THE NATIONAL LAW REVIEW

Seventh Circuit Holds Pay-if-Paid Provisions Are Not Void Under Indiana Public Policy: Construction Law Alert

BARNES & THORNBURG LLP
Article By
Scott R. Murphy
Clifford J. Shapiro
Barnes & Thornburg LLP

- Construction Law
- Insurance Reinsurance & Surety

- Indiana
- 7th Circuit (incl. bankruptcy)

Tuesday, May 15, 2012

On May 11, 2012, the U.S. Court of Appeals for the Seventh Circuit issued a decision in ***BMD Contractors, Inc. v. Fidelity and Deposit Company of Maryland*** (No. 11-1345), affirming a lower court summary judgment in favor of a surety on a payment bond.

The case arose from the construction of an automobile transmission manufacturing plant. Before construction was completed, the owner filed bankruptcy, resulting in missed payments that flowed down the chain of contractors. BMD, a second-tier subcontractor, sued on a payment bond. The surety prevailed because its principal, with whom BMD contracted, was not liable for payment under the “pay-if-paid” provision in the subcontract:

> “It is expressly agreed that the owner's acceptance of the subcontractor's work and payment to the contractor for the subcontractor's work are conditions precedent to the subcontractor's right to payments by the contractor.”

The Court rejected arguments that the conditional language in the subcontract should be construed as a “pay-when-paid” clause which governs the timing of payment, but not the ultimate obligation to pay.

Sitting in diversity jurisdiction and applying Indiana law, the Court made its best prediction of how the Indiana Supreme Court would decide the case. While Indiana courts had not previously decided the specific issue, based on prior decisions the Court concluded that the condition precedent language in the subcontract was sufficient to create a pay-if-paid provision under Indiana law.

The Court also rejected arguments that such provisions are void under Indiana public policy, given Indiana's “strong background presumption favoring freedom of contract” and the clearly stated language in the subcontract. The surety could assert all defenses available to its principal, including the pay-if-paid provision, and was not liable under the payment bond.