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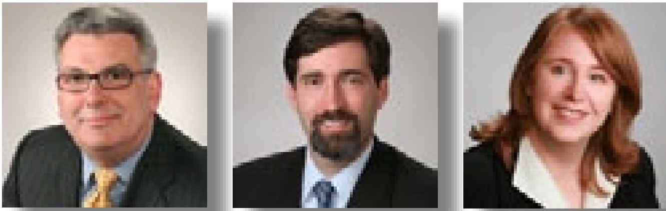

CONSTRUCTION UPDATE – March 2014

by Rich Reizen, Chair, Eric Sparks, Partner, and
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"The Evolution of Additional Insured Endorsements" by Ellen Chapelle

Published in the ABA Construction Litigation Winter 2014 newsletter, Ellen's article provides timely insight on both the recent changes to the standard CGL insurance policy endorsements and how they may affect the construction industry. Click here: "The Evolution of Additional Insured Endoresments"

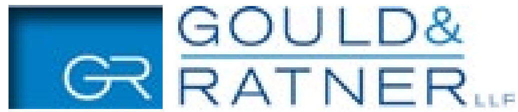
Pay-if-Paid Clause Held to Be Enforceable as a Contract Defense (Though Not a Lien Defense)

The U.S. Court of Appeals for the Seventh Circuit has held that under Indiana law, a "pay-if-paid" clause under a subcontractor's construction contract is a valid defense to the subcontractor's claim for payment under its contract with its general contractor. *BMD Contractors, Inc. v. Fidelity and Deposit Company of Maryland*, 679 F.3d 643 (7th Cir. 2012).

Those in the construction industry will be familiar with provisions in subcontracts that state either (a) that the subcontractor's payment will be due only when the contractor has been paid by the owner for the subcontractor's work (known as a "pay-when-paid" clause) or (b) that the subcontractor's payment will be due from the contractor only if the contractor has been paid for that work under its contract with the owner (known as a "pay-if-paid" clause). In Illinois, for example, it has been understood that the Mechanics Lien Act (770 ILCS 60/ 0.01 *et seq*.) provides that pay-if-paid clauses cannot be asserted as a defense against payment under the Mechanics Lien Act. Similarly, under Indiana law, the right to record a lien could not be prevented by a contractual condition that requires payment from a third person (*e.g.*, a pay-if-paid clause).

However, the 7th Circuit Court held that, despite the existence of Indiana's statutory provision that prohibited the conditioning of lien rights upon a pay-if-paid clause, the pay-if-paid clause could be asserted as a valid defense to the subcontractor's claim for payment under its contract with the general contractor (and also a valid defense for the contractor's surety).

In Illinois, the courts have not yet addressed this specific issue in connection with the Illinois Mechanics Lien Act, but the *BMD Contractors* case provides a guide for what may come. For general contractors (and their sureties), the case is a helpful reminder to require 'pay-if-paid' clauses in subcontracts. For subcontractors, the case is a warning to avoid 'pay-if-paid' clauses where possible and to keep a sharp eye on perfecting other remedies (such as lien rights) when such clauses cannot be avoided.



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Legislative News

The Illinois General Assembly is considering a bill (HB 4657) that will radically alter the Mechanics Lien Act (770 ILCS 60/0.01 *et seq*.), as it would permit the substitution of a bond in place of a lien claimant's right to foreclose its lien and sell the property to satisfy the lien claim. Under the proposed bill, a lien claimant's leverage stands to be greatly reduced. Currently, the bill has been referred to the House Rules Committee. If the bill is passed, it will be the most significant revision to the Mechanics Lien Act since 1903.

The Illinois General Assembly is considering a bill (SB 3023) to amend the Mechanics Lien Act that, among other things, would make it against public policy and unenforceable to enter into an agreement to subordinate one's right to a mechanics lien to another's interest if the consideration for that subordination agreement is the awarding of the construction contract itself.

The Illinois General Assembly is also considering a bill (HB 5663) to amend the Mechanics Lien Act which would require all construction contracts to be in writing in order to give rise to a mechanics lien claim. Needless to say, if this bill were passed, it would seriously change construction practices throughout the State.

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