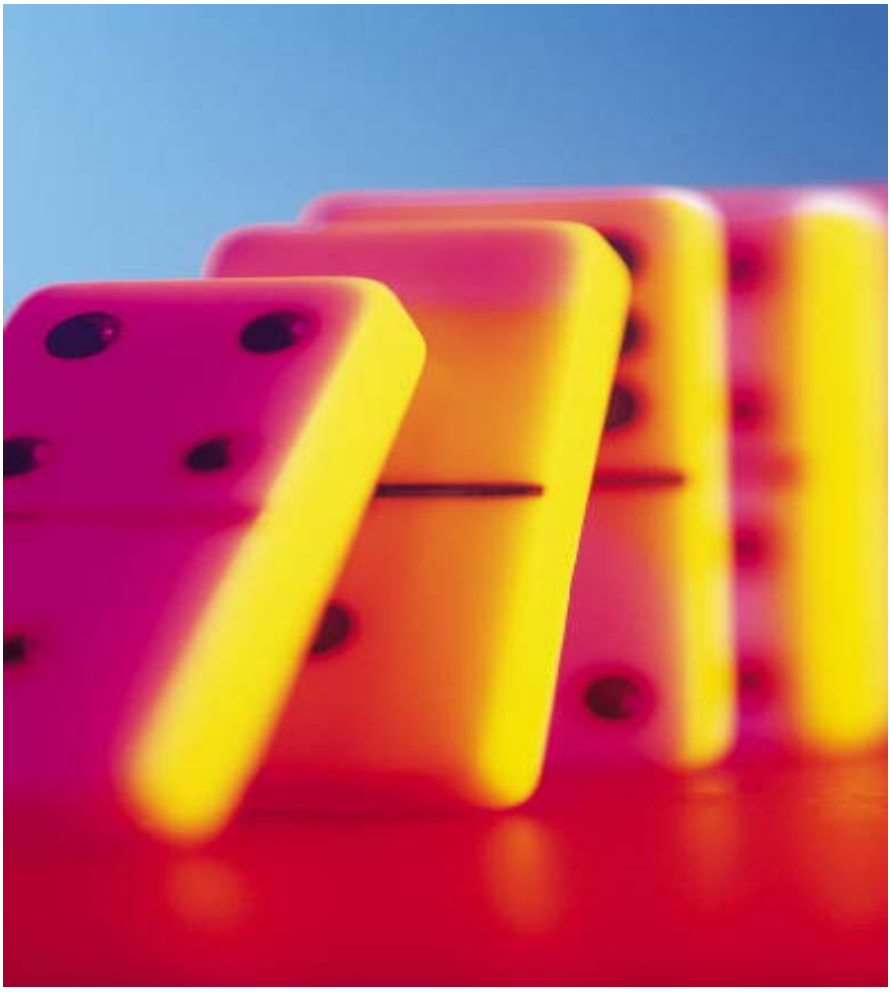
ENFORCEABILITY OF CONTINGENT PAYMENT CLAUSES IN TEXAS



Published September, 2007

COMPILED BY
ASSOCIATED GENERAL CONTRACTORS
TEXAS BUILDING BRANCH

ENFORCEABILITY OF CONTINGENT PAYMENT CLAUSES IN TEXAS

CONTENTS

I. Preamble

With the passage of Senate Bill 324, the 2007 Texas Legislature promulgated a new section of the Texas Business & Commerce Code that governs enforcement of contingent payment clauses in certain construction contracts, effective September 1, 2007. The law is found at §35.521 of the Code. This booklet has been prepared to help all construction industry participants understand and comply with the requirements of the Code. What follows is a summary of the statute, a discussion of the notice requirements, and a series of questions and answers that will help construction industry participants put these statutory requirements in proper context and perspective.

Construction is risky business for contractors, subcontractors and suppliers. They face many risks related to safety, design, production, price escalation, material shortages, manpower shortages, differing site conditions, and more. These risks are allocated by the parties' construction contracts. The risk of financial failure of the party buying the construction services or goods is a very significant risk. Many general contractors pass on the risk of an owner's non-payment by requiring subcontractors to agree to "pay-when-paid" clauses. These clauses allow the general contractor to wait for a reasonable time for the owner to pay before paying the subcontractor. Some general contractors go further, and shift to the subcontractor the risk that payment may *never* come — through a "pay-if-paid" clause that makes the subcontractor's payment absolutely conditional upon the owner's payment. "Pay-if-paid" clauses are also known as *contingent payment clauses*.

Most would agree it would be unfair to enforce a contingent payment clause to deny payment to a subcontractor if the owner's refusal to pay was caused by the contractor's own breach of the contract with the owner. Conversely, it would be unfair to invalidate a contractor's contingent payment clause if the subcontractor's breach caused the owner's refusal to pay. While an owner's failure to pay is rare, and unfair application of contingent payment clauses rarer still, the construction industry has spent a lot of time discussing, negotiating, litigating, and lobbying over the proper use of contingent payment clauses. The AGC-Texas Building Branch and the Texas Construction Association worked together for over 6 years in search of a reasonable compromise. A compromise was reached. It is embodied in this new law.

The new statute expressly allows contingent payment clauses to be enforced in some circumstances. It restricts their enforcement in others. Subcontractors have gained because the law will restrict the enforcement of contingent payment clauses in circumstances where enforcement would be improper. Contractors have gained in that the law establishes a process that, if followed, will preclude attack on the contingent payment clause. Both general contractors and subcontractors have gained the right to request information from owners concerning funding to pay for the project, as well as a *statutorily-protected right to stop work* if the owner fails to pay or the owner refuses to provide that information.

The result is a law not without imperfection and complexity. The complexity, however, creates a framework for all players in the construction industry to use and fairly enforce contingent payment clauses.

Every party to a construction contract should carefully consider the requirements of the statute. As the law is actually applied to construction contracts in the coming months and years, many questions will arise. These questions may lead to further legislative and court interpretation. Future editions of this booklet will address these issues.

