SUBJECT: Enforceability of contingent payment clauses in construction contracts

COMMITTEE: Business and Industry — favorable, with amendment

VOTE: 7 ayes — Giddings, Elkins, Darby, Bohac, Martinez, Solomons, Zedler

1 present not voting — Castro

0 nays

1 absent — Bailey

SENATE VOTE: On final passage, March 14 — 30-0, on Local and Uncontested Calendar

WITNESSES: For — Michael J. Chatron, AGIC Texas Building Branch; Ed Reeve, Texas Contractors Association; Roy A. Mack; (*Registered, but did not testify:* Renea Beasley, Independent Electrical Contractors of Texas-IEC of Texas; Mackie Bounds, Texas Construction Association; Richard M. Bruns, DFW Drywall and Acoustical Contractors Association; Rodney Hooker, Texas Burglar and Fire Alarm Association; Jim Reynolds, Mechanical Contractors Association of Texas and Mechanical Contractors Association of Austin; Brian E. Chester; Robert L. Vallance II)

Against — (*Registered, but did not testify:* Jack Erskine, Austin Industries)

BACKGROUND: Contingent payment clauses are payment provisions that often are negotiated into construction contracts. They make payment for work performed by one party conditional upon receipt of payment by another person. Typically, the general or prime contractor will include a provision in its subcontract agreement that makes its obligation to pay the subcontractor conditional upon the general or prime contractor's receipt of payment from the owner.

Several laws protect contractors and subcontractors who are not paid by project owners. Lien laws allow contractors to hold a security interest in the property itself and receive payment from the proceeds of the property's sale following the bankruptcy of the property owner, for example. The

Prompt Pay Act (Property Code, ch. 28) allows prime contractors and subcontractors to cease work on a project, following a reasonable period of nonpayment and notice to the obligor, until they are paid. Under the Texas Construction Trust Act (Property Code, ch. 162), all construction funds on a project are held in a trust fund for the benefit of the people that worked on it. If a general contractor is paid by an owner and does not pay the subcontractor, the subcontractor can go to the local district attorney, claiming that the general contractor has misappropriated trust funds, which could lead to the indictment of the general contractor on charges of a third-degree felony (two to 10 years in prison and an optional fine of up to $10,000) for failure to pay the subcontractor.

DIGEST: SB 324, as amended, would create Business and Commerce Code, sec. 35.521, governing the enforceability of contingent payment clauses in construction contracts and defining the rights and duties of the parties involved — the contingent payor (general contractor), the contingent payee (subcontractor), and the obligor (project owner).

A general contractor could not enforce a contingent payment clause if the owner's nonpayment was because the general contractor did not meet all its contractual obligations, unless the failure to meet the obligations was the fault of the subcontractor. The general contractor could not enforce a contingent payment clause after the effective date of a written notice submitted by the subcontractor objecting to further enforceability, unless the owner was a government entity that made a successful claim of sovereign immunity and the general contractor had exhausted all other means of collecting funds. The written notice could not be sent until 45 day after the subcontractor submitted a written request for payment for a regular progress payment or an invoice. The notice would become effective on the latest of the:

- 10th day after the general contractor received the notice;
- eighth day after interest began to accrue against the owner under a contract for a private, real property improvement or public building or public work of the federal government; or
- the 11th day after interest began to accrue against the owner under a contract for a public project for a state agency or political subdivision.

This notice would not prevent enforcement of a payment clause if the project owner had a dispute regarding the subcontractor's failure to meet

its contract requirements and the general contractor gave written notice to the subcontractor that the subcontractor's notice did not prevent enforcement of the payment clause. The subcontractor would have to receive notice from the general contractor by the later of the fifth day before the date the written notice from the subcontractor became effective or the fifth day after the date the general contractor received the notice from the subcontractor.

Once the subcontractor had been paid the obligation that gave rise to the notice provided to the general contractor, the contingent payment clause would be reinstated for work performed or materials furnished after payment was received.

