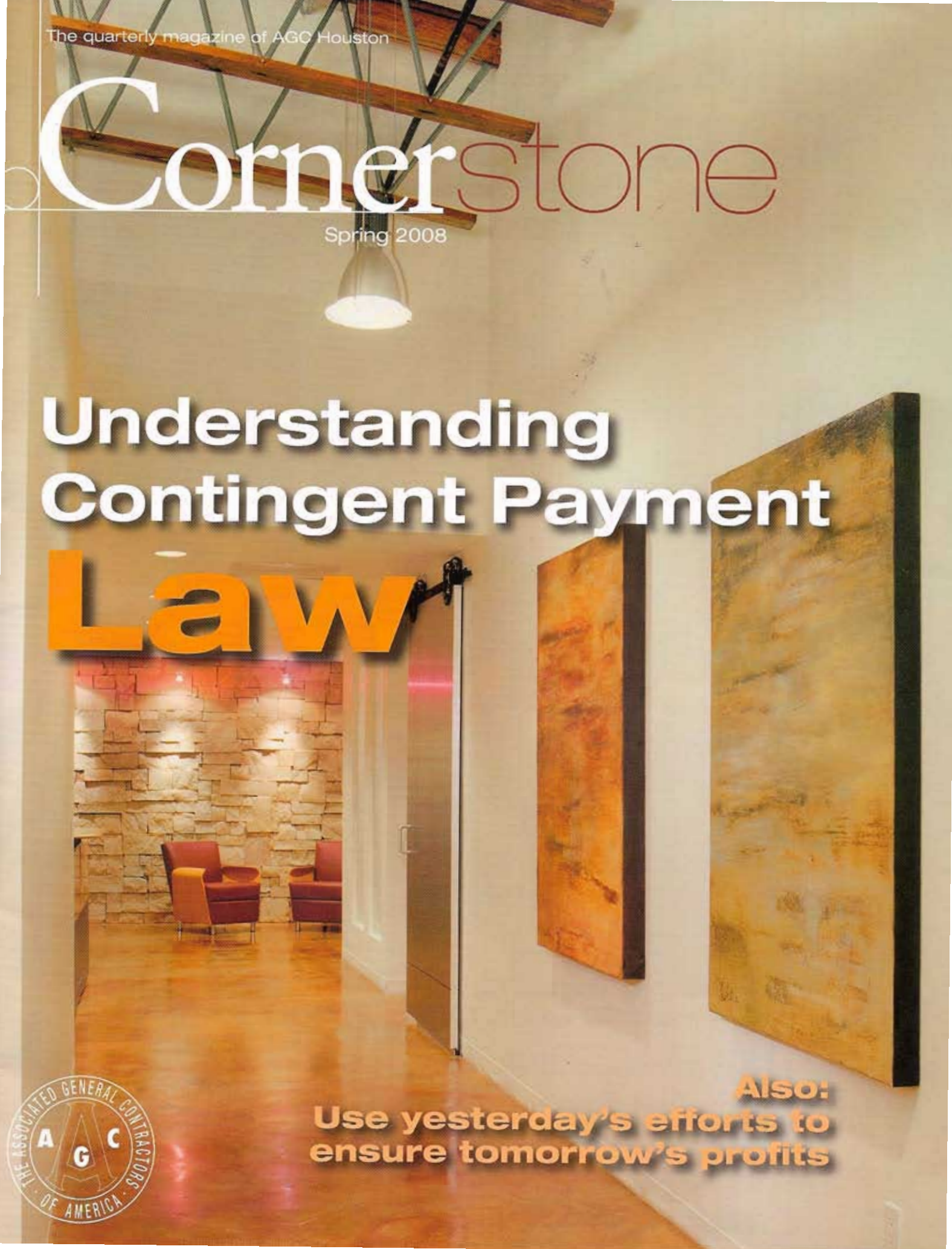
The quarterly magazine of AGC Houston

Cornerstone

Spring 2008

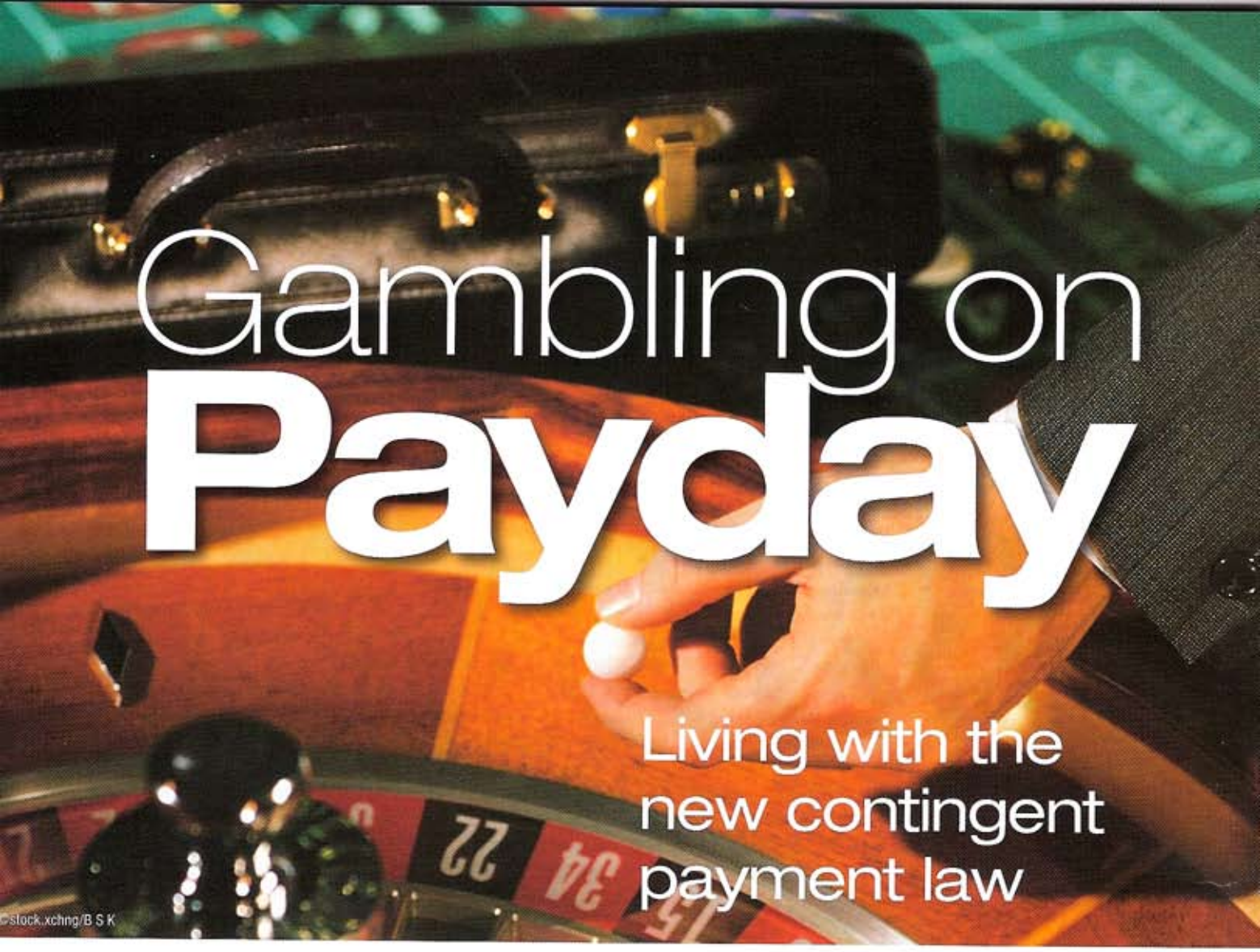


Understanding Contingent Payment Law

Also:
Use yesterday's efforts to ensure tomorrow's profits

Gambling on Payday

Living with the new contingent payment law



By Gavin McGee

The distinction between an enforceable contingent payment clause and one relating only to the timing of payment is often identified by the labels "pay if paid" versus "pay when paid" clauses.

For at least 50 years, the construction industry has struggled with the issue of contingent payment clauses in form contracts. Contingent payment clauses are usually subcontract provisions conditioning a general contractor's obligation to pay subcontractors on prior receipt of payment from project owners.

General contractor and subcontractor groups have fought over this issue for nearly 20 years.

Early draft legislation presented to the Texas Legislature by subcontractor organizations sought to void contingent payment clauses entirely. Subsequent drafts allowed enforcement of a contingent payment clause only if the clause was conspicuous and payment had been "wrongfully withheld...by the owner." None of this proposed legislation was accepted by the legislature and the battle waged on. On September 1, 2007, a new law went into effect that settled the argument—at least for now.