The Board of Directors and Legislative Committee of AGC -Texas Building Branch wish to express their sincere appreciation to these construction lawyers and others for their assistance in the preparation of this book:

Robert Bass
Winstead Sechrest & Minick, P.C.
Austin, Texas

George Baldwin
Ford Nassen & Baldwin, P.C.
Austin, Texas

Bill Coats
Coats, Rose, Yale, Ryman & Lee, P.C.
Houston, Texas

Gregory Cokinos
Cokinos, Bosien & Young, P.C.
Houston, Texas

Kyle Gooch
Canterbury, Stuber, Elder, Gooch & Surratt, P.C.
Dallas, Texas

Steve Harrison
Harrison & Steck, P.C. Fort Worth, Texas

Tim Matheny
Ford Nassen & Baldwin, P.C.
Dallas, Texas

Curt Martin
Construction Resolutions, LLC
Houston, Texas

Rodney Moss
Balfour Beatty Construction
Dallas, Texas

David Peden
Porter & Hedges, L.L.P.
Houston, Texas

Rick Reed
Coats, Rose, Yale, Ryman & Lee, P.C.
San Antonio, Texas

Jason Spencer
Ford Nassen & Baldwin, P.C.
Austin, Texas

Special thanks goes to San Antonio construction lawyer, Rick Reed of Coats, Rose, Yale, Ryman & Lee, for his work as the principal author and editor of this publication and for chairing the group of volunteer professionals who worked on this publication.

This booklet is only intended to convey a general understanding of the statute. Readers are encouraged to seek specific legal advice concerning the particular facts involving in any question about the enforcement of a contingent payment clause or related statutory duties in the context of their specific construction contracts and factual situations.

II. Summary of §35.521 of the Texas Business & Commerce Code

Enforcement of Contingent Payment Clauses Generally. Contractors often put contingent payment clauses in their subcontracts. These clauses are sometimes called "*pay-if-paid*" or "contingent payment" clauses. The contractor uses these clauses to avoid financial disaster, by spreading among the subcontractors the risk of non-payment if the owner fails to pay the contractor. A typical clause reads like this:

> "Subcontractor agrees to assume the risk that the Owner may fail to pay for the Subcontractor's Work. The Contractor shall have no obligation to pay the Subcontractor for its Work unless Owner has first paid Contractor for the Subcontractor's Work. Contractor's receipt of payment from the Owner for the Subcontractor's Work is a condition precedent to any obligation of Contractor to pay the Subcontractor."

Before enactment of §35.521 of the Texas Business & Commerce Code, the courts in Texas would generally enforce a contingent payment clause as long as it clearly stated the parties' intention that the subcontractor would bear the risk of the owner's failure to pay the contractor. Texas courts would not allow a contractor to forever avoid payment to the subcontractor if the contingent pay clause was at all unclear on this. Nor would Texas courts allow the contractor to avoid payment if the clause only said that the subcontractor would get paid "when" the Contractor gets paid. A so-called "*pay-when-paid*" clause merely leaves the *time* of payment uncertain. Eventually, the fact of the owner's non-payment becomes irrelevant, and the contractor must still pay the subcontractor. (Appendix V of this booklet generally discusses the Texas court decisions relating to contingent payment clauses. The pre-statute common law remains important in analyzing and resolving contingent payment disputes under contracts that are not subject to the statute.)

Some courts in other states have ruled that, when the contractor is the very cause of the Owner's withholding of payment and breaches his own obligations to the Owner, the Contractor cannot hide behind a contingent payment clause to avoid paying his subcontractors. This is known as the "*prevention doctrine*." The new Texas statute essentially codifies the prevention doctrine in Texas. It also applies a number of notice requirements and deadlines that will govern the enforcement of contingent payment clauses.

Certain Construction Contracts Excluded. The new restrictions on contingent payment clauses do not apply to *all* construction contracts. It will only apply to construction management contracts and construction contracts to improve real property *executed on or after* September 1, 2007, the date this law becomes effective. (See S. B. 324, Section 2 and Section 3.) It will apply to contingent payment clauses in subcontracts, lower-tier subcontracts, and supply contracts.

Construction contracts excluded from application of the law are those *solely* for design services, road and highway and other civil projects, and quadruplex or smaller residential construction projects. See §35.521(u). Therefore, contingent payment clauses will still generally be enforceable in these contracts under common law, without regard to the statute.

Note, however, the significance of the use of the word "*solely*" as used in §35.521(u). The law may still apply to restrict enforcement of a contingent payment clause in these types of contracts if the scope of work goes beyond the stated exception. For example, if an engineering firm enters into a design-build subcontract, such contract is not *solely* for the rendering of design services, and the law will apply. In addition to excluding contracts for design services, the definition of "contingent payee" expressly excludes architects and engineers, so it appears contingent payment clauses remain generally enforceable against them under the common law. (As noted previously, see Appendix V of this booklet for a discussion of Texas common law relating to the enforcement of contingent payment clauses.)

Contracts Subject to Sovereign Immunity. The law also expressly provides that a contingent payment clause can be enforced if non-payment is due to the primary obligor's "successful" assertion of the defense of sovereign immunity. The primary obligor who can assert such a defense is, of course, the State of Texas and, to a lesser extent, its primary government units. However, the contingent payor (the contractor) must exhaust all remedies available to it to collect payment under the Texas Government Code. A contractor's efforts to exhaust its remedies for non-payment through the State Office of Administrative Hearings (SOAH) process can be a costly and uncertain endeavor.

It is important to remember that most, but not all, political subdivisions below the level of a primary unit of state government no longer have sovereign immunity as a defense to contractual liability. For example, municipalities, public school districts and junior college districts, and special-purpose districts or authorities no longer enjoy sovereign immunity as a defense to breach of contract actions on written contracts for providing goods and services.[1] Counties enjoy only a limited waiver of sovereign immunity as a defense to liability under a written contract for engineering, architectural or construction services or goods related to those services.[2] While these local government units do not have sovereign immunity, they may still contractually require exhaustion of administrative remedies under their contracts before taking any formal legal action (which obligation to exhaust may be imposed by the contractor upon its subcontractors and suppliers). It remains to be seen whether such "duty to exhaust" provisions would violate the "anti-waiver" provisions of the statute so as to effectively preclude a subcontractor's or supplier's enforcement of its payment rights notwithstanding a contingent payment clause.