A general contractor or its surety could not enforce a contingent clause if the subcontractor was considered to be in direct contractual relationship with the project owner. A contingent clause also could not be enforced if it was proven unconscionable — that is, if the general contractor had not:

- diligently communicated in writing to the subcontractor about the financial viability of the project owner and the existence of an adequate financial arrangement to pay, prior to the contract becoming enforceable;
- reasonably attempted to collect amounts owed from the owner; and
- made, or offered to make, an assignment to the subcontractor of a cause of action against the owner for the amounts owed to the subcontractor by the general contractor and offered assistance in the collection efforts.

To exercise diligence in communicating the financial viability of the project owner, the general contractor would be required to provide the subcontractor with the name, address, and business phone of the owner and the name and address of the surety on any payment bond related to the contract. For private property improvements, the general contractor also would have to furnish:

- a description of the property on which the improvements were being constructed;
- a statement by the property owner of the amount and terms of the loan, whether there was a foreseeable default by the owner, and the contact information for the borrowers and lenders if a loan had been obtained for the project; and

- a statement from the property owner, supported by evidence from all applicable banks or other depository institutions, of the amount, source, and location of funds available to pay the balance of the contract if there was no loan or the loan was not sufficient to pay for the entire project.

For public projects performed for a state or local government, the general contractor would furnish a statement from the government entity that funds were available and authorized for the full contract amount. For public projects performed for the federal government, the general contractor would furnish the name of the contracting officer. The general contractors and subcontractors could cease performance on a private project or a state or local government project if the government entity did not provide information on the financial viability of the project after the 30th day following the entity's receipt of a written request for the information.

A contingent payment clause could not be used as a basis for invalidation of the enforceability or perfection of a mechanic's lien. The bill would make the assertion of a contingent payment clause an affirmative defense to a civil action for payment under a contract. It would not affect any provision for the timing of payment under a contract if payment would be made in a reasonable time. The bill would prohibit a person from waiving rights under this section by contract or other means, and it would not allow a project owner to stipulate that a general contractor could not allocate risk by means of a contingent payment clause.

The provisions of this bill would not apply to a contract that was solely for:

- design services;
- the construction or maintenance of a road, highway, street, bridge, utility, water supply project, water or wastewater plant, water and wastewater distribution or conveyance facility, wharf, dock, airport runway, drainage project, or related type of project associated with civil engineering construction; or
- construction or improvements to a structure that was less than 10,000 square feet and was a single family residence, duplex, triplex, or quadruplex.

In addition, the bill would not apply to a subcontract under a prime contract in excess of $10 million.

The bill would take effect September 1, 2007, and would apply only to contracts or agreements entered into on or after that date.

SUPPORTERS SAY:

SB 324, as amended, would serve the interests of both general contractors and subcontractors by providing a fair system in which these parties would share the risk of an owner's nonpayment. While an owner often may refuse to pay for construction on the grounds that terms of the contract have not been met, it is also the case that some owners simply go bankrupt or fail to pay for reasons unrelated to the contract. The bill would allow for general contractors to take proper measures to obtain payment from project owners and also provide protections for subcontractors who should not bear the full burden of nonpayment.

When an owner does not pay even when all the terms of a contract have been met, both the general contractor and subcontractor are adversely affected. Because these parties share the common goal of getting paid, it is counterproductive for a general contractor to simultaneously seek obligations from the owner and defend suits from subcontractors. Before the subcontractor sought further action, the bill would give the general contractor 45 days to seek payment from the owner. It also would allow the general contractor to bring a cause of action against the project owner for the amounts owed to the subcontractor and assistance in the collection efforts. Setting a basis for cooperation between subcontractors and general contractors when nonpayment was the fault of neither party would help all contractors in the end.

Although contingent payment clauses often represent a legitimate business decision essential to the economic viability of both the general contractor and subcontractor, all too often unscrupulous general contractors use these clauses unfairly to subject subcontractors to risk they cannot control. These clauses can be exploited by contractors to avoid payment to subcontractors where the owner legitimately has withheld payment from the contractor because of poor performance. Even though the subcontractor was not at fault and had fulfilled its obligations, the subcontractor has little recourse to seek payment from the contractor.

