC* in holding that lack of privity barred the pass-through claims. The court in *Marriott* found it significant that the contractor asserted its entitlement *on behalf of* the subcontractors in addition to claiming its own damages resulting from the same actions. The court distinguished *Hyman*, in which the contractor was "prepared to show that the claims were recoverable as its own damages," from both *APAC* and *Marriott* where the contractors framed their claims *ex rel.*

The contractor in *Marriott* also entered into liquidating agreements with the subcontractors, which limited the contractor's liability to that portion recovered from the owner. Contrary to federal decisions (such as *J.L. Simmons*) that allow such liquidating agreements for pass-through claims, the court in *Marriott* held that, because the contractor's liability was contingent on its recovery from the owner, the contractor had no real fear of being held liable to the subcontractors and lacked any potential future liability. Under this reasoning, liquidating agreements in Virginia would have to preserve at least some liability for the contractor if the contractor is unable to recover from the owner.

Three years later in *Tyger Construction Company, Inc. v. VDOT*,[18] the Court of Appeals of Virginia arguably limited its previous holding in *APAC* when it again faced a situation in which a general contractor sued VDOT based upon damages that its subcontractor sustained. In permitting the suit to continue, the court distinguished *APAC* by emphasizing that, in *Tyger*, the contractor's petition in the circuit court was brought in the contractor's name as the aggrieved party, and the petition alleged injury and consequent damages suffered by the contractor. According to the court, this form of pleading took *Tyger* "out of the ambit of *APAC*."

Although not expressly holding that pass-through claims are permissible in Virginia, the court in *Tyger* favorably cited to the US Supreme Court's *Blair* decision allowing pass-through

claims in stating that "the general contractor is ordinarily the party who has contracted to perform the work and who has the right to sue for recovery under the contract." Moreover, the court's reasoning made no reference to the 1991 statutory change (presumably because the contract was entered into in 1985 prior to the amendment), relying instead on the fact that the contractor brought the claim in its own name for its own damages, thereby "facially satisfying the privity of contract doctrine." The Court of Appeals declined to opine regarding whether the contractor suffered damages and whether the contractor was entitled to recover under the contract, but also did not indicate that costs would be unallowable to the extent they included the subcontractor's costs.

Lessons Learned in Asserting Pass-Through Claims in Virginia

Based on the case law examined above, contractors cannot bring claims "on behalf of" their subcontractors against a private or public owner in Virginia, with the exception of claims against VDOT. Nevertheless, contractors may still be able to recover costs incurred by their subcontractors arising out of owner acts, omissions, or responsibilities in Virginia if: (1) the action is brought in the contractor's own name, (2) the costs are asserted as the contractor's own damages based on potential future liability under VA. CODE § 8.01-281(A), and (3) the contractor has not entered into liquidating agreements making its liability entirely contingent on recovery from the owner. Absent further clarity from the Supreme Court of Virginia and the General Assembly, however, the success of such an approach remains uncertain.

Endnotes:

1 In a 2004 decision examining the allowability of pass-through claims, the Texas Supreme Court noted that, of the nineteen states to address the issue in published opinions, only Connecticut expressly rejected pass-through claims. *Interstate Contracting Corp. v. City of Dallas*, 135 S.W.3d 605, 613-14 (Tex. 2004).

2 321 U.S. 730 (1944).

3 *Id.* at 737-38.

4 99 Ct. Cl. 435 (1943). Under *Severin*, the contractor maintained the burden of proof in showing that it remained liable to the subcontractor for the amount at issue. The courts have reversed course and now place the burden of proof on the government to prove that the contractor has no liability to the subcontractor for the amount in dispute. *See Harper/Nielsen-Dillingham Builders, Inc. v. United States*, 81 Fed. Cl. 667, 675 (2008); *Ace Constructors, Inc. v. United States*, 70 Fed. Cl. 253, 289 (2006).

5 304 F.2d 886 (Ct. Cl. 1962).

6 *Id.* at 887.

7 14 Va. Cir. 187 (Fairfax 1988).

8 *Id.*

9 *Gemco-Ware, Inc. v. Rongene Mold & Plastics Corp.*, 360 S.E.2d 342, 344 (Va. 1987).