Enforceability of Contingent Payment Clauses. A "contingent payment clause" is defined under §35.521(a)(2), as follows:

> "'Contingent payment clause' means a provision in a contract for construction management, or for the construction of improvements to real property or the furnishing of materials for the construction, that provides that the contingent payor's receipt of payment from another is a condition precedent to the obligation of the contingent payor to make payment to the contingent payee for work performed or materials furnished."

[1] See Local Government Code §§271.152 and 271.155.
[2] See Local Government Code §262.007.

The law does not prohibit the use of, but restricts the enforceability of contingent payment clauses. The statute declares in §35.521(b) when a contingent payment clause will and will not be enforced:

> "*A contingent payor (or its surety) may not enforce a contingent payment clause to the extent that the obligor's nonpayment to the contingent payor is the result of the contractual obligations of the contingent payor not being met, unless the nonpayment is the result of the contingent payee's failure to meet the contingent payee's contractual requirements.*" (Emphasis added.)

The statute's defined terms of "obligor, contingent payor, and contingent payee make the law applicable to construction contracts at all levels. Using terms for the typical contractor/subcontractor scenario, §35.521(b) would read:

> "*A **Contractor** (or its surety) may not enforce a contingent payment clause to the extent that the **Owner**'s nonpayment to the **Contractor** is the result of the contractual obligations of the **Contractor** not being met, unless the nonpayment is the result of the **Subcontractor**'s failure to meet the **Subcontractor**'s contractual requirements.*" (Emphasis added.)"

The underlined phrases make it clear that a contingent payment clause may still be enforced if the reason for non-payment to the subcontractor is unrelated to the contractor's failure to meet its obligations to the owner. Thus, if the contractor's failure to pay the subcontractor is because of the owner's financial difficulties or the owner's breach of the prime contract, the clause should still be enforceable. Under either of these scenarios, and assuming an effectively drafted contingent payment clause, the contingent payment clause should be effective and enforceable as long as the contractor is careful to take appropriate countermeasures if the subcontractor objects to enforcement (as discussed below) and the contractor does not receive payment from the owner.

Generally, contingent payment clauses will be unenforceable under any one of the following four (4) situations:

(1) The owner's non-payment is caused by the contractor's failure to meet its obligations to the owner (unless such failure is due to the failure of the subcontractor against whom the contractor enforces the contingent payment clause);

(2) The contingent payment clause is contained in a sham contract, as defined in §53.026 of the Texas Property Code (i.e. a situation where the general contractor is controlled by the owner, or the general contractor and owner had no good faith intention that the contractor would perform the prime contract);

(3) The subcontractor gives the contractor a timely and effective notice objecting to the enforcement of the clause, and the contractor fails to timely advise the subcontractor in writing that its notice of objection is ineffective due to the subcontractor's default; or

(4) Enforcement of the contingent payment clause would be "unconscionable."

Also, §35.521(i) states that a contingent payment clause cannot be used to invalidate the enforcement or perfection of a mechanic's lien for labor performed or materials furnished. While §35.521(i) does not expressly state that a contingent payment clause is "unenforceable" as a defense to a mechanic's lien, that probably is the case with respect to an owner's contention that the contingent payment clause should defeat a subcontractor's mechanic's lien (particularly if the subcontractor has, by the time of the foreclosure proceeding, properly objected to the contingent payment clause in accordance with the statute).

A contractor who is careful to counter a defaulting subcontractor's improper objection to a contingent payment clause will be in a better position to defend the owner against the defaulting subcontractor's lien claim.

No party can be forced to give up its rights under the statute to object to the enforcement of a contingent payment clause or to obtain certain information relating to the Owner's ability to pay for the project. Under §35.521(s), w*aivers are expressly prohibited*.

Assuming non-payment due to an Owner's financial failure or breach, there is still a question whether an effectively drafted contingent payment clause *will* or *will not* be enforced. The answer now will turn on whether the Contractor and the Subcontractor each adhere to a number of procedural notice and counter-notice requirements that must be followed by each of them to enforce, or fight the enforcement of, a contingent payment clause. A discussion of the notice requirements follow in the next section of this booklet.

III. Notice requirements

Each party to a construction contract with a contingent payment clause must adhere to certain requirements for giving notice concerning its rights under the statute and under the clause. See Appendix I for a diagram of the basic notice requirements of the statute.

Subcontractor's notice requirements. To effectively object to the enforcement of a contingent payment clause and protect the right to receive payment on its pay application, a subcontractor must meet several requirements set out in §35.521(c) of the statute:

1. *Written Objections; 45-Day Waiting Period.* The subcontractor may send a notice of objection only after forty-five (45) days has passed from the submission of the subcontractor's pay request. Obviously, a pay application cannot be considered *submitted* until it is *received.* A subcontractor's notice of objection may be deemed ineffective if it is sent before the 45 day waiting period has run. The subcontractor needs to know when the general contractor *received* its pay application in order to know when a notice of objection may properly be sent. The subcontractor can either establish the time of receipt by obtaining a signed receipt or other written acknowledgment from the contractor showing the date when the subcontractor's pay application was received, or send its pay application by certified mail, return receipt requested.

2. Pay Applications Must be Complete. The Subcontractor's submission of the pay application must have been made *in accordance with the subcontract.* Subcontracts often require a subcontractor to submit considerable back-up documentation with each pay request, including partial releases of liens, indemnities, receipts, certifications, etc. Thus, the subcontractor needs to be able to prove that, on the date of submission, its payment request properly reflected the

amount due under the express terms of the subcontract, allowed all appropriate credits, and included all the necessary supporting documentation required by the subcontract. Otherwise, the contractor will be able to maintain that the subcontractor's notice of objection is ineffective.