Subcontractors that are not paid in a timely fashion still must pay employees, creditors, and other business expenses in the meantime. This

places a huge and unfair burden on the subcontractor. It is unfair that a subcontractor should finance construction projects without requiring general contractors to assume the same risk. Without some limits placed on contingent payment clauses, the issue no longer is one of timely payment, but of financial ruin.

While under current law subcontractors function as high risk lenders — providing labor and materials on credit that they will be paid — SB 324 appropriately would shift the obligation to pay for contractual services rendered in good faith back to the contractor. It would give a subcontractor recourse for obtaining payment for work that met contract requirements either by rendering the contingency clause unenforceable and pressuring the contractor to pay, or by prompting a contractor who prevailed against the owner to notify and pay the subcontractor in a timely manner.

Lien law is insufficient to protect subcontractors. There currently is some question as to whether a subcontractor with a contingent payment clause even can file a lien for nonpayment. Because payment is a contingency, it can be argued that the general contractor has no obligation to pay the subcontractor, and therefore that the subcontractor has no debt upon which to attach a lien.

Additionally, an owner has defenses to a lien attached by a subcontractor because the owner is in debt to the contractor, not the subcontractor. Even if lien law were more friendly toward subcontractors, there still would be an issue about contingent payment clauses regarding nonpayment under government contracts, because liens cannot be filed against public works. Some current statutes, such as the Prompt Pay Act and the Texas Construction Trust Act, are useful, but they do not provide enough protections for subcontractors.

Contingent payment clauses under current law have caused some subcontractors to inflate their prices to defray their costs in the event that they never receive payment. SB 324, by granting additional assurances to subcontractors that they would be paid, should help to reduce some of that inflation, thereby reducing the overall cost of construction projects.

OPPONENTS SAY:

This bill would hamper the negotiating power of parties that is fundamental to contract law. It would tip the scales so that subcontractors operated with substantially less risk while still signing on for a share of the profits. Requiring general contractors to shoulder more of the risk of not

being paid by an owner, but still having to pay subcontractors, could be damaging to many general contracting businesses. In turn, any factor that adversely affected the general contracting industry would trickle down to subcontractors that rely on general contractors for work. By preventing a contractor from spreading risk adequately, this bill could drive up the cost of construction to customers.

Nowadays, general contractors often have very few employees themselves and act more as brokers of labor. It is the subcontractors who perform most of the work and who should be paid for it. Any legislation permitting contingent payment clauses would set the precedent for a "pay when paid" philosophy that severely would cripple subcontractors who not only had not received payment for one job, but also had foregone the opportunity to work on other projects for which they could be paid. Instead of creating new requirements for contingent payment clauses, the Legislature should amend lien laws so that subcontractors would have recourse against an owner who did not pay the general contractor.

This bill also is unnecessary, because the issues it seeks to address already are covered in other areas of the law. A subcontractor can use lien law, the Prompt Pay Act, and the Texas Construction Trust Act to seek payment from contractors. These laws contain civil remedies, and even possible criminal penalties, that already are adequate to persuade a contractor to settle an account promptly with a subcontractor when justified.

OTHER OPPONENTS SAY:

If contingent payment clauses are to be permitted, it should be made mandatory that subcontractors receive statements from the owner regarding financial viability. Requiring that subcontractors submit a written request to obtain such information places the burden on them to obtain information that they should have already received in the first place. Subcontractors should have full knowledge of the sort of risk they are assuming in entering into any contract. There are many cases in which a subcontractor would not have performed work had it been privy to financial information about the project. In addition, homebuilding, highway construction, and other projects should not be excluded because there still exist risks in these industries from which subcontractors should receive protection.

NOTES:

The committee amendment would limit the applicability of the bill to a subcontract under a prime contract that was less than $10 million.

A similar bill in the 2005 regular session, HB 1146 by Chisum, passed the House, but died in the Senate after being reported favorably by the Senate Business and Commerce Committee and recommended for the Local and Uncontested Calendar.