Defending Payment Bond Claims — What Is To Be Done?

by Scott W. Kowalski and Mark A. Burgin

Construction suretyship is a tripartite relationship where a surety issues bonds to guarantee a contractor's obligation for performance and payment to an "obligee." Sureties expect that their bond obligations will mirror the contractor's obligations as defined by the operative contracts. However, in certain circumstances, the surety's liability may be greater than the contractor's obligations and exceed the operative contract terms. We discuss one such circumstance here — can a surety assert defenses to payment bond claims based upon the clear terms of the underlying contract?

Bond Claim

Generally, owners require performance and payment bonds to guarantee the principal's performance to the owner and the principal's payment obligations to its downstream subcontractors and suppliers. A payment bond claimant typically has a direct contract with the contractor or a contract with a subcontractor of the contractor.[1] In responding to payment bond claims, sureties rely upon the terms in the contractor's subcontract to ensure that only valid claims for payment are satisfied.[2] Once a payment bond claim is made, a surety must independently investigate the claim and either resolve or deny the claim. In responding to payment bond claims, sureties will look to the terms of the payment bond and the law to assess available surety defenses (notice, material modification, and the bond amount), and will look to the terms of the applicable contract of the surety's principal for contractual defenses. One such term is a "pay-if-paid" clause, which spreads

the risk of owner nonpayment down to the subcontractors. Although Virginia courts will enforce "pay-if-paid" clauses in disputes between general contractors and subcontractors, a surety's ability to rely on the same clause in defending a payment bond claim is doubtful, depending on the type of project.

This article explores the limitations imposed by courts on a surety's ability to rely upon a "pay-if-paid" provision in the contractor's subcontract for private and public projects.

Private Projects

The Supreme Court of Virginia has not addressed whether a surety may assert a principal's "pay-if-paid" clause as a defense by relying solely upon language in the contractor's subcontract. As such, Virginia circuit courts and federal courts have speculated as to how the Supreme Court of Virginia would rule on the issue.

Virginia courts frequently cite to the Fourth Circuit Court of Appeals' decision in *Moore Brothers Co. v. Brown & Root, Inc.*, 207 F.3d 717 (4th Cir. 2000). In *Moore Brothers*, a developer contracted with Brown & Root Inc. to construct the Dulles Toll Road Extension, a private project.[3] The contractor obtained a payment bond and entered into subcontracts, which included "pay-if-paid" clauses.[4] After an arbitrator awarded additional compensation to the contractor, the developer advised that it could not pay the award.[5] In turn, the contractor denied payment to its subcontractors based on the "pay-if-paid" clause in the subcontracts.[6]

The subcontractors then filed payment bond claims in the US District Court for the Eastern District of Virginia, which granted summary judgment to the subcontractors and determined that the surety could not rely on the "pay-if-paid" clause in the subcontracts to avoid payment.[7] On appeal, the Fourth Circuit affirmed, holding that a surety cannot assert a principal's "pay-if-paid" defense to a subcontract claim if the "pay-if-paid" language is not expressly incorporated into the payment bond.[8] The court found it nonsensical to suggest that the owner's nonpayment could absolve the surety of its obligation to pay claimants because that would defeat the purpose of a payment bond.[9] The court concluded that the Supreme Court of Virginia would not allow a surety to invoke the "pay-if-paid" clause as a defense in these circumstances.[10]

The Circuit Court for the City of Roanoke reached a different conclusion in *IES Commercial, Inc. v. The Hanover Insurance Co.*, CL16-108 (Va. Cir. Ct. City of Roanoke May 3, 2016). In *IES Commercial,* the property manager contracted with a general contractor to construct the Center in the Square facility, a private project in Roanoke.[11] The contractor obtained a payment bond and entered into subcontracts, which included a "pay-if-paid" clause.[12] A subcontractor filed suit on the payment bond due to nonpayment, and the surety defended based upon the subcontract's "pay-if-paid" clause.

The court held that the surety could rely on the subcontract's "pay-if-paid" clause because a surety can assert any defense that is available to the contractor, and a "pay-if-paid" clause is a valid and enforceable defense for a contractor in Virginia.[13] Furthermore, the court determined that the payment bond did not create independent obligations for the surety separate from those imposed on the contractor in the subcontract.[14] As a matter of judicial policy, the court found no compelling reason to single out "pay-if-paid" defenses from other defenses available to a surety on private projects by requiring that "pay-if-paid" clauses be in both the subcontract and the payment bond. One reason is that subcontractors can protect their interests by asserting mechanic's liens against the owner's property on private projects.[15]

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Although the state of the law on private projects for the surety's "pay-if-paid" defense remains uncertain in Virginia, there is greater clarity in the realm of public construction projects.

