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The Third Circuit Affirms the Enforceability of a Pay-if-Paid Provision

by Patrick R. Kingsley

The recent decision of Sloan & Co. v. Liberty Mutual Ins. Co., 653 F.3d 175 (3rd Cir. 2011), involves a myriad of claims and legal issues important to owners, general contractors, subcontractors and sureties.

The Nature of the Dispute

The Sloan case focused on waterfront condominiums built in Philadelphia. The general contractor, Shoemaker Construction Co., hired Sloan & Co. as the drywall and carpentry subcontractor. Shoemaker, as principal, issued a payment bond with Liberty Mutual Insurance Co. as surety, guaranteeing payment to the subcontractors. At the project's completion, the owner refused to pay Shoemaker nearly \$6.5 million. Of that amount, \$5 million was owed to the various subcontractors, including Sloan. The owner claimed it was withholding money for several reasons, one of which was that the carpentry and drywall work was deficient. As a result, Shoemaker refused to pay Sloan the full amount of the remaining balance of \$1 million Sloan claimed was due.

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Pennsylvania Court Orders Surety to Immediately Fund Public Improvements within a Development – for Protection of Health and Safety

by Jeffrey D. Grossman

Earlier this year, the Commonwealth Court of Pennsylvania decided Hatfield Township v. Lexon Insurance Company, 15 A.3d 547 (Pa. Cmwth. Ct. 2011), a controversy that arose from a developer's abandonment of a residential subdivision project before completing all requisite public improvements. Hatfield Township claimed that the surety, Lexon Insurance Co., was immediately responsible for completing public improvements pursuant to the subdivision bond Lexon issued. The trial court awarded Hatfield Township the rarely imposed relief of a preliminary injunction and ordered Lexon to immediately pay the township \$521,538 for the construction of certain public improvements that Hatfield Township argued, and the court determined, were necessary to protect the health and safety of the development's residents and individuals passing through. This preliminary relief included payment for driveway apron replacements, erosion

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Pay-if-Paid Provision *(continued)*

Shoemaker sued the owner to recover the balance of the prime contract. Sloan then made a claim against Liberty Mutual for payment on the surety bond. Liberty Mutual denied the claim in its entirety, reserving all of its rights and defenses. As a ground for denying any payment obligation to Sloan, Liberty Mutual suggested that Sloan was not entitled to payment from Shoemaker because the owner had not paid Shoemaker. As a result, Sloan filed the instant lawsuit against Liberty Mutual.

As the Sloan lawsuit against Liberty Mutual was heating up, the Shoemaker lawsuit against the owner was winding down. Shoemaker learned that the owner's financial situation made it unable to satisfy a judgment for the entire claim, even if one were awarded to Shoemaker. Therefore, it entered into a settlement agreement with the owner for \$1 million, apparently all that the owner was able to pay. Shoemaker then offered its subcontractors their *pro rata* share of amounts owed in exchange for a release of claims. Sloan refused and continued to press its lawsuit against Liberty Mutual.

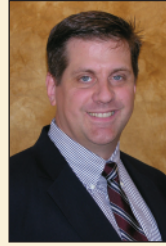
In the action brought by Sloan, Liberty Mutual argued that Shoemaker's obligation to pay Sloan was conditioned on its receipt of payment from the owner, and that Sloan was entitled to be paid only the amount Shoemaker received from the owner for Sloan's work. Liberty also argued that it was entitled to deduct Sloan's share of legal fees stemming from Shoemaker's suit against the owner. Sloan argued that Liberty Mutual waived its right to claim such offsets by failing to assert them within 45 days of Sloan's initial claim, per the timing requirements in the bond.

The Enforceability of the Contingent Payment Provision

The contract in question contained the following contingent payment provision:

Final payment shall be made within thirty (30) days after the last of the following to occur, the occurrence of all of which shall be conditions precedent to such final payment ... [owner] shall have accepted the work and made final payment thereunder to [Shoemaker] ... [Shoemaker] shall have received final payment from [owner] for [Sloan's] work.

Liberty Mutual argued that these conditions constitute a pay-if-paid clause. Although the contractual provision in question expressly contains the words "conditions precedent," the trial court found that there was not



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sufficient evidence of intention to shift the risk of nonpayment onto the subcontractor. Instead, the trial court explained that it had to look at the contract as a whole. The trial court expressly noted that the provision did not indicate that the subcontract would not be paid "unless and until" funds were received from the owner. Moreover, the trial court found it significant that the document contained language that "final payment shall be made."

The U.S. Circuit Court of Appeals for the Third Circuit reversed these conclusions, finding that the provision in question "unequivocally" provided that the owner's payment to the contractor was a condition precedent to the contractor's payment obligation to the subcontractor. The Court embraced Pennsylvania law that follows the plain meaning of contract interpretation. According to the Court, Pennsylvania case law recognizes that express language of condition is sufficient to establish a pay-if-paid condition precedent. Moreover, the Court expressly rejected the trial court's notion that additional, redundant language was necessary to underscore the parties' intent to create a valid pay-if-paid clause.

The Pass-Through Liquidating Agreement

However, to make matters more complicated, the contract also contained a provision that described a process by which Sloan could sue Shoemaker for final payment. The language provides:

[I]f within six months of the date that final payment is due to [Shoemaker from the owner], [Sloan] has not received final payment for its work [Sloan] may pursue its claim against [Shoemaker] and its surety for final payment as follows:

If within six months of the date that final payment is due and payable to [Shoemaker], [Shoemaker] commences a legal proceeding against [owner] ... to resolve its own claim for final payment, [Sloan] agrees not to pursue its claim against [Shoemaker] or [Liberty Mutual] unless and until the contract dispute

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Pay-if-Paid Provision *(continued)*

resolution and all appeals thereto are completed and become final ...