3. *Written Objections Required for Each Pay Application*. The subcontractor must send a separate notice objecting to enforcement of a contingent payment clause for *each* pay application on which payment has not been received. Under §35.521(g), a subcontractor's notice of objection, once effective (as discussed further below), precludes the contractor's enforcement of a contingent payment clause for all purposes until the subcontractor gets the payment of the debt giving rise to its effective written notice of objection. Once payment is made, the contingent payment clause is "reinstated" for work subject to subsequent payment requests.

4. *Effectiveness of Written Objections*. Assuming the subcontractor's pay request was properly submitted and the 45 day waiting period has run with respect to the subcontractor's notice of objection, §35.521(c) states that the subcontractor's right to prevent enforcement of the clause depends on when the subcontractor's written objection becomes *effective*. §35.521(c) also states a contingent payment clause *will not* be enforceable once the subcontractor's notice of objection has become effective. If the contractor never receives a written notice of objection from the subcontractor, or if the notice is ineffective, the contractor will be able to enforce a contingent payment clause to avoid payment to the subcontractor. When the subcontractor's notice of objection becomes effective is found in §35.521(d). This is where it gets very complicated for both the contractor and the subcontractor.

The subcontractor's notice of objection to the enforceability of a contingent payment clause becomes effective on the *later of* the following days: the 10th day after the Contractor receives it, or the 8th day or the 11th day following the date when interest begins to accrue on the payment due the Subcontractor, depending on whether the project is a private job governed by the Prompt Pay Act, or a public job or a federally financed public job subject to the Texas Government Code or the U. S. Administrative Code. These timing calculations are complicated and require careful analysis of the applicable statutes cited in §35.521(d) to make a correct determination on effectiveness of the subcontractor's notice of objection. See Appendix III for a more specific discussion of this.

Contractor's notice requirements. The contractor's notice requirements to be able to enforce an otherwise properly drafted contingent payment clause are found in §35.521(e). (In a case where the owner's non-payment is due to the owner's financial failure or other breach, §35.521(b) would make these requirements inapplicable; however, the contractor would be wise to respond to a subcontractor's notice of objection to avoid any doubt over its right to enforce the contingent payment clause as the result of an owner breach.) To the extent that the owner's nonpayment is due to a failure of the contractor to meet its contractual obligations, there are two (2) major requirements:

1. *Owner's Non-payment Must be Due to the Subcontractor's Failure*. The contractor must show that the "obligor" (the owner) is withholding payment because the objecting subcontractor failed to meet its obligations under its subcontract. There are no time limits on how soon the contractor must be able to show that the owner's non-payment is due to a dispute over the subcontractor's default, however, a contractor may want to seek agreement of the owner in the

prime contract to cooperate in identifying the particular subcontractor whose default is the reason for non-payment, as well as an express agreement to release payment for any subcontractor's work that is not in dispute.

2. *Contractor Must Timely Counter the Subcontractor's Written Objection.* The contractor must be able to show that it *timely* advised the subcontractor in writing that the subcontractor's notice of objection "does not prevent enforcement of the contingent payment clause." This means the contractor must be able to establish that the owner's non-payment (i) is not due to the contractor's failure to meet its own obligations, and (ii) is due to the objecting subcontractor's failure to meet its obligations. Assuming the contractor can show these facts, the contractor must advise the subcontractor in writing of this within a very short time. The subcontractor must *receive* the contractor's written advice that the subcontractor's notice of objection does not prevent enforcement of the contingent payment clause *not later than the 5th day before the later of* (a) the day the subcontractor's notice of objection becomes effective, or (b) the day the Contractor actually receives the objecting subcontractor's notice objecting to enforcement of the contingent payment clause.

As mentioned above, see Appendix III for how to determine when the subcontractor's notice of objection becomes effective. Obviously, the contractor would be well-advised to tell a subcontractor as soon as possible when the subcontractor's default will result in non-payment unrelated to the contractor's failure to meet its obligations.

Assuming the contractor has met the notification obligations discussed above, the contractor should be able to enforce the contingent payment clause, so long as its enforcement would not be "unconscionable." The contractor can establish that enforcement would not be "unconscionable" by taking the specific steps discussed in the next section of this booklet.

Enforcement of a contingent payment clause cannot be "unconscionable."

Enforcement of a contingent payment clause cannot be "unconscionable" under §35.521(j). The statute provides in §35.521(k) that a contractor's enforcement of a contingent payment clause will not be unconscionable if the contractor takes certain steps both *before and after* entering into a binding subcontract. *Before* entering into a binding subcontract, the contractor must exercise diligence in investigating the owner's ability to pay. *After* subcontracting, and in the event of an owner nonpayment, the contractor will be considered to have acted with due diligence in the enforcement of a contingent payment clause if the contractor also makes reasonable effort to collect from the owner or enables the subcontractor to do so directly. These steps are discussed in more detail below, and establish so called "safe harbors" that a contractor can take, and must prove were taken, to enforce a contingent payment clause. Enforcement of a contingent payment clause by a contractor who fails to undertake these steps leaves the question of "unconscionability" to a trier of fact.

Assuming the contractor has taken these steps, including the exercise of diligence under Section 35.521(k), the subcontractor would have the burden of proving that the enforcement of the clause would be "unconscionable". This is an extremely tough burden to meet, in that the subcontractor must prove, among other things, the clause would be so unfair in its application that no reasonable, informed person would agree to it. While the statute does not diminish this burden, it does provide a "safe harbor" for a contactor who takes certain steps to avoid being

subjected to a claim of unconscionability in the first instance. If these steps are taken, unconscionability cannot be asserted against the contractor.

First and foremost, a contractor will be considered to have acted with diligence under §35.521(k) if the contractor can prove that, before a subcontract becomes effective, the contractor has "exercised diligence in ascertaining and communicating" to the subcontractor the "financial viability of the primary obligor and the existence of adequate financial arrangements to pay for the improvements."
As noted above, the statute now enables a contractor to obtain certain information for the subcontractor about the project and the owner's financial viability to support the enforcement of a contingent payment clause. The requirements vary for public and private projects, as discussed further below.

