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Payment Bonds May Not Protect Subcontractors From The Effect of Pay-if-Paid Clauses

A recent decision by the Third Circuit Court of Appeals is drawing attention for what may be seen as precedent for allowing sureties to defend payment bond claims based on contingent payment clauses contained in subcontracts. In *Sloan v. Liberty Mutual Ins. Co.*, 653 F.3d 175 (3rd Cir. 2011), the Third Circuit reversed a judgment of over \$900,000.00 in favor of a subcontractor on a payment bond claim, finding that the plaintiff's subcontract included a "pay-if-paid" clause which made the general contractor's duty to pay contingent upon its receipt of payment from the project owner. The decision is raising eyebrows for several reasons, including the fact that it permitted a surety to have the benefit of a "pay-if-paid" clause in a subcontract to which the surety was not a party, eliminating the subcontractor's likely sole source of recovery.

In *Sloan*, the project owner engaged a general contractor to develop condominiums in Philadelphia. The general contractor retained various subcontractors for the project, including the plaintiff. By the time the project was completed, the owner and the general contractor were embroiled in a protracted dispute over payment and alleged deficiencies in workmanship, with the owner allegedly withholding over \$6 million. Citing the dispute, the general contractor did not pay several subcontractors, including the plaintiff.

The plaintiff subcontractor proceeded to make a claim against the project's payment bond. The surety denied the claim and argued that payment was not due under the terms of the subcontract, which, it argued, contained a "pay-if-paid" clause. The trial court rejected the surety's argument, finding that the language of the clause in question was not a contingent payment clause, and entered judgment in favor of the subcontractor. However, on appeal, the Third Circuit reversed the trial court and held that the provision was indeed a "pay-if-paid" clause, finding that its language indicated an intent to shift the risk of the owner's nonpayment onto the subcontractor.

While *Sloan* was focused on the question of whether the subcontract contained a contingent payment clause, the court essentially assumed, without expressly finding (apparently because the issue was not raised by the plaintiff), that the surety was permitted to assert a contingent payment subcontract provision to shield it from liability. The question of whether a surety may do so implicates a unique policy concern, because payment bonds are traditionally seen as safety-nets for subcontractors and suppliers. "Pay-if-paid" clauses are controversial even as between contractors and subs, and some jurisdictions have found them to be unenforceable altogether. Whether sureties, who are not parties to the subcontract, may deny a claim based on a contingent payment clause is even more controversial, as doing so may leave the sub without a remedy. Generally, a surety is permitted to defend a bond claim by "standing in the shoes" of the contractor and assert whatever defenses it may have had. That notion, however, is not so easily applied when the subcontract includes a "pay-if-paid" clause, because allowing a surety to do so may essentially make the payment bond an illusory remedy where there is an insolvent contractor. In situations where lien rights have also been waived, the subcontractor may be left without any effective means of recovering payment.

Before *Sloan*, there was no authority expressly answering the question of whether sureties may assert "pay-if-paid" defenses, and the *Sloan* decision itself does not expressly address the question. It is unclear whether the opinion will be considered precedential on the issue, although sureties will be sure to take--and are already taking--that position. It is possible that *Sloan* may be found irrelevant in future cases because its material facts predate a 2007 amendment to the Pennsylvania Mechanics' Lien Law, which conditions the validity of a mechanics' lien waiver on the posting of a payment bond, evidencing a public policy against leaving subcontractors without both lien rights and payment bond remedies. There will certainly be future litigation on this question.