



# Construction Newsletter

A Summary of Important Recent Construction and Insurance Developments

May/June 2009

Volume XIV Number 3

## IN VIRGINIA, FLOW DOWN PROVISIONS MAY BE USED TO ESTABLISH PROCEDURAL REQUIREMENTS RELATED TO DISPUTE RESOLUTION

Subcontracts in the construction industry commonly contain a “flow down” provision. In a typical flow down provision, the general contractor includes language that requires subcontractors to assume the same obligations and requirements toward the general contractor that the general contractor assumes toward the owner. Additionally, subcontractors are entitled to the prime contract’s dispute-resolution and redress provisions in their disputes with the general contractor. The most basic flow down provisions require that subcontracts incorporate the terms of the prime contract, the general conditions, and all other prime contract documents. Of course, flow down provisions are nearly infinitely flexible, and the owner may mandate that certain obligations in the prime contract appear in subcontracts, while permitting the general contractor to exclude other portions of the prime contract in its subcontracts.

Virginia law recognizes the construction industry practice of including “flow down” provisions in subcontracts, and permits flow down provisions to include procedural requirements governing litigation. In *Steadfast Ins. Co. v. Brodie Contractors, Inc.*, 2008 U.S. Dist. LEXIS 88448, Judge Kiser of the U.S. District Court for the Western District of Virginia granted summary judgment for the defendant masonry subcontractor, who argued that the general contractor failed to file suit within the requisite statute of limitations. The contractor filed suit against the subcontractor a little more than five years after the substantial completion date. Accordingly, the dispositive issue was whether the substantial completion date or some other date triggered the running of Virginia’s five-year statute of limitations for breach of a written contract.

The general contractor, Skanska USA Building, Inc. (“Skanska”), entered into a prime contract with the Danville Regional Medical Center (“DRMC”) for remodeling and renovation work. The prime contract contained a provision that stated that all subcontract agreements “shall allow to the Subcontractor, unless specifically provided otherwise in the subcontract agreement, the benefit of all rights... that the Contractor, by the Contract documents, has against the owner.” In forming a subcontract with Brodie Contractors, Inc. for masonry work, Skanska implemented the prime contract’s flow down provision by including language in the

subcontract that stated that “[t]he Contract Documents consist of this Agreement and... the Agreement between Owner and Contractor for the... Project, all Conditions to the Agreement between the Owner and Contractor (General, Supplementary and any other Conditions)...” Although Skanska could have modified Brodie’s rights with respect to Skanska, it declined to, and instead included all of the provisions of the prime contract in the subcontract.

One of the provisions of the prime contract addressed the date on which the statute of limitations would begin to run for any claims. In relevant part, the language of the prime contract stated that, with respect “to acts or failures to act occurring prior to the relevant date of substantial completion, any applicable statute of limitations shall commence to run any alleged cause of action shall be deemed to have accrued in any and all events not later than such date of substantial completion [*sic*].” Despite this inelegant language, it is apparent that the statute of limitations began to run on any claims by the owner against the general contractor for claims arising from the general contractor’s pre-substantial completion acts by no later than the substantial completion date.

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## VIRGINIA MECHANIC'S LIENS AND THE 150-DAY RULE

According to Virginia Code § 43-4, a mechanic's lien claimant's recovery is limited to the contract value of labor and material furnished "150 days prior to the last day on which labor was performed or material furnished to the job preceding the filing" of the memorandum of lien, although there are exceptions to this "150-day rule," including, for example, retainage. Virginia courts strictly construe this statutory provision, invalidating liens which include claims for labor and material beyond the 150-day limitations period. One reason for this requirement is to protect owners from stale claims. Section 43-15 of the Virginia Code, however, provides that,

*No inaccuracy in the memorandum filed, or in the description of the property to be covered by the lien, shall invalidate the lien, if the property can be reasonably identified by the description given and the memorandum conforms substantially to the requirements of §§ 43-5, 43-8 and 43-10, respectively, and is not willfully false.*