Private Projects

To demonstrate diligence on a private project under §35.521(m), the contractor must obtain the owner's and any surety's identity and contact information, a legal description of the property to be improved, and information about any financing for the project. If the owner borrows to pay for the improvements, the contractor must ask the owner for a statement supported by "reasonable credible evidence" from the lender of the amount borrowed, a summary of the terms of the loan, the identity of the lender and all borrowers, and a statement of whether an owner default is foreseeable. If there is no loan, or the loan is not sufficient to pay for the project, then the contractor must obtain the owner's statement as to the amount, source, and location of funds available to pay for the work. The sample form provided in Appendix IV(A) may be used to request information from the owner that is sufficient to fulfill the requirement for diligence for private projects. A contractor can also take advantage of the statute to ask for more financial information than the statute requires if the situation warrants it. For example, if the contractor is considering an especially high risk project involving an owner who has no proven track record and is entirely dependent on the project as collateral for financing to pay for the project, a contractor may also want to insist that the owner furnish certified financial statements, a copy of the loan agreement, and lender set aside agreements, among other things. The form of questionnaire in AGC's "Guidelines for Obtaining Owner Financial Information," published in 1998, may be a useful guide to making such further requests. See Appendix IV(C) for a copy of the questionnaire.

Whatever the level of financial information a contractor decides to seek from a private project owner about its ability to pay, the contractor should expect the owner to require absolute confidentiality on the part of the contractor and each subcontractor, as a condition of being qualified to be considered for the project. The sample form in Appendix IV(A) establishes the contractor's agreement to treat the information as confidential; but an owner may insist on the execution of a more detailed confidentiality agreement as a condition of providing the requested financial information.

Public Projects

The contractor is required under §35.521(n) to obtain the identity and contact information of the government owner, the surety on the payment bond, and the owner's statement that "funds are

available and have been authorized for the full contract amount." It should be noted that the general contractor cannot be faulted if the provided information shows a substantial credit risk. The general contractor must simply provide such information as it has been provided by the Owner. For public projects, the sample form provided in Appendix IV(B) may be used to request sufficient information from the owner that is sufficient to fulfill the requirement for diligence.

Steps Required in Event of Owner Nonpayment.

In the event of non-payment by the owner, the contractor seeking safe harbor protection from a claim of unconscionability also must *either (i)* make reasonable effort to collect for the subcontractor's work, *or (ii)* assign, or offer to assign, to the subcontractor a pass-through claim against the owner. A pass-through claim must be assigned to the subcontractor within a reasonable time to pursue the owner directly, and it cannot have become barred by the contractor's failure to preserve it. A contingent payee's (subcontractor's) right to enforce a pass-through claim against the primary obligor (owner) is expressly recognized in §35.521(l). Since §35.521(s) prohibits contractual waiver of the statute, an owner can not contractually restrict or preclude a contractor from passing a claim through to a subcontractor.

Failure by the contractor to fulfill all aspects of the above requirements may preclude the general contractor's safe harbor protection against a claim of unconscionability. However, such a failure does not necessarily render enforcement of a contingent payment clause unconscionable.

Owners are required by §35.521(p) to provide the contractor the information required to demonstrate due diligence within thirty (30) days after it is requested, and if the owner refuses to do so, the contractor and any subcontractor or supplier and any surety are relieved of any obligation to perform.

If an owner refuses to provide the required information, and the contractor continues to perform despite such refusal, an owner might take the position that the contractor's continued performance waived any right to stop performance. However, §35.521(s) says that a person cannot waive the law by contract *or other means*. Therefore, it appears that the contractor who continues performance for an uncooperative owner in this situation could choose to stop performance at any time during the project.

IV. Questions and Answers

1. Should construction industry participants consult with knowledgeable construction law professionals in the review of their construction contracts and subcontracts, and in dealing with specific fact situations? **ABSOLUTELY**. While this booklet has been prepared to inform those involved in the construction industry generally, it is no substitute for a careful reading of the statute and competent professional advice. Those involved in the legislative process and the analysis of the statute, carefully considered the answers to the following questions, but the information provided in this book does not constitute legal advice or provide legal opinions.

2. If a subcontract has a pay when paid clause and not an enforceable pay-if-paid clause, does this law apply? **No.**

3. If a contractor does not avail itself of the safe harbor protections of the statute by exercising due diligence to obtain information on the owner's ability to pay for the project, is its contingent payment clause deemed "unconscionable?" **No.** The safe harbor protection of the statute is simply an automatic way to avoid a claim of unconscionability. If the contractor does not avail itself of the safe harbor provisions, the subcontractor must still allege and prove unconscionability in order for the clause to be found unenforceable.

4. If a contractor has an enforceable contingent payment clause, must it enforce it? **No.** Many contractors have paid subcontractors in situations where the general contractor has not been paid, despite having an enforceable contingent payment clause. Whether a contractor decides to use a contingent payment clause, or to enforce it in the event of owner nonpayment, is a question that the contractor addresses at the time, having weighed all factors.

5. Suppose the owner fails to pay the contractor for work performed by *both* Subcontractor A and Subcontractor B, because Subcontractor B defaulted, delayed the project so badly that the owner has a claim for damages that exceeds the sum of the amounts due both subcontractors. The owner withholds the entire amount of the contractor's pay request, and neither Subcontractor A nor Subcontractor B gets paid. The fact is non-payment was Subcontractor B's fault, not the contractor's fault. Can the contractor still enforce a contingent payment clause in Subcontractor A's subcontract to avoid payment to Subcontractor A? **NO.** The owner's non-payment is due to the "obligations of the contractor not being met" – albeit obligations assumed by Subcontractor B under its Subcontract to the Contractor. Thus, one defaulting subcontractor could leave the contractor vulnerable, unable to enforce its contingent payment clause against other non-defaulting subcontractors. This makes the careful selection of capable subcontractors all the more critical.

