REVISITING RESTRICTIONS ON CONTINGENT PAYMENT CLAUSES

By R. Carson Fisk (as seen in *Texas Construction* October 2007)

One of the most fiercely debated contract clauses-the contingent payment clause-has finally been regulated in Texas. Otherwise known as a "pay if paid" clause or a "pay when paid" clause, a contractor may rely on this clause if an owner fails to pay the contractor for work performed and the subcontractors are demanding payment. Subcontractors despise them as they spread a contractor's credit risk to the subcontractor and subject the subcontractors to risks they cannot control. Although some subcontractors may also use such clauses and the new law applies equally to them, for purposes of this article the use of the clause is discussed in the context of the owner-contractor relationship.

In passing SB 324, the legislature recognized that these clauses have the potential to be used by "unscrupulous contractors" to avoid payment to subcontractors where the owner has legitimately withheld payment because of the contractor's default. The objective of the bill is to clarify the circumstances in which these clause are enforceable. While the use of the contingent payment clause is still permissible, the restrictions discussed below may not be waived. It should be noted that these restrictions do not apply to contracts solely for design services, civil engineering construction services such as may be required for roads, bridges, and utilities, and improvements to or the construction of detached single-family residences, duplexes, triplexes, or quadruplexes.

Effective September 1, 2007, a contractor or its surety may not enforce a contingent payment clause unless the non-payment by the owner is a result of the subcontractor's failure to meet its contractual obligations. Additionally, the restrictions only apply to owner-contractor agreements entered into on or after that date. Once 45 days have lapsed from when the subcontractor first submits a full and complete written request for payment and after a contractor has relied on the clause in failing to make a required payment, the subcontractor may send written notice to the contractor objecting to the further enforceability of the clause. After receipt of this notice, the clause is deemed unenforceable on the later of the tenth day after receipt of the notice, the eighth day after interest begins to accrue against the owner under certain statutes related to private projects and federal projects, and the eleventh day after interest begins to accrue against the owner on state projects.

However, this notice does not prevent enforcement of the clause if the owner has a dispute regarding amounts owed due to the subcontractor's actions and the contractor notifies the subcontractor, in writing, that the subcontractor's notice is not effective. The subcontractor must receive the contractor's responsive notice no later than the fifth day before the date the subcontractor's written notice becomes effective or the fifth day after the contractor receives the subcontractor's written notice. Regarding all notices, the

timing aspects are important and should be carefully considered. Once the subcontractor has received the payment that prompted it to send notice, the enforceability of the contingent payment clause is reinstated.

On public projects, the subcontractor's notice does not prevent enforcement of the clause if a contractor has exhausted all available statutory rights and the owner has successfully asserted the defense of sovereign immunity. Additionally, a contingent payment clause may not be enforced in the following situations:

(i) if the contractor and the owner are in a "sham" relationship;

(ii) to invalidate a mechanic's lien claim; or

(iii) if enforcement of the clause is unconscionable.

Enforcement is not unconscionable if the contractor has made reasonable efforts to collect the amount owed or has made an effort to assign, to the subcontractor, a cause of action against the owner for amounts owed. In the case of assignment, the contractor must agree to cooperate in collection efforts and the assignment must not be subject to defenses caused by the contractor. Additionally, before the associated contract is effective, the contractor must prove it has exercised diligence in informing the subcontractor of the financial viability of the owner and the existence of adequate financial arrangements. To show diligence, a contractor must provide to the subcontractor information such as the name of any lender, the address of the owner and any surety, and certain information about financial arrangements. The statute lists the specific information required.

Some of the information must be obtained from the owner, who is required to provide the information within 30 days of receiving a written request. If the owner fails to provide the information, the contractor, subcontractor, and their sureties are excused from performance of the contract. While an owner may have an obligation to furnish certain information, extreme care should be given in refusing to perform a contract on these grounds and all concerns should be well documented. Also, as a contractor-subcontractor agreement is independent from an owner-contactor agreement, the fact that a contractor determines it is excused from performance may not preclude the subcontractor from seeking some form of legal relief from the contractor.

Whether one views SB 324 as restricting parties' freedom to contract or as providing much needed reform, owners, contractors, and subcontractors should take the time to familiarize themselves with the statute and consider the legal implications of this change in the law. There are a number of legal pitfalls that have been created and the contractor that fails to pay his subcontractor thinking his well-crafted contingent payment clause will protect him proceeds at great risk.