

**SUBJECT:** Rules governing contingent payment clauses in certain construction contracts

**COMMITTEE:** Business and Industry — committee substitute recommended

**VOTE:** 6 ayes — Giddings, Elkins, Bohac, Martinez Fischer, J. Moreno, Solomons  
0 nays  
1 present not voting — Kolkhorst  
2 absent — Oliveira, Zedler

**WITNESSES:** For — Michael von Ohlen; Robert Bass and C.D. Henderson, Texas Building Branch - Associated General Contractors; Mackie Bounds, Texas Construction Associates and Texas Masonry Council; John M. Braun, Austin Associated General Contractors and Braun & Butler Construction; Brian Chester; Dwight A. Davis; Gary Fagan; Jennifer Junker; Dennis Lewis, Potter Concrete, Ltd.; Evelyn J. Page, Texas Construction Association and Central Texas Masonry Contractors Association; George Pontikes, Jr.; Doris J. Reid, Texas Construction Association and Texas Masonry Council; (*Registered, but did not testify:*) Christopher Bean, Independent Electrical Contractors Texas Gulf Coast; R. Renea Beasley, IEC of Texas; Jonathan Betcher, Austin Chapter Associated General Contractors; Neva Biggs, Biggs Plumbing & Mech Co. Inc. and Austin Chapter of American Subcontractors Association; William Biggs; Travis Blair, Associated Plumbing Heating-Cooling Contractors of Texas and Texas Construction Association; Mike Boyle, Texas Building Branch - Associated General Contractors and M.J. Boyle General Contractor, Inc.; Travis K. Byrd; Jackie Fagan; Bob Fretz, Jr., Texas Building Branch of the Associated General Contractor; Nancy Jones, Associated Plumbing-Heating Cooling Contractors Association and Texas Construction Association; Virginia M. Lee, Texas Glass Association; Dough McMurry, The San Antonio Chapter of the Associated General Contractors; Jason Moore; Shannon Noble, Texas Air Conditioning Contractors Association; Doug Nunnely, San Antonio Chapter of Associated General Contractors ; Sarah Pruitt, Texas Building Trades Council; James R. Reynolds, Mechanical Contractors Association of Austin, Inc. and Mechanical Contractors Association of Texas, Inc.; Raymond Risk, Texas Construction Association;

Lucas Robinson; Jason Schnurr; William L. Shirley; Chuck Simpson; Michael L. Smith; Michael K. Stewart, Texas Aggregates Association; Linda White, American Subcontractors Association, North Texas; Richard L. White, Mills Electrical Contractors

Against — Art Daniez, Boring and Tunneling Company of America and Associated General Contractors of Texas; Dave Freeman; Charles Hardy, Austin Industries Inc. and Associated General Contractors - Texas Highway Heavy; Stephen Harrison, Harrison, Steck, Hoover & Drake, Attorneys & Counselors; Steve Henry, CF Jordan LP, EMJ Corporation, and Austin Industries, Inc.; Rodney Moss, Centex Construction Company; Richard Ringo; Richard B. Thompson, Buford-Thompson Company and General Contractors; *(Registered, but did not testify:)* Jennifer Newton, Associated General Contractors of Texas Highway, Heavy, Industrial & Utilities; Lawrence Olsen, Texas Good Roads Association; Stephanie Stinebaugh, Zachry Construction Corporation

On — *(Registered, but did not testify:)* Yvonne R. Castillo, Texas Society of Architects

**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.

There are several laws that 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:**

CSHB 541 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). The bill would not apply to a contract that was solely for design services.

A contingent payor or its surety could not enforce a contingent payment clause to the extent that the contingent payor or one of its subcontractors, other than the contingent payee, was to blame for nonpayment by the obligor.

After an unpaid debt had accrued for 30 days, the contingent payee could submit a written request for payment along with notice objecting to the further enforceability of the contingent payment clause. Ten days after receiving this notice, a contingent payor or its surety could not enforce a contingent payment clause for work performed or materials delivered from that point forward.

