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Significant Change in the Law Regarding Contingent Payment Clauses[1]

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Contingent payment clauses when used in construction contracts are clauses which shift financial risk from one party, normally the general contractor, to another, normally the subcontractor. Typically, the general contractor contractually conditions its obligation to pay its subcontractors upon receipt of payment from the owner by use of a contingent payment clause. Because the contractor has no legal obligation to pay until receipt of funds from the owner, the contractor shifts the financial risk of non payment by the owner for whatever reason to the numerous subcontractors on its project. Theoretically, the subcontractor is compensated for this financial risk of non payment by charging a higher price to the general contractor for this risk taken.

Texas courts allow parties to enforce contingent payment clauses so long as it is clear from the subcontract agreement that the parties intended that payment from the owner to the contractor create an express condition precedent to the general contractor's obligation to pay the subcontractor. Many general contractors believe that this ability to spread the financial risk of owner non payment to their subcontractors is essential to their economic viability and they believe the subcontractor is compensated for taking this risk through its subcontract price. Many subcontractors believe that it is unfair to shift financial risk of non payment to them under all circumstances because they have little or no ability to 1) determine the financial viability of the owner or 2) control the general contractors conduct in relation to its dealing with the owner or other subcontractors, thus no real ability to adequately evaluate and manage the risk assumed so as to reasonably quantify the cost of that risk.

As a result of this tension, organizations representing both general contractors and subcontractors attempted for a number of years to fashion legislation to address these issues. On June 15, 2007, Governor Perry signed into law Senate Bill 324 statutorily limiting the enforceability of contingent payment clauses contained in certain construction contracts. The legislation added Section 35.521 to the Texas Business and Commerce Code.

Before discussing the details of the new statute, it is important to know what contracts it does not apply to. The statute does not apply to contracts that are solely for:

1) design services,

2) the construction or maintenance of a road, highway, street, bridge, utility, water supply project, water plant, wastewater plant, water or wastewater distribution or conveyance facility, wharf, dock, airport runway or taxiway, drainage project, or related type of project associated with civil engineering construction, or

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3) improvements to or the construction of a structure that is a detached single-family residence, duplex, triplex, or quadruplex.

Further, the statute does not apply when the person receiving payment is an architect or engineer. Finally, the statute does not apply to clauses in construction contracts which merely effect the timing of payment, so long as payment is to be made within a reasonable time (commonly known in the construction industry as pay-when-paid clauses as opposed to pay-if-paid clauses).

What the new statute does apply to is contracts for both public and private work for 1) construction management; 2) new, repair, or remodeling construction of real property; and 3) the furnishing of materials for the construction. The statute is effective for contingent payment clauses contained in these contracts and agreements entered into on or after September 1, 2007 and the statute can not be waived by the parties. Interestingly, the statute also prohibits the owner from preventing the general contractor from using contingent payment clauses to allocate its financial risk.

The new statute settled the issue of a contingent payment clauses effect on the enforceability and perfection of a mechanics lien (i.e. can a mechanics lien be validly perfected and enforced if there is no payment due the subcontractor because non payment to the subcontractor results because the owner has not paid the general contractor) by prohibiting a contingent payment clause from being used as the basis for invalidation of the enforceability or perfection of a mechanics lien under Chapter 53 of the Texas Property Code.

The new statute prohibits the enforcement of contingent payment clauses by the general contractor or its surety in the following situations:

1) to the extent that the owner's non payment to the general is a result of the failure of the general contractor to meet its obligations to the owner, unless the non payment is the result of the subcontractor's default on its contractual requirements. The effect of this is to continue to place the risk of the owner's financial insolvency on the subcontractor where a contingent payment provision is in its subcontract, but relieves the subcontractor of the risk of general contractor breach of its contract with the owner as the reason for non payment, unless the breach results from the subcontractor's default on its contractual obligations;

2) if the owner and the general contractor are the same entities, i.e. a sham contract under section 53.026 of the Texas Property Code;

3) if the enforcement would be unconscionable; and

4) after the subcontractor gives statutorily required notices to the general contractor.

Both the unconscionability and notice exceptions to enforcement of contingent payment clauses place certain obligations on the owner, general contractor, and subcontractor which are beyond the scope of this article.

A new era in financial risk shifting between subcontractors and general contractors begins for all applicable contracts entered on or after September 1, 2007. Because the new statute is quite lengthy and complex in relation to notice and unconscionability, it is prudent to seek competent counsel and educate oneself on this significant change in the law.

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