The Back Story

The conflict was first addressed in the courts. Reported cases involving these provisions date back to the early 1960s. In the mid '80s, Texas courts established what language was required in order to

make these clauses enforceable. Early versions of these payment provisions simply stated that general contractors didn't have to pay their subcontractors until they had received payment from project owners. The disputes arose when owners—for whatever reason—*never* paid general contractors, who then sought to avoid paying their subcontractors based on these clauses. The courts resolved the issue by requiring clear and specific language stating that receipt of payment from an owner was "an express condition precedent" to the contractor's obligation to pay its subcontractors, thus explicitly shifting the risk of nonpayment by the owner. Without this language, the courts held that these clauses related merely to *when* the general contractor must pay, not *if* he must pay; if the owner never paid, the general contractor was still responsible to pay its subcontractors within a reasonable time.

This led to the more stringent language we commonly see in form subcontracts today and ushered in the subcontractors' lobbying efforts to remove the provisions altogether. The distinction between an enforceable contingent payment clause and one relating only to the timing of payment is often identified by the labels "pay if paid" versus "pay when paid" clauses. This distinction remains important because the new law defines a contingent payment clause in accordance with the courts' description of an enforceable "pay if paid" clause, and the so-called "pay when paid" clauses are excluded from the law's restrictions.

After a final attempt at banning these clauses failed in the 2001 Legislative Session, groups representing subcontractors and general contractors began a concerted effort to draft a compromise bill that they could jointly present to the legislature. By the 2007 session, groups representing primarily commercial construction interests had reached an accord. Dissenting groups were excluded from the language of the bill—thereby clearing the way for an agreed submission. This year, with virtually no opposition, the legislature unanimously passed the compromise bill. Senate Bill 324—now Texas Business and Commerce Code section 35.521 and titled "Agreement for Payment of Construction Subcontractor"—was signed into law by Governor Perry on June 16, 2007. It went into effect on September 1, 2007. It significantly restricts but does not prohibit the use and enforceability of contingent payment clauses in certain construction contracts.

In a Nutshell

Outside the title there is no reference to "subcontractors" in the statute. The law refers to "obligors, contingent payors and payees" rather than owner, generals and subcontractors. It will apply equally to anyone seeking to enforce a contingent payment clause, whether they are general contractors, subcontractors or others. However, for ease of reference in this article, I will assume a typical commercial contract relationship between an owner (obligor), general contractor (contingent payor) and subcontractor (contingent payee), and reference the provisions of the new law accordingly. This article is an overview of a lengthy and complicated new law. It isn't intended to address all aspects of this statute, or even address all of its contents. It's intended as a review of the most relevant portions and commentary on some of the more likely practical issues regarding each. A copy of the actual statute is available from the AGC or online from a number of sources.

Primary restrictions on enforcement

1. Breach of Prime Contract

Neither a general contractor nor its surety can enforce a contingent payment clause if the general contractor is not paid due to a breach of its contract with the owner. However, this does not apply to enforcement against a subcontractor whose breach of its subcontract is the cause for the owner's non-payment. On its face, this appears a reasonable adaptation of the common law "prevention doctrine,"—*i.e.* one cannot use the non-occurrence of a condition to excuse his performance if he caused the condition not to occur. However, in application, several practical issues give cause for concern.

First, an owner may withhold payment for other reasons, yet claim it is due to a breach by the general contractor, or withhold funds for a suspected breach that turns out to be invalid. The new law provides little in the way of defense for a general contractor who has not breached its contract but may need time to prove that to an owner, or even a judge. Second, a legitimate problem with the work of one subcontractor, while not necessarily the fault of the general contractor, could still constitute a breach by the general contractor, thereby preventing the general contractor from enforcing the clause against any other subcontractor on the project—even if the owner is withholding funds well beyond the amount owed for the work of the defaulting subcontractor. The new law places no restrictions on the amounts the owner can withhold. The Prompt Payment Act—chapter 28 of the Texas Property Code—provides some protection for the general contractor in this situation. But exceptions in that statute create problems for the general in practical application.

2. Notice of Objection by Subcontractor

A subcontractor can challenge the enforcement of a contingent payment clause by submitting a written notice of objection to the general contractor on or after the 46th day after the subcontractor's submission of a written request for payment. If the subcontractor's work is not the cause of the owner's withholding payment, the contingent payment clause is unenforceable as to work performed after the notice becomes effective, as defined in the statute. Once the debt that was the subject of the notice has been satisfied, the contingent payment clause goes back into effect for work performed thereafter. Each subsequent objection to enforcement of the contingent payment clause must be the subject of a separate notice from the subcontractor in order to trigger the provisions of the statute.

