# The Impact of Pay-if-Paid Clauses on Payment Bond Claims and Mechanic's Lien Rights in Virginia

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Since 1995, Virginia courts have recognized the validity of "pay-if-paid" clauses (sometimes referred to as "pay-when-paid") in subcontracts. To be enforceable, the clause must clearly state that the general contractor's obligation to pay its subcontractor is conditioned upon the general contractor having first received payment for the subcontractor's work from the owner.

Two questions which have arisen occasionally in Virginia are whether a valid pay-if-paid clause is a defense to a subcontractor's claim against the general contractor's payment bond, and whether such a clause is a defense to a subcontractor's mechanic's lien against the project. Surprisingly, neither of these questions has been answered by Virginia's highest court, the Supreme Court of Virginia. There are, however, decisions from other courts that provide guidance on these issues.

**Payment Bond Claims**

In *Moore Bros. Company v. Brown & Root, Inc.*, the United States Court of Appeals for the Fourth Circuit was required to determine how the Supreme Court of Virginia would rule on the issue of whether a payment bond surety can assert its principal's pay-if-paid clause defense where the payment bond itself did not incorporate a pay-if-paid provision. The court ruled that the bonding company could not rely on the pay-if-paid clause in its principal's subcontract as a defense to liability on the bond because the bond was a separate agreement from the subcontract and did not include a pay-if-paid provision. The court noted that the language of the payment bond included an unconditional promise to pay a claimant who had not been paid in full for all sums as may be justly due within 90 days after work was completed by the claimant. In rejecting the bonding company's reliance on the pay-if-paid clause, the court noted that the very purpose of the payment bond was to insure that claimants who perform work are paid for their work in the event that the bonding company's principal, the general contractor, does not pay. It would defeat the very purpose of a payment bond, said the court, if non-payment by an owner to a general contractor could negate the bonding company's obligation to pay an otherwise valid claim on the bond.

The court also found support for its decision in cases from several other state and federal courts

that had rejected similar attempts by payment bond sureties to invoke "pay-if-paid" defenses available to their principals in subcontracts where the bonds themselves contained no such payment contingency. The court therefore concluded that a payment bond surety cannot invoke a pay-if-paid defense of its principal if the payment bond does not include its own pay-if-paid provision.

The *Moore Bros.* case highlights additional danger for subcontractors agreeing to contingent payment clauses. The clause can bar a claim under the subcontract against the unpaid general contractor. In addition, if the general contractor's payment bond incorporates the terms of the subcontract by reference, the surety has a good argument that the pay-if-paid clause is incorporated in the bond and bars the claim against the bond. Unfortunately, most subcontractors do not see the general contractor's bond until they choose to make a claim on it. Subcontractors should ask for a copy of the general contractor's payment bond before executing a subcontract.

**Mechanic's Liens**

In 1999, Virginia Code ? 43-4, a part of Title 43 addressing mechanic's liens, was amended to allow a mechanic's lien claimant to include in his lien "sums which are not yet due because the party with whom the lien claimant contracted has not yet received such funds from the owner or another third party." This amendment appears to permit a mechanic's lien notwithstanding a pay-if-paid clause. There are not yet any Virginia court decisions interpreting this amendment. At least one circuit court, however, the Circuit Court of York County, Virginia, recently determined a subcontractor's mechanic's lien to be invalid because of such a clause.

In *RRMM Design Build, LLC v. The Marquis at Williamsburg, LLC*, an unpaid subcontractor filed a mechanic's lien and a suit to enforce its lien. The subcontract contained a pay-if-paid clause. The project owner filed for liquidation in bankruptcy, which left no funds available to pay the general contractor.

The lender for the project requested that the court invalidate the subcontractor's lien and dismiss the subcontractor's suit to enforce the lien based on the pay-if-paid clause. The lender argued that under Virginia law, a mechanic's lien has its foundation in and must conform with the underlying contract, in this case the subcontract with the general contractor. The lender argued that since (a) the subcontractor contained a valid pay-if-paid clause and (b) the general contractor had not received and would never receive payment from the owner for the subcontractor's work, then (c) the general contractor was not indebted to and had no obligation to pay the subcontractor under the subcontract. Thus, argued the lender, Virginia law would not recognize the subcontractor's mechanic's lien as valid. Relying on case law from other states, the lender also asserted that, by agreeing to the pay-if-paid provision, the subcontractor effectively waived its mechanic's lien rights.

In response, the subcontractor argued that the lender had misconstrued Virginia law, that Va. Code ? 43-4 specifically allowed a lien where a pay-if-paid clause was in play, and that cases from other states finding waiver of lien rights where there was a pay-if-paid clause were not relevant. Without elaboration, the circuit court agreed with the lender, declared the mechanic's lien invalid

and unenforceable and granted the lender's motion to dismiss the lien enforcement action.

The *RRMM Design* case is one circuit court's view of Virginia law. Other circuit courts could disagree. Yet, the case is cause for concern for subcontractors in Virginia as it demonstrates that courts may determine that pay-if-paid clauses not only can defeat a subcontractor's contract claim against a general contractor for non-payment, but can also waive mechanic's lien rights against the project.[1]

> [1] Notably, some states, such as North Carolina, outlaw pay-if-paid clauses altogether. Others, such as Maryland, allow the clauses but declare that they cannot be used to defeat a subcontractor's right to claim a mechanic's lien or sue on a payment bond.

*For more information about this topic, please contact the author or any member of the Williams Mullen Construction Team.*

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