6. Suppose that a subcontractor fails to include all necessary supporting documentation with a pay application in accordance with the payment requirements of the subcontract, as a result of which the subcontractor's later notice of objection is ineffective to stop the

enforcement of a contingent payment clause as to that payment application. Can the subcontractor remedy its failure to properly object by re-submitting a correct pay application, and re-asserting its objection to the enforcement of the contingent payment clause? **YES.** As long as the subcontractor has at least waited 45 days from the date of submission of a complete and proper pay application before objecting, as required by Section 35.521(c), there appears to be no other time constraint on when a subcontractor can object to the enforcement of contingent payment clause.

7. If a subcontractor properly objects to the enforceability of a contingent payment clause, and the owner later pays for the subcontractor's work after the subcontractor's notice of objection has become effective, does the contractor have any right to enforce the contingent payment clause thereafter, in the event of a subsequent non-payment and subsequent timely notice? **YES**. An effective notice of objection will preclude enforcement of the contingent payment clause as to work performed from the date that the notice becomes effective until the date the subcontractor receives the payment. Under section 35.521(g), once the subcontractor receives payment of the "indebtedness giving rise to the [subcontractor's] written notice [of objection]. . . the contingent payment clause is *reinstated* as to work performed or materials furnished *after the receipt of the payment*."

8. Suppose a subcontractor waits 100 days after submitting its pay request to send a notice of objection, and more than a month's interest has already accrued – is the subcontractor's notice of objection effective immediately upon receipt? **NO.** The subcontractor's notice of objection will not be effective until 10 days after the contractor actually receives the subcontractor's notice of objection.

9. Does a contractor have to get an owner to confirm when non-payment is due to a subcontractor's default in order to countermand a subcontractor's notice of objection to the enforceability of a contingent payment clause? **NO.** The statute does not require the owner's confirmation as to the reason for nonpayment. The contractor, actually, should be in a better position to know of a subcontractor's breach of its contractual obligations. Most reasonable owners will agree in a prime contract to notify a contractor promptly (hopefully within 45 days) why any payment is withheld. The prompt payment statute also requires an owner to specifically state the reasons for any withholding of payment, and provide a contractor a reasonable opportunity to resolve the problem, or offer to pay a reasonable amount to resolve it. However, if the contract is silent on this, and an owner refuses to acknowledge whether a subcontractor's default is the reason for non-payment, the contractor can assert in a countermanding notice to the subcontractor that both the contractor and the owner have a valid basis for withholding payment due to the failure of the subcontractor to meet its contractual requirements, as provided in §35.521(e). Obviously, documentation on the project becomes even more important under this statute, because the general contractor has a very short window within which to respond to a subcontractor's objection in order to preserve the enforceability of a valid contingent payment clause.

10. Before the statute goes into effect on September 1, should a general contractor seek information about the ability of the owner to pay for the work? **YES.** Contractors need

to be especially careful to avoid the conundrum of agreeing to a prime contract with an Owner before September 1, 2007, and entering into subcontracts after that date. An Owner may argue it has no statutory duty to provide the information required to demonstrate due diligence, since the prime contract predates the effective date of the statute; yet, the subcontractor will be able to assert that its subcontract is subject to the statute and that the contractor's failure to provide the required information renders enforcement of the contingent payment clause unconscionable.
However, the Code, in §35.521(k)(1), says:

> "The enforcement of a contingent payment clause is not unconscionable if the contingent payor: . . . proves that the contingent payor [Contractor] has exercised diligence in ascertaining and communicating in writing to the contingent payee [Subcontractor], ***before the contract in which the contingent payment clause has been asserted becomes enforceable*** against the contingent payee [Subcontractor], the financial viability of the primary obligor [Owner] and the existence of adequate financial arrangements to pay for the improvements; . . . . "

Thus, as long as a contractor can show that it diligently sought the information from the owner before the effective date of the subcontract containing the contingent payment clause, the contractor may not be precluded from enforcing the contingent payment clause or enjoying the statute's safe harbor protection from claims of unconscionability, even though the prime contract pre-dated September 1, when the owner was under no statutory duty to provide evidence of its ability to pay.

Whether the owner whose prime contract *predates* September 1 is subject to a cessation of work *after* September 1 for refusing to provide evidence of its ability to pay is unclear. Section 2 of S. B. 324 says:

> "Section 35.521, Business & Commerce Code, as added by this Act, applies only to a contingent payment clause under which payment is contingent on the receipt of payment under a contract or other agreement entered into on or after September 1, 2007."

This provision is susceptible of two interpretations. One interpretation is that the contract containing the contingent payment clause, i.e. the *subcontract*, must have been entered into on or after September 1, 2007, for the statute to apply, and the date of the prime contract is irrelevant to the determination of the parties' rights and obligations. Under this interpretation, a subcontract entered into after September 1, 2007 could be governed by the statute even though the prime contract was entered into *before* September 1, 2007, and the owner could be vulnerable to a work cessation.

The other interpretation is that the contract under which the contingent payment must be made, i.e. the *prime contract* with the owner, must have been entered into on or after September 1, 2007, for the statute to apply. Under this interpretation, a subcontract entered into after September 1, 2007, would not be governed by the statute and the owner would not be vulnerable to a work cessation under a prime contract that was effective before September 1. This argument, however, would appear to be flawed, since the date of the prime contract seems to be irrelevant to an owner's obligation to provide the information under §35.521(p).

In the face of this ambiguity, a contractor might consider taking an additional precaution in addition to asking the owner to provide information on its ability to pay for the project. A contractor could reserve the right in a subcontract issued *before* September 1 to enter into a newly restated subcontract *after* September 1 that "renews" and makes the contingent payment clause effective for a separate nominal legal consideration to be paid after September 1, and after the contractor has renewed a request to the owner to provide such information under the statute.