Public Construction Projects

On federal construction projects, courts have determined that the Miller Act requires sureties to reimburse claimants for "the amount due" even if the obligation is not specified

in the payment bond.[16] In determining the "amount due" under the Miller Act and in the context of contractual provisions governing payment, a number of courts have held that a payment bond surety cannot assert the principal's contractual defense if the provision impacts the *timing or right of recovery*, but can assert the principal's contractual defense if the provision impacts the *measure of recovery*. This distinction was discussed in detail in the Ninth Circuit's decision in *United States ex. rel. Walton Technology, Inc. v. Weststar Engineering, Inc.*, 290 F.3d 1199 (9th Cir. 2002),[17] which held that a "pay-if-paid" clause was a *timing or right of recovery* provision and could not be relied upon by a surety.

Recently, the *Walton Technology* distinction was raised in *United States ex rel. VT Milcom, Inc. v. PAT USA, Inc.*, 2017 U.S. Dist. LEXIS 109572 (W.D. Va. July 14, 2017). In *VT Milcom*, the United States Army Corps of Engineers awarded a contract for minor construction on facilities in Qatar.[18] The contractor provided a Miller Act payment bond and issued a subcontract that included the following "pay-if-paid" provision: "The Contractor's receipt of payment from the Owner is a condition precedent to the Contractor's obligation to pay the Subcontractor."[19] The subcontract also contained a payment schedule that provided for payment of 20 percent upon material purchase, 60 percent upon installation/testing/commissioning (ITC), and 20 percent upon final acceptance.[20] After the prime contract was terminated for default (for reasons unrelated to the subcontractor), the contractor terminated the subcontract.[21] The subcontractor filed suit against the contractor and the surety to recover the remaining balance that the subcontractor claimed was due.[22]

On summary judgment, both parties relied upon *Walton Technology*'s distinction between *timing or right of recovery* and *measure of recovery* provisions under the Miller Act. The surety argued that the milestone payment schedule was a *measure of recovery* provision and, because the subcontractor had not achieved the ITC completion milestone, the 60 percent payment was not due.[23] Conversely, the subcontractor argued that the payment provision was a *timing or right of recovery* provision, similar to a "pay-if-paid" provision, and could not be enforced to avoid liability under the Miller Act bond.[24]

The *VT Milcom* court granted the subcontractor's motion for summary judgment on the payment bond claim.[25] Relying upon the *Walton Technology*'s distinction to determine the "sums justly due," the court found that the milestone payment schedule was a *timing of recovery* provision, not a *measure of recovery* provision and, therefore, could not be enforced against the subcontractor under the Miller Act.[26] The court found it persuasive that a number of other provisions of the subcontract addressed payment terms and procedures, but none of these provisions referenced the payment milestone schedule.[27]

As for payment bond claims on state projects subject to Virginia's "Little Miller Act," the Supreme Court of Virginia has not yet issued a ruling on point. However, the Court has recognized that Virginia's "Little Miller Act" is similar to the federal Miller Act and was enacted for the same purpose.[28] In the absence of applicable Virginia decisions, Virginia courts often rely upon federal Miller Act case law in assessing the parameters of "Little Miller Act" bond claims.[29] Therefore, it is likely that sureties on public projects in Virginia will be prohibited from relying upon a subcontract's "pay-if-paid" provision in defending against payment bond claims.

Conclusion

Until the Supreme Court of Virginia makes a determination, the state of the law in Virginia regarding the ability of a private project's surety to enforce a subcontract's "pay-if-paid" clause remains uncertain. Nearly 20 years ago, the Fourth Circuit presented its interpretation of Virginia law in *Moore Brothers.* Just this past year, however, a Virginia circuit court issued a directly contrary ruling in *IES Commercial.*

It is always a questionable undertaking to predict the path of the law. One of the long-standing justifications for a payment bond is to protect owners from the potential failure of their contractors to make payments to subcontractors. Allowing a surety to enforce a contractor's "pay-if-paid" provision does not thwart that justification because the operation of the clause requires that the payment failure originate with the owner. Regardless, the safest course for contractors and their sureties is to assume that provisions such as "pay-if-paid" clauses will not be enforced unless the clause is specifically included in the payment bond.