10 "As a practical matter, the practice of allowing claims of subcontractors and suppliers to be brought as part of the contractor's claim has long been recognized by the judiciary as promoting judicial economy and efficiency by obviating the need for each subcontractor and supplier to bring its own suit against its higher tier subcontractor, contractor, and surety. Proliferation of proceedings in different courts arising out of the same set of facts has been a result not welcomed by the judiciary." 6 Bruner & O'Connor Construction Law § 19:25 (West 2015).

11 9 Va. App. 450 (1990).

12 VA. CODE ANN. § 33.1-192.1 is now cited as VA CODE ANN. § 33.2-1102 (West 2015). This article refers to the former citation.

13 Pass-through claims on public contracts in Virginia could be complicated by issues of sovereign immunity and the requirement that the sovereign must consent to be sued. The commonwealth has provided limited consent to be sued in contract cases as reflected in VA CODE § 8.01-192. Virginia has a long-standing policy of consenting to be sued, as Judge Bouldin observed, that since 1778, it has been the "cherished policy of Virginia" to allow citizens "the largest liberty of suit against herself" in contract cases. *XL Specialty Ins. Co. v. Com., Dep't of Transp.*, 47 Va. App. 424, 433 (2006) (citations omitted) (finding courts have not extended the commonwealth's waiver of sovereign immunity for contractual suits to equitable remedies absent an explicit statutory waiver). *APAC* expressly did not decide whether VA. CODE § 33.1-192.1 was intended to waive VDOT's sovereign immunity, instead focusing entirely on privity of contract. *APAC*, 9 Va. App. at 453. The court in *Tyger Construction Company, Inc. v. VDOT*, 17 Va. App. 166 (1993), discussed herein, similarly focused on privity of contract in its analysis and made no reference to sovereign immunity.

14 The Supreme Court of Virginia referenced *APAC* in dicta in *XL Specialty Insurance Company v. Commonwealth, Department of Transportation*, 269 Va. 362, 372 n. 4 (2005) in examining whether a surety qualified as a "contractor" under VA. CODE § 33.7-387 (now cited as VA. CODE § 33.2-1103) for purposes of bringing an equitable subrogation claim against VDOT. The decision, however, did not opine on the allowability of pass-through contract claims.

15 Specifically, Virginia Code §§ 33.1-386 (now cited as VA. CODE § 33.2-1101), 33.1-387 (now cited as VA. CODE § 33.2-1103), and 33.1-192.1 (now cited as VA. CODE § 33.2-1102) were amended to add language reflecting that, in addition to claiming for himself against VDOT, a contractor could claim "on behalf of a subcontractor or person furnishing material for the contract." *See* 1991

Virginia Laws Ch. 691 (H.B. 1512). Pass-through claims have been allowed against VDOT by subcontractors since the 1991 amendments. *See, e.g., Asphalt Roads & Materials Co., Inc. v. Com., Dept. of Transp.*, 257 Va. 452, 512 S.E.2d 804 (1999); *Driggs Corp. v. Com. of Va.*, 1996 WL 1065551 (Va. Cir. Ct. 1996).

16 *See* VA. CODE §§ 2.2-4300 *et seq.* In 2000, the General Assembly sought to commission a study to consider whether the Virginia Public Procurement Act ("VPPA") should be amended to "allow contractors to submit claims to public owners on behalf of subcontractors and suppliers who incurred costs and expenses on public projects due to acts or omissions of the public owner," as with VDOT contracts. H.J. Res. 229, 2000 Gen. Assem., Reg. Sess. (Va. 2000) *available at* http://leg1.state.va.us/cgi-bin/legp504.exe?001+ful+HJ229+pdf (last visited on October 6, 2015). Unfortunately, the resolution ultimately failed, and the study was never performed. *See* History of H.J. Res. 229, 2000 *available at* http://lis.virginia.gov/cgi-bin/legp604.exe?ses=001&typ=bil&val=hj229.

17 30 Va. Cir. 515 (Fairfax 1990).

18 17 Va. App. 166 (1993).

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