(Emphasis added.) A potential issue arises, therefore, when a lien claimant mistakenly includes amounts earned outside of the 150-day limitations period in its memorandum of lien. Should a court strictly construe § 43-4 of the Virginia Code and invalidate the lien or apply § 43-15 and treat such a mistake as an inaccuracy and allow the lien claimant to pursue enforcement of its lien rights? In *Smith Mountain Building Supply, LLC v. Windstar Properties, LLC*, 227 Va. 387 (2009), the Virginia Supreme Court held that the inclusion of charges for materials supplied outside the 150-day limitation period in § 43-4 of the Virginia Code renders such a lien invalid and unenforceable.

In *Smith Mountain Building Supply*, a material supplier furnished materials to the general contractor on two projects from June 24, 2005 to March 9, 2006, with March 9, 2006 being the last day on which the material supplier furnished materials to the two residential projects. Applying the 150-day limitation period prescribed by § 43-4 of the Virginia Code, the material supplier could lien the projects for work performed from October 10, 2005 through March 9, 2006, i.e., 150 days prior to the last day of work. The material supplier timely filed two memoranda of mechanic's liens, though mistakenly included charges for materials furnished to the projects prior to October 10, 2005.

The owner of the property filed a motion for summary judgment, asserting that the material supplier's inclusion of sums due for materials furnished prior to October 10, 2005 rendered the memoranda of mechanic's liens invalid. The material supplier argued that any such inclusion was a mistaken inaccuracy and that, under § 43-15 of the Virginia Code, such inaccuracy could be excused by the court.

The material supplier directed the Court's attention to its decision in *Reliable Constructors, Inc. v. CFJ Properties*, 263 Va. 279 (2002), in which the court found that a lien claimant's inclusion of a fine in its memoranda of liens constituted an inaccuracy within the meaning of § 43-15 and that the

inaccuracy was not willfully false. The material supplier argued that the inclusion of charges for materials furnished to the projects prior to October 10, 2005 was an equivalent inaccuracy.

The court rejected the lien claimant's argument, distinguishing *Reliable Constructors* from the instant appeal on the basis that, in *Reliable Constructors*, the court focused on the nature of the sum erroneously included in the memorandum of lien. The court reasoned that a fine is not a sum due for labor performed or materials furnished and, therefore, could not be recovered in a mechanic's lien action regardless of the 150-day rule. In *Smith Mountain Building Supply*, by contrast, the inaccuracy in the material supplier's lien was the sum claimed for materials furnished to the projects, an issue directly addressed in § 43-4 of the Virginia Code. Accordingly, this inaccuracy violated the express requirements of § 43-4 of the Virginia Code.

The lesson to be learned from *Smith Mountain Building Supply* is that, in pursuing a mechanic's lien, a lien claimant risks total invalidation of its lien if it claims sums due from beyond the 150-day limitations period. Lien claimants should be careful in preparing a memorandum of lien, cognizant of the effect that including sums due for stale work may have on their lien rights.

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In Virginia, the running of the statute of limitations is considered to be a right enjoyed by defendants. The Virginia Supreme Court has stated that "[t]he immunity from suit that arises by operation of the statute of limitations is as valuable a right as the right to bring the suit itself." Consequently, the protection of the statute of limitations is considered a "right" which the subcontractor enjoyed under the flow down provision of the prime contract between Skanska and DRMC. Moreover, any language in the prime contract regarding the statute of limitations becomes part of the subcontract by virtue of the subcontract's incorporation of all prime contract documents into the subcontract. As a result, any act or omission on the part of the subcontractor is treated the same for statute of limitations purposes as an act or omission on the part of the general contractor. In this case, the statute of limitations began to run on the substantial completion date, August 19, 2002.

