

WHEN SUBSTANTIAL COMPLETION FAILS TO PAY

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If a dispute arises with an owner after a contractor achieves substantial completion of its work on a project, the contractor is generally entitled to receive its full contract balance minus the cost to correct or complete any disputed items. However, there are often exceptions to this legal premise built right into the contract that can cut off a contractor's right to payment *regardless of whether substantial completion was achieved*.

Contracts often contain "conditions precedent" provisions which require one party to fully perform a particular obligation before the other party is required to perform one of its own obligations. There can be dozens of these provisions throughout a contract, including: (1) timely notice following a delay before being entitled to additional compensation or time for that delay; (2) that change orders be in writing before the obligation to pay arises; (3) opportunity to cure before termination; and (4) the obligation to perform work prior to payment. The most well-known condition precedent is the contingent payment provision, having made recent headlines with the passage of the new statute last year. Conditions precedent provisions are valuable because they allow a party to mitigate or shift risk that it cannot control to the party most capable of controlling the risk; but, sometimes these provisions produce seemingly harsh results if not properly negotiated before the contract is signed. This is especially true when a condition precedent requires a contractor to perform a specific act in order to receive payment.

An extreme example of a condition precedent affecting a contractor's right to payment is currently before the Texas Supreme Court. According to the appellate court in the *T.A. Operating Corp. v. Solar Applications Engineering, Inc.*, 191 S.W.3d 173 (Tex. App. – San Antonio 2005) case, the contractor in the case substantially completed a \$4 million project, leaving only \$8,000 of disputed punch list items unfinished. The contractor, relying on the premise that it substantially performed, argued that it was entitled to receive its full balance minus \$8,000. Unfortunately for the contractor, the contract contained a condition precedent provision requiring the contractor to provide an all-bills paid affidavit as a condition precedent to the owner's obligation to pay the contractor. When the contractor could not provide the affidavit, the owner refused to pay the contractor its final payment application valued at nearly \$400,000.

The contractor prevailed on its claim in the trial court, but the appellate court focused on the condition precedent provision and reversed the trial court's decision. The appellate court reasoned that the owner had no obligation to pay the contractor the final payment because the contractor, by failing to provide the all-bills paid affidavit, did not meet all prior conditions to receive payment. The appellate court looked to the underlying purpose for including the condition precedent in the contract, stating that the all-bills paid affidavit was to assure that the owner did not face double liability if a subcontractor filed a lien claim against the owner's property after the owner made final payment to the

contractor. The owner understood during contract negotiations that this was a risk that it needed to mitigate and it required the contractor to accept the condition of providing an all-bills paid affidavit before being entitled to receive final payment. The court considered the risk of double liability significant enough to ignore the fact that the contractor substantially performed the contract. The court acknowledged that harsh results will occur from a failure to perform a condition precedent, but stated that the results are outweighed by a party's right to freely negotiate and enter into a contract with agreed upon terms.

The Texas Supreme Court recently granted the contractor's petition for review of *Solar Applications* case, but it is unknown whether Texas' highest court will elect to uphold or reverse the appellate court's decision. Either way, the Texas Supreme Court's decision will determine the future interpretation and enforcement of conditions precedent provisions in construction contracts governed by Texas law, especially as these provisions relate to payment.

The *Solar Applications* case shows that Texas courts, with few exceptions, favor the express language of contracts. Parties must be aware that courts will enforce conditions precedent provisions in their contracts, no matter how seemingly harsh the result. However, contractors can and should assess and mitigate the risk of conditions precedent provisions especially as they relate to payment terms. For example, contractors should insist in the contract that they will not have to provide an all-bills paid affidavit if there is a good-faith dispute between the contractor and its subcontractor. This will typically require the contractor to promise to defend and indemnify the owner from claims and to bond around any lien claims filed against the property. After the deadline has passed for subcontractors to file liens against the owner's property, the owner should be contractually required to make payment. If a lien claim is filed in the interim, bond around it. Once the deadline to file lien claims has passed, the owner arguably has little to no liability to lien claimants (interestingly, the appellate court failed to discuss that the deadline had long passed for filing and foreclosing a lien claim in the *Solar Applications* case, and it is unknown whether this will be addressed by the Texas Supreme Court).

All-bills paid affidavits (and lien releases) should also be "conditional," meaning that they should be conditioned on the actual receipt of payment and will not be effective until the contractor receives the payment. Finally, a contractor should negotiate a provision in its contract with the owner stating that the contractor shall not be required to provide a subcontractor's lien release, an all-bills paid affidavit, or even to defend and indemnify the owner against lien claims if the reason for a subcontractor's lien claim or refusal to sign a release is due to the owner's failure to make payment.

While express conditions precedent can have extreme consequences, they serve valuable purposes to a party – whether a contractor or an owner – trying to control certain risks. Recognizing the condition, especially when it relates to payment, and negotiating a limit to its application will help reduce the harsh effects.