11. Is there a relationship between a subcontractor's right to stop work under the public and private prompt pay acts (Tex. Prop. Code § 28 and Tex. Govt. Code §§ 2251.001-.055, respectively) and a subcontractor's right to stop work under the statute? **NO**, not a direct relationship, although there are similarities in the statutes. Under the prompt payment acts, a contractor or any subcontractor has the right to stop work if the owner has not paid undisputed funds within the prescribed time limits, provided the requisite written notice is given to the owner and its lender by the contractor or the subcontractor. In comparison, the statute allows parties to request certain project and project financing information from the owner or governmental authority. If such information is not provided by the owner within 30 days of receiving a written request, the contractor, subcontractors, and sureties are relieved of the obligation to initiate or continue performance of the work. Neither of these work stoppage remedies modifies or augments the other.

12. What is the effect of a subcontractor's notice of objection to the enforcement of a "pay when paid" clause, rather than a contingent payment clause ("pay-if-paid")? **NONE.** A "pay-when-paid" clause merely defers the time of payment, and is not a contingent payment clause. A contingent payment clause makes payment from the primary obligor (usually the owner) an absolute condition precedent to the obligation to pay the subcontractor. Therefore, the subcontractor's notice of objection to enforcement of a "pay-when-paid" clause *should* be of no consequence. Note, however, that prompt payment statutes specify deadlines for payment of subcontractors, in both public and private construction. Therefore, a contractor should carefully consider whether and how to respond to such a notice, rather than ignore it. A contractor may also want to pay careful attention to subcontract terms that provide agreement on circumstances which could delay payment and how long such payments may be reasonably delayed.

13. Does this statute apply to a subcontract for striping or curbing of a parking lot as part of the work for a commercial plaza? **UNKNOWN.** The statute does not apply a contract that is "solely for . . . construction or maintenance of a road, highway, street, ridge, utility, water supply project, water plant, wastewater plant, water and wastewater distribution or conveyance facility, wharf, dock, airport runway or taxiway, drainage project, or related type of project associated with civil engineering construction . . . ." The subcontract could be treated as "solely" related to construction "associated with civil engineering."

14. Assuming the contractor exercises "due diligence" to obtain from the owner the financial viability of the owner and/or the existence of security for payment, and communicated this to a subcontractor in writing before the subcontract is signed, is this enough to assure

the general contractor have the safe harbor protections against claims of unconscionability? **NO.** The legislation also requires the contractor to "make reasonable efforts to collect" the amount due to the subcontractor or assign the contractor's rights against the owner for the safe harbor provision to apply.

15. Will a contractor, subcontractor, or their sureties waive their statutory right to be relieved of their obligations if the owner refuses to provide information concerning its ability to pay and/or security, and the contractor and subcontractor nevertheless proceed to execute their subcontract and commence working? **PROBABLY NOT**. The language of the statute prohibits waivers by contract "*or otherwise."* Continued performance would not, therefore, constitute a waiver. The statute also states that the contractor and subcontractor in this situation are "relieved of the obligation to *initiate or continue* performance . . . ." The use of the word "continue" suggests that a party may start work and then decide not to "continue". Any party considering a discontinuation of work should consider the legal implications of whether to characterize this as an outright termination or merely a suspension of the performance of work.

16. Should a contractor, subcontractor, or supplier continue to take steps timely to enforce their lien and bond claim rights, while taking action as required by the statute to enforce payment from the owner? **YES.** The statute is not an exclusive remedy. Parties will lose the right to assert a lien or bond claim if they do not timely meet the applicable requirements for asserting their claims – those requirements are independent of the statute relating to enforcement of contingent payment clauses.

17. If a subcontractor fails to pay a labor broker for the services of borrowed laborers, and the labor broker files a mechanics lien claim, can the contractor rely on the contingent payment clause to defeat the labor broker's lien claim? **NO.** A contingent payment clause cannot be used to defeat a valid lien claim. The statute states in §35.521(i) that a contingent payment clause may not be used "as a basis for invalidation of the enforceability or perfection of a mechanic's lien."

18. If a subcontractor's objection to a contingent payment clause becomes effective because of another subcontractor's default (i.e., the owner's nonpayment is therefore technically due to the contractor's failure to meet its obligations to the owner and the contractor does not issue a countermanding notice), will the subcontractor's subsequent failure to give further notices objecting to enforcement of the contingent payment clause result in the clause being enforceable as to the subcontractor's future pay applications? NOT NECESSARILY. While one effective notice can block enforcement of contingent payment clause as to materials and labor furnished thereafter, the contingent payment clause is "reinstated" as to any later payment applications if the owner or contractor pays the subcontractor's payment application that was the subject of the notice. Also, there is no deadline by which a subcontractor must give notice objecting to a contingent payment clause if an owner fails to pay for the subcontractor's properly performed work. The only time constraint on the subcontractor's issuance of a notice of objection is the requirement for the expiration of the 45 day period, which operates as a *waiting* period. The subcontractor to whom payment is due can issue a payment at any time after expiration of this waiting period.

19. Can a subcontractor insist on being assigned a right to recover directly from an owner who fails or refuses to pay for the subcontractor's properly performed work? **NO.** In order to avail itself of the safe harbor protection of the statute, a contractor can decide to either attempt to collect from the Owner any payment due for the subcontractor's work, or assign a pass-through claim to the subcontractor. That is an election the contractor can make. In the absence of special circumstances, the subcontractor typically has no right to assert a direct claim against an owner unless the contractor has agreed to assign to the subcontractor the right to do so.

20. In exercising due diligence to obtain and provide subcontractors information concerning the primary obligor's ability to pay for a project, is a lessee who hires a contractor to construct improvements on leased land considered the primary obligor? **YES.** The statute defines the primary obligor as the owner of the "real property to be improved or repaired." Therefore, the lessee/owner should be treated as the primary obligor, not the landlord who leased the land to the lessee/owner.

21. In order for a contractor to be able to establish that it exercised due diligence to obtain and provide subcontractors the information described by the statute concerning the primary obligor's ability to pay for the project, does the statute require a contractor to ensure the accuracy of the information supplied by the primary obligor on its ability to pay for the project? **NO.** Subsection 35.521(p) only obligates the primary obligor to furnish the information on the primary obligor's ability to pay as described in the statute. Subsections 35.521 (n) and (o) provide that the contingent payor (the contractor) will be "considered to have exercised due diligence" if the contingent payee (the subcontractor) "receives" the required information from the contingent payor (the contractor).