However, if the nonpayment by the contingent payor stemmed from a dispute in which the obligor refused to pay — claiming that the contingent payor had failed to meet contract requirements — and if the contingent payor prevailed in this dispute, it could continue to enforce the contingent payment clause by:

- giving written notice to the contingent payee, not later than 10 days after receiving the original notice from the contingent payee, explaining the bona fide reasons for dispute with the obligor; and
- paying the contingent payee in a timely fashion all amounts owed that were received from obligor for the contingent payee's performance.

In addition, notice from the contingent payee objecting to the further enforceability of the clause would not prevent its enforcement to the extent that the contingent payor could not collect the funds because the obligor made a valid claim of sovereign immunity. This would neither create or validate a sovereign immunity defense or extend to a primary obligor any additional

defenses than existed in current law.

A contingent payor or its surety could not enforce a contingent clause if the contingent payee was considered to be in direct contractual relationship with the obligor. A contingent clause also could not be enforced if it was proven unconscionable; that is, if the contingent payor had not:

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

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 an obligor to stipulate that a contingent payor could not allocate risk by means of a contingent payment clause.

The bill would take effect September 1, 2003.

**SUPPORTERS  
SAY:**

Contingency payment clauses commonly are used in the construction industry by general contractors to spread their credit risk to subcontractors. To some extent, this represents a legitimate business decision essential to the economic viability of both parties, but 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 the contractor's poor performance. Even though the subcontractor was not at fault and had fulfilled its obligations, the

subcontractor would have little recourse to seek payment from the contractor.

Subcontractors that are not paid timely 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.

Whereas under current law subcontractors function as high risk lenders — providing labor and materials on credit that they will be paid — this bill appropriately would shift the obligation to pay for contractual services rendered in good faith back to the contractor. Take the case of a subcontractor who had not been paid because the project owner refused to pay the general contractor due to poor performance that was not the fault of the subcontractor. This bill would give the subcontractor recourse 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 can even 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.

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. This bill, 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

This bill would be contrary to the principles of competition and free enterprise

**SAY:** by hampering the negotiating power of parties that is fundamental to contract law. It would be unfair to general contractors by attempting to create an artificial business climate where subcontractors were able to operate in a risk-free environment while still signing on for a share of the profits.

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.

By preventing a contractor from spreading risk adequately, this bill would drive up the cost of construction. A general contractor who was bound to a subcontractor by a contingent pay clause and who did not receive payment from an owner, would have to choose between paying a subcontractor with money not yet collected for the job or terminating the subcontractor and employing another subcontractor, who also might demand a guarantee of payment. A general contractor who could not spread credit risk among subcontractors would find it necessary to charge customers significantly higher rates.

Many general contractors, like subcontractors, are small, family-owned companies. Requiring general contractors to shoulder so much of the risk of not being paid by an owner, but still having to pay subcontractors, could be very damaging to many general contracting businesses. Some undoubtedly would go out of business, which in turn would hurt the subcontractors who once relied on such companies for work.

**OTHER  
OPPONENTS  
SAY:** Instead of creating new requirements for contingent payment clauses, the Legislature should amend lien laws so that subcontractors had recourse against an owner who did not pay the general contractor.

**NOTES:** The committee substitute would exclude architects and engineers from the definition of contingent payee and would not apply to contracts solely for design services. It would change the time period before the notice received by the contingent payor became effective from five to 10 days and would require that notice be given in accordance with the contract requirements. It would

add circumstances under which the notice would not prevent the enforcement of a contingent payment clause and would add that a contingent payment clause could not be enforced for non-collectible funds because of a primary obligor's assertion of sovereign immunity. It would specify what types of action would constitute unconscionability. CSHB 541 would add that an obligor could not prohibit a contingent payor from allocating risk by means of a contingent payment clause.

The companion bill, SB 256 by Harris, was scheduled for public hearing in the Senate Business and Commerce committee on April 29.