Upon completion of the Contractor Dispute Resolution ... [Sloan] may pursue any remaining claim for final payment it may have against [Shoemaker] or its surety.

Elsewhere, the contract provided:

[I]f [Sloan's] claims are prosecuted or defended by [Shoemaker] ... the [Sloan] agrees ... to pay or reimburse [Shoemaker] for all expenses and costs, if any, in connection therewith.

The court concluded that this did not invalidate a pay-if-paid provision. To the contrary, it simply provided an endpoint for the pay-if-paid provision by specifying when and for how much Sloan may sue Shoemaker in certain conditions. According to the court, this language constitutes a “pass-through” liquidating agreement. The fact that Sloan was not a party to the lawsuit was of no moment because \$5 million of the \$6.5 million that Shoemaker sought against the owner was for the exclusive benefit of its subcontractors.

Therefore, the court held that Sloan must bear its share of the owner's failure to pay by accepting only a *pro rata* share of the recovery by Shoemaker rather than the full balance of its contract. According to the court, to hold otherwise would eliminate the incentive of the contractor to pursue claims for the benefit of subcontractors.

Protection of Health and Safety *(continued)*

controls, roadway repairs, a final paving course, installation of streetlights and repair of drainage structures. The trial court concluded the township had demonstrated an immediate threat to health and safety and further determined that the preliminary injunction was necessary to restore the parties to the *status quo*. Lexon appealed the preliminary injunction to the Commonwealth Court of Pennsylvania.

The Commonwealth Court affirms the injunction, but revises the scope of work for Lexon to immediately perform.

Waiver

Liberty Mutual also argued that it was entitled to deduct Shoemaker's legal fees and costs from Sloan's recovery. Before deciding the merits of that claim, the court had to address whether the claim was preserved or waived. Sloan argued that because the particular issue was not raised within 45 days of Sloan's initial claim, it was waived per the terms of the bond. The bond required that Liberty Mutual respond to Sloan's claims within 45 days. Liberty Mutual only *generally* denied Sloan's entire claim within 45 days. But rather than explaining the various offsets it planned to claim, it simply reserved its rights and defenses. The trial court found, and the Third Circuit agreed, that Liberty had not waived its position. The court found that a surety is not obligated to state every reason or contention it has or may later have in connection with a general denial of claim in order to preserve such claims and positions.

The Inclusion of Attorneys' Fees as Expenses

Turning to the merits of the offset position, the court concluded that the term “expenses and costs” in the contract included attorneys' fees, in addition to other litigation-related expenses and costs. The Third Circuit noted that although the general rule is that attorneys' fees are not recoverable from an adverse party, an exception applies where there is an agreement to the contrary. In this case, the most natural meaning of “expenses and costs” in a paragraph discussing procedural mechanisms for lawsuits and other dispute resolution proceedings is that the term includes attorneys' fees. ■

On appeal Lexon argued that the township had an adequate remedy at law – breach of the development bond and resulting damages – and therefore a preliminary injunction was improper. The Commonwealth Court, relying upon Pennsylvania's Municipalities Planning Code, disagreed. Citing a provision within the code that granted “the governing body of a municipality” the ability to enforce any bond “by appropriate, legal and *equitable* remedies” (emphasis added), the court determined that the township had no adequate remedy at law. In a somewhat circular fashion, the court explained that “forcing the Township to pay for the improvements before seeking relief from the Courts, as Lexon suggests, would be contrary to the legislative intent behind §511 [of the

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Protection of Health and Safety *(continued)*

Municipality’s Planning Code] and deprive the Township of its statutory remedy [of equitable relief].”

Yet, the court also recognized that the objective of the preliminary injunction is to preserve the *status quo*, which is defined as “the last peaceable and lawful uncontested status preceding the underlying controversy.” In determining this status, the Commonwealth Court looked to the point in time when the developer abandoned its duties under the land development agreement and, as a consequence, triggered the surety’s responsibilities. Thus, any of the abandoning developer’s improvements that required repair post-abandonment to protect health and safety were ripe for preliminary injunctive relief.

However, such relief would not include completing work that the developer had not yet performed at the time it abandoned the project. For example, the court agreed with the trial court that Lexon was required to immediately fund the township for correcting flaws in the binder course of the roadway, but Lexon was not required to immediately fund final paving. The court explained that the developer had completed the binder course, albeit deficiently, prior to abandoning the project; subsequent to its abandonment, trenches developed and created flaws within the binder course. The surety was required through a preliminary injunction to immediately fund repairs for the binder course. However, the developer had not yet performed any final paving, and thus, requiring the surety to immediately fund the final paving work would not return the parties to the *status quo*.



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What it means

The apparent lesson of Hatfield Township is that under Pennsylvania law, a surety may be ordered to immediately fund public improvements under a development bond, to the extent that an obligee/municipality must **perform repairs** to an abandoning developer’s work in order to **protect the health and safety** of residents in, or travelers through, a development. A surety’s immediate obligation, however, is only to maintain the *status quo* – that is, to maintain, as complete and properly performed, the work that the developer performed before abandoning the project. While the surety also may be required under the terms of the bond to fully complete other work that the principal/developer agreed to perform in the development agreement, that obligation in its entirety is not properly the subject of a preliminary injunction.

Accordingly, when faced with a development bond claim under Pennsylvania law, the surety should be prepared to immediately fund repairs to the abandoning developer’s work to the extent that such repairs are needed to protect the health and safety – or face the prospect of a motion seeking to compel such funding. ■

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