22. If, in the exercise of due diligence, questions arise about the primary obligor's information concerning its ability to pay for the project, can supplemental requests be made to obtain additional information? **YES.** The statute does not limit the number of requests that may be made to a primary obligor to obtain all information that is appropriate in the exercise of due diligence.

23. Must a subcontractor take advantage of all of the provisions of this statute? **No.** The vast majority of subcontractors and general contractors have successfully shared risks and prospered without this statute for many years. The statute was passed to deal with isolated abusive situations. AGC-Texas Building Branch anticipates that most of its members, and the subcontractors they work with, will continue to do business together and share risks largely without change. Work stoppages and notice contests can be disruptive to the construction process. Most construction industry participants recognize this. Many will try to work together to deal with owner non-payment situations without resort to this statute.

Appendix I – Copy of S. B. 324

S. B. No. 324

AN ACT

relating to contingent payment clauses in certain construction contracts.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF TEXAS:

SECTION 1. Subchapter D, Chapter 35, Business & Commerce Code, is amended by adding Section 35.521 to read as follows:

Sec. 35.521. AGREEMENT FOR PAYMENT OF CONSTRUCTION SUBCONTRACTOR. (a) In this section:

(1) "Contingent payee" means a party to a contract with a contingent payment clause, other than an architect or engineer, whose receipt of payment is conditioned on the contingent payor's receipt of payment from another person.

(2) "Contingent payment clause" means a provision in a contract for construction management, or for the construction of improvements to real property or the furnishing of materials for the construction, that provides that the contingent payor's receipt of payment from another is a condition precedent to the obligation of the contingent payor to make payment to the contingent payee for work performed or materials furnished.

(3) "Contingent payor" means a party to a contract with a contingent payment clause that conditions payment by the party on the receipt of payment from another person.

(4) "Improvement" includes new construction, remodeling, or repair.

(5) "Obligor" means the person obligated to make payment to the contingent payor for an improvement.

(6) "Primary obligor" means the owner of the real property to be improved or repaired under the contract, or the contracting authority if the contract is for a public project. A primary obligor may be an obligor.

(b) A contingent payor or its surety may not enforce a contingent payment clause to the extent that the obligor's nonpayment to the contingent payor is the result of the contractual obligations of the contingent payor not being met, unless the nonpayment is the result of the contingent payee's failure to meet the contingent payee's contractual requirements.

(c) Except as provided by Subsection (f), a contingent payor or its surety may not enforce a contingent payment clause as to work performed or materials delivered after the contingent payor receives written notice from the contingent payee objecting to the further enforceability of the contingent payment clause as provided by this section and the notice becomes effective as provided by Subsection (d). The contingent payee may send written notice only after the 45th day after the date the contingent payee submits a written request for payment to the contingent payor that is in a form substantially in accordance with the contingent payee's contract requirements for the contents of a regular progress payment request or an invoice.

(d) For purposes of Subsection (c), the written notice becomes effective on the latest of:

(1) the 10th day after the date the contingent payor receives the notice;

(2) the eighth day after the date interest begins to accrue against the obligor under:

(A) Section 28.004, Property Code, under a contract for a private project governed by Chapter 28, Property Code; or

(B) 31 U.S.C. Section 3903(a)(6), under a contract for a public project governed by 40 U.S.C. Section 3131; or

(3) the 11th day after the date interest begins to accrue against the obligor under Section 2251.025, Government Code, under a contract for a public project governed by Chapter 2251, Government Code.

(e) A notice given by a contingent payee under Subsection (c) does not prevent enforcement of a contingent payment clause if:

(1) the obligor has a dispute under Chapter 28, Property Code, Chapter 2251, Government Code, or 31 U.S.C. Chapter 39 as a result of the contingent payee's failure to meet the contingent payee's contractual requirements; and

(2) the contingent payor gives notice in writing to the contingent payee that the written notice given under Subsection (c) does not prevent enforcement of the contingent payment clause under this subsection and the contingent payee receives the notice under this subdivision not later than the later of:

(A) the fifth day before the date the written notice from the contingent payee under Subsection (c) becomes effective under Subsection (d); or

(B) the fifth day after the date the contingent payor receives the written notice from the contingent payee under Subsection (c).

(f) A written notice given by a contingent payee under Subsection (c) does not prevent the enforcement of a contingent payment clause to the extent that the funds are not collectible as a result of a primary obligor's successful assertion of a defense of sovereign immunity, if the contingent payor has exhausted all of its rights and remedies under its contract with the primary obligor and under Chapter 2251, Government Code. This subsection does not:

(1) create or validate a defense of sovereign immunity; or

(2) extend to a primary obligor a defense or right that did not exist before the effective date of this section.

(g) On receipt of payment by the contingent payee of the unpaid indebtedness giving rise to the written notice provided by the contingent payee under Subsection (c), the contingent payment clause is reinstated as to work performed or materials furnished after the receipt of the payment, subject to the provisions of this section.

(h) A contingent payor or its surety may not enforce a contingent payment clause if the contingent payor is in a sham relationship with the obligor, as described by the sham relationships in Section 53.026, Property Code.

(i) A contingent payment clause may not be used as a basis for invalidation of the enforceability or perfection of a mechanic's lien under Chapter 53, Property Code.

(j) A contingent payor or its surety may not enforce a contingent payment clause if the enforcement would be unconscionable. The party asserting that a contingent payment clause is unconscionable has the burden of proving that the clause is unconscionable.

(k) The enforcement of a contingent payment clause is not unconscionable if the contingent payor:

(1) proves that the contingent payor has exercised diligence in ascertaining and communicating in writing to the contingent payee, before the contract in which the contingent payment clause has been asserted becomes enforceable against the contingent payee, the financial viability of the primary obligor and