The general contractor's only statutory defense to a subcontractor's notice—other than a limited exception for a sovereign immunity issue—is a written response notifying the subcontractor that the owner is withholding funds based on a good faith

dispute involving the subcontractor's work. The general contractor must send this response in accordance with a complicated set of alternative deadlines depending on the type of project. In most cases, the response will have to be received by the subcontractor within five days. This offers little time for a contractor to determine the reason(s) for an owner's failure to make a payment, and should be addressed in the prime contract.

3. Sham Contracts

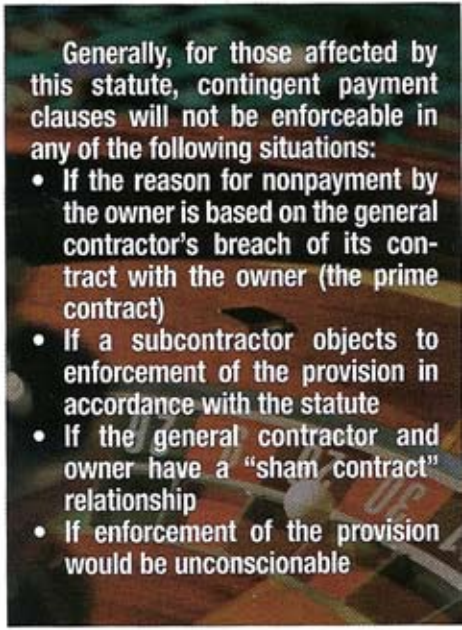
Contingent payment clauses may not be enforced by general contractors in a "sham contract" relationship with an owner, as defined in the Texas Property Code. Section 53.026 of the Code defines a "sham contract" as one in which either the contractor can effectively control the owner, or the owner can effectively control the contractor, through ownership of voting stock, interlocking directorships or otherwise.

This is the least significant exclusion under the new law. It was unlikely parties in such a business relationship could have enforced their contingent payment clauses even before this new statute, because of the prevention doctrine addressed above. The new law simply codifies this doctrine in the case of a "sham contract" relationship.

4. Unconscionability

Finally, the statute prohibits enforcing a contingent payment clause if doing so would be "unconscionable." This appears to be the legislature's attempt to address situations where payment is withheld by an owner due to financial difficulty, or lack of action by a general contractor to pursue payment on its subcontractors' behalf. General contractors can defend against a claim of unconscionability by furnishing certain information to subcontractors about the owner and its lender establishing the owner's access to adequate funding for a project, in addition to payment from the owner in good faith or offering to assign its contractual claim against the owner to the subcontractor.

The financial information required for this defense is described generally as credible evidence of the owner's financial viability, and the existence and adequacy of project funding. The statute outlines what specific information may be provided by a contractor to ensure his entitlement to this defense. There are three separate lists in the statute, depending on whether the project is private, state or federal. Private owners and the State are required to provide this information within thirty days of a request, or the general contractor,



Generally, for those affected by this statute, contingent payment clauses will not be enforceable in any of the following situations:

- **If the reason for nonpayment by the owner is based on the general contractor's breach of its contract with the owner (the prime contract)**
- **If a subcontractor objects to enforcement of the provision in accordance with the statute**
- **If the general contractor and owner have a "sham contract" relationship**
- **If enforcement of the provision would be unconscionable**

its surety, and subcontractors are relieved of their obligations to perform under the contract. A general contractor can only use this defense where it provided this information to subcontractors prior to their execution of the subcontract. Therefore, general contractors should consider conditioning their bids (especially any anticipated commencement and completion dates) on the timely receipt of this information from the owner and/or its lender(s).