The general contractor, who brought a claim against the subcontractor more than five years after August 19, 2002, argued that the statute of limitations should not have begun to run until the general contractor sent the subcontractor a letter formally rejecting the subcontractor's work. However, Judge Kiser found no ambiguity in the flow down provision, and applied the statute of limitations to the subcontract as it was specified in the prime contract. The lesson to be learned, therefore, is that all parties to construction contracts and subcontracts in Virginia must be aware of any potential flow down provisions and must recognize that contractual provisions affecting their rights may not necessarily be found in the subcontract itself.

## CONSTRUCTION NEWSLETTER

## VIRGINIA COURT REAFFIRMS THE VALIDITY OF PAY-IF-PAID PROVISIONS IN CONSTRUCTION SUBCONTRACTS

Construction subcontracts frequently contain “pay-if-paid” clauses which, if enforceable, excuse a general contractor from paying its subcontractors until the general contractor receives payment from the owner for the subcontractor’s work. This insulates the general contractor from paying the subcontractor out-of-pocket and shifts the risk of owner non-payment from the general contractor to the subcontractor. The validity of such pay-if-paid clauses varies from state-to-state, as some states find such provisions to be unfair to subcontractors and, therefore, against public policy and unenforceable. Recently, such a conditional payment provision was considered in *Universal Concrete Products Corp. v. Turner Construction Co.*, Civil Action No. 2:08cv298, (E.D. Va. 2009).

In *Universal Concrete*, the general contractor entered into a subcontract under which the subcontractor agreed to fabricate certain precast architectural concrete for a new residential project. The parties further agreed, in relevant part, that “[t]he obligation of [the general contractor] to make a payment under this Agreement...is subject to the express condition precedent of payment therefor by the Owner.”

The subcontractor commenced work in July 2007. The subcontractor continued performing until February 2008. Apparently, in the fall of 2007, the owner began experiencing financing issues of which the general contractor was made aware. Nonetheless, the general contractor permitted its subcontractors to continue working until March 2008, at which point the general contractor notified the subcontractor that the owner had stopped work on the project.

Having not been paid for its work, the subcontractor demanded payment and eventually filed suit against the general contractor. Among other claims, the subcontractor alleged that the general contractor breached the subcontract by failing to make timely payments and by failing to deal with the subcontractor in good faith, an implied obligation of any contracting party.

In response, the general contractor filed a motion for summary judgment. Addressing the breach of contract claim, the general contractor contended that it was entitled to summary judgment because it had not been paid by the owner for the subcontractor’s work and, therefore, pursuant to the pay-if-paid language of the subcontract, no payment was due. The court agreed with the general contractor’s statement of the law finding that Virginia contracts (construction or otherwise) must be construed and enforced as written, without adding terms that were not included by the parties. The court explained that, because the general contractor and subcontractor had agreed to a subcontract including clear and un-

ambiguous pay-if-paid terms, the court was required to enforce that contractual provision. As the evidence before the court indicated that the owner had not made payment to the general contractor for the work performed by the subcontractor, the court granted the general contractor’s motion for summary judgment as to the subcontractor’s breach of contract claim.

**B**ecause the general contractor and subcontractor had agreed to a subcontract including clear and unambiguous pay-if paid terms, the court was required to enforce that contractual provision.

Next, the court considered the subcontractor’s breach of good faith claim. As a general rule, every contract includes an implied covenant that the parties will act in good faith with each other. In *Universal Concrete*, the subcontractor alleged that the general contractor breached this implied duty because it knew of the owner’s financial problems and, despite this knowledge, allowed the subcontractor to continue its work on the project. The general contractor sought to dismiss

this claim on the basis that it claimed to have notified the subcontractor of the financing issues and alleged that the owner’s stop-work order applied only to on-site construction, not off-site fabrication of precast concrete panels. Accordingly, the general contractor sought summary judgment on the subcontractor’s claim on the basis that it did not act in bad faith. The court concluded, however, that it could not grant the general contractor’s motion for summary judgment on this claim because there were a number of factual questions yet to be determined; thus, the claim was not ripe for adjudication at this stage of the litigation. Accordingly, the court allowed the subcontractor’s breach of good faith claim to proceed to trial. However, at trial the court ruled that the subcontractor failed to prove that the contractor breached the duty of good faith.