The state of the law on the surety's enforcement of "pay-if-paid" clauses on federal projects in Virginia is not finally determined, but the path seems clear — sureties cannot rely upon contractual "pay-if-paid" clauses in defending against payment bond claims. Although the Fourth Circuit has not issued a decision directly on point, the Eastern District of Virginia has indicated its belief that subcontract provisions similar to "pay-if-paid" clauses will not be enforceable by a surety under a Miller Act bond. The path was illuminated further in a recent decision by the Eastern District of Virginia in which a Miller Act surety's enforcement of a "no damages for delay" clause was denied as a *timing of recovery* provision, which the court determined was prohibited by the Miller Act.[30]

Endnotes:

1 Robert J. Duke, Comment, *The Tucker Act and Payment Bond Surety's Equitable Claim of Subrogation Post-Blue Fox: Keys to the Courthouse Doors*, 54 Cat. U.L. Rev. 267, 268-69 (2004); Marchelle M. Houston et al., *Bond, Contractual, and Statutory Provisions and the General Agreement of Indemnity*, *in* Bond Default Manual 1, 10 (Duncan L. Clore et al. eds., 3d ed. 2005); 40 U.S.C. § 3131(b)(2); Va. Code Ann. § 2.2-4337(A)(2); *see also* American Institute of Architects' ("AIA") A312-2010 § 16.2.

2 Duke, *supra* note 1, at 270; Restatement (Third) of Suretyship and Guaranty § 27(1) & cmt. A (1996); *see also Bd. of Supervisors of Fairfax Cnty. v. S. Cross Coal Corp*, 238 Va. 91, 96, 380 S.E.2d 636, 639 (1989).

3 *Moore Bros.*, 207 F.3d at 721.

4 *Id.*

5 *Id.*

6 *Id.*

7 *Id.*

8 *Id.* at 722-24.

9 *Id.* at 723.

10 *Id.* (citing *OBS Co. v. Pace Constr. Corp.*, 558 So. 2d 404 (Fla. 1990); *Brown & Kerr, Inc. v. St. Paul Fire & Marine Ins. Co.*, 940 F. Supp. 1245 (N.D. Ill. 1996); *Shearman & Assoc., Inc. v. Continental Cas. Co.*, 901 F. Supp. 199 (D.V.I. 1995)).

11 *IES Commercial*, slip op. at 2.

12 *Id.*

13 *Id.* at 1, 4.

14 *Id.* at 4.

15 *Id.* at 5-6.

16 In discussing the term "the amount due", the Court noted that "[t]he term 'sums justly due' appeared in a prior version of the Miller Act, and so many of the cases discuss that term. But the two terms are interchangeable because the amendments made no substantive changes." *United States ex rel. VT Milcom, Inc. v. PAT USA, Inc.*, 2017 U.S. Dist. LEXIS 109572, at *14 n.10 (W.D. Va. July 14, 2017).

17 In *Walton Technology*, a contractor and subcontractor entered into an agreement which stated: ". . . any further payment to [the subcontractor] . . . *shall only be made when and if paid by the Navy* . . ." 290 F.3d at 1202. The surety argued that there were no "sums justly due" because the Navy had not made payment. *Id.* at 1203. The Court held that the surety could not rely upon the "pay-if-paid" clause because it would act as an implied waiver of the subcontractor's right to recovery under the Miller Act, it would contradict the express terms of the Miller Act, and it was not sufficiently clear and explicit to act as a legally valid waiver. *Id.* at 1208-09.

18 *VT Milcom*, 2017 U.S. Dist. LEXIS at *3; Compl. ¶ 4; Answer ¶ 4; Stipulation ¶ 1.

19 *VT Milcom*, 2017 U.S. Dist. LEXIS at *3, 6; Compl. ¶¶ 9-10, 17, Ex. C; Answer ¶¶ 9-10, 17.

20 *VT Milcom*, 2017 U.S. Dist. LEXIS at *9, 19-20.

21 *Id.* at *4; Def. Answer to Pl.'s Req. for Adm. No. 73; Stipulation ¶¶ 6-7.

22 *VT Milcom*, 2017 U.S. Dist. LEXIS at *4-5; Stipulation ¶ 10; *see* Compl.

23 *VT Milcom*, 2017 U.S. Dist. LEXIS at *4-5.

24 For purposes of this article, we are considering the surety's reliance upon the payment milestone schedule in the subcontract to be the equivalent of reliance upon a "pay-if-paid" provision.

25 *Id.* at *21.

26 *Id.* at *20.

27 *Id.*

28 *See Solite Masonry Units Corp v. Piland Constr. Co.*, 217 Va. 727, 730-31, 232 S.E.2d 759, 761 (1977).

29 *See Vulcan Materials Co. v. Betts*, 315 F. Supp. 1049, 1050 (W.D. Va. 1970).

30 *See United States ex rel. Kitchens To Go v. John C. Grimberg Co., Inc.*, 2017 U.S. Dist. LEXIS 173362, 2017 WL 4698217 (E.D. Va. 2017).

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