Recommendations

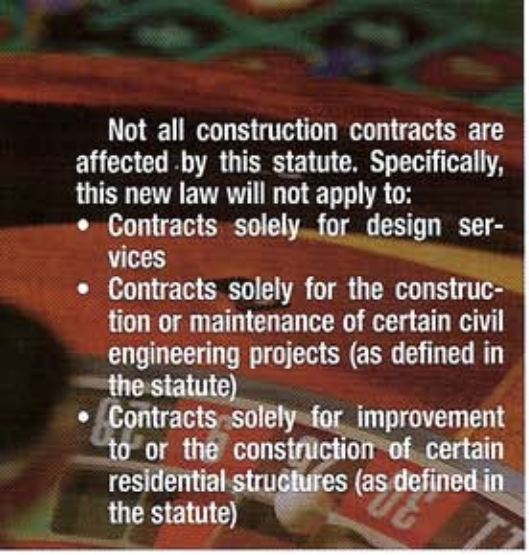
This new statute is complicated and untested. We can only speculate as to how Texas courts will interpret some of its more complicated and possibly conflicting provisions. There are additional issues and requirements not discussed in this article. But in an effort to address the issues we currently anticipate, the following steps should be considered.

Whenever possible, general contractors should add provisions in prime contracts designed to avoid conflicts arising from this new law. These may include shorter payment terms, immediate work stoppage for non-payment, procedures for determining reasonable amounts to be withheld by the owner in the event of conflict and possibly an indemnity provision tailored to defray the costs incurred by a general contractor due to any wrongful withholding of payments by the owner. The owner should also be required to specifically identify the causes of any claimed right to withhold payment. This information should be provided to the general in time to comply with the deadlines for responding to a subcontractor's written notice of objection.

General contractors should also familiarize themselves with and be prepared to enforce their rights under the Prompt Pay Act requiring payment from the owner by the 35th day after submission of an approved payment request, or the fifth day after the owner receives funding from its lender. This statute also addresses the contractor's right to suspend work if payments are not made timely. Then, provide the required financial information to subcontractors prior to their execution of the subcontracts. And, address in bid proposals and prime contracts the time this may delay the start of the project, as well as the potential costs incurred if the information is delayed, or if a subcontractor refuses to work on a project based on the information provided by the owner.

Regarding subcontract forms, the statute prohibits any contractual waiver of its provisions. However, some provisions can assist in complying with the statute, as well as allowing time to resolve disputed issues with an owner prior to payment coming due to the subcontractors. Also, because a subcontractor's invoice can trigger certain deadlines prematurely, subcontracts should clearly state the time for submission and state that invoices submitted prior to that time will not be considered. Finally, because "pay when paid" clauses are not affected by the new law, they too should be utilized in some manner.

Subcontractors need to familiarize themselves with the notice provisions required under the new law and be vigilant in sending out the required notices. They also need to be prepared to review and analyze the owner's financial information provided by the general contractor and act upon it if the information causes concern



Not all construction contracts are affected by this statute. Specifically, this new law will not apply to:

- **Contracts solely for design services**
- **Contracts solely for the construction or maintenance of certain civil engineering projects (as defined in the statute)**
- **Contracts solely for improvement to or the construction of certain residential structures (as defined in the statute)**

over project funding. They can also expect to see some new provisions in form subcontracts addressing some of these issues. The legislature has furnished subcontractors with a powerful weapon in their efforts of debt collection. The industry will be best served if it is used wisely and with restraint, remembering it would not have been possible without the combined efforts of generals and subcontractors.

Owners and lenders should be prepared to receive and respond to requests from general contractors for significant financial information that has not previously been requested of them, but perhaps should have. Untimely or incomplete responses may lead to project delays or cancelled contracts. Some of the information required by the statute is somewhat vague. Most relates to information that will not be released lightly. Confidentiality issues are certain to arise, as well as disputes over the adequacy of the information provided.

Wrapping Up

Opinions about the use of contingent payment clauses vary greatly, and there are legitimate points on both sides of the issue. Subcontractors have long argued that it is inherently unfair to withhold their payment when there is no complaint about their work. Generals counter that they should not be made to bear the entire burden for an owner's wrongful withholding of payment in amounts they cannot control.

Both arguments have merit.

For the last 20 years, I have worked for subcontractors, general contractors and as a construction lawyer. In that time, I have seen these clauses used inappropriately to avoid valid claims for payment, and I have seen them save good companies in bad situations from financial ruin. Regardless of your position, the issue is now resolved and there will be changes to our industry resulting from it, both good and bad. Some of those who have been wrongly denied payment for the performance of good work will be aided by its provisions. Others may be hurt by them, whether deserved or not. It is all but inevitable.

Future legislative amendments and court decisions should eventually resolve questions left unanswered about the application of this law, and perhaps address some of the more extreme results that could occur. Meanwhile, all construction professionals must prepare for compliance with its provisions or face serious consequences. ■

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