While the subcontractor’s appeal of the trial court’s decision is pending, the court’s ruling in *Universal Concrete Products v. Turner Construction* highlights the adverse effect of a pay-if-paid provision on a subcontractor’s ability to recover on a breach of contract claim.

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from denial of that motion—regardless of whether the litigant is in fact eligible for a stay.” The underlying merits of a request for a stay are irrelevant and an appellate court even has jurisdiction over frivolous claims for a stay.

As many construction contracts include arbitration language, *Arthur Andersen* will have a lasting impact on the industry, insofar as it confirms that nonparties to the agreement may be able to compel arbitration of disputes arising under the construction contract and that a party seeking to compel arbitration may immediately appeal an adverse decision.

## CONSTRUCTION NEWSLETTER

**U.S. SUPREME COURT HOLDS THAT STATE LAW DETERMINES  
HOW ARBITRATION AGREEMENTS ARE ENFORCED  
UNDER THE FEDERAL ARBITRATION ACT**

In a recent decision with far-reaching ramifications for the construction industry, the U.S. Supreme Court recently held that courts must look to state law when determining whether to stay proceedings in favor of arbitration under the Federal Arbitration Act (“FAA”).

In *Arthur Andersen LLP v. Carlisle*, 129 S. Ct. 1896 (2009), certain individual investors (“Plaintiffs”) sought to minimize the tax consequences from the 1999 sale of their construction-equipment company. In pursuit of a tax-reduction strategy, Plaintiffs’ accounting firm, Arthur Andersen LLP (“Arthur Andersen”), introduced the Plaintiffs to Bricolage Capital, LLC (“Bricolage”) and the law firm Curtis, Mallet-Prevost, Colt & Mosle, LLP, both of which served the Plaintiffs in an advisory role. These advisors recommended a tax shelter strategy where illusory losses were generated through purchasing foreign currency options and stock warrants in newly-created limited liability companies (the “LLCs”). The newly-created LLCs had investment-management agreements with Bricolage that called for the arbitration of disputes.

The IRS declared the tax shelter illegal and ultimately found Plaintiffs liable for taxes, penalties, and interest. Plaintiffs then filed a lawsuit against Bricolage, Arthur Andersen and others (collectively “Defendants”) in federal court in Kentucky. Defendants sought to stay the litigation and demanded that Plaintiffs arbitrate according to the LLC-Bricolage agreements.

Bricolage subsequently filed for bankruptcy rendering its motion moot. Plaintiffs fought against arbitration on the ground that the LLCs, not Plaintiffs, were signatories to the agreements with Bricolage. The district court denied the Defendants’ motion to stay and compel arbitration, from which Defendants appealed. The Court of Appeals for the Sixth Circuit dismissed the appeal, noting that the appeal was meritless because Defendants sought to arbitrate on the basis of the LLCs’ agreements with Bricolage.

The Supreme Court reversed the Sixth Circuit’s decision. First, the Supreme Court stated that the Defendants’ motion to arbitrate had merit. The Supreme Court held that, under the FAA, state contract law governs the scope of arbitration provisions, including which parties are bound to them. As state law can permit nonparties to an arbitration agreement to enforce such a provision, arbitration may be appropriate, even if pursued by a nonparty to the original arbitration agreement.

The Supreme Court also decided that the Sixth Circuit had jurisdiction over the appeal. The FAA states that “an appeal may be taken from...an order...refusing a stay of any action,” creating an exception to the usual rule that appeals can only be taken from a final decision. As the Court reasoned, any litigant who asks for a stay...is entitled to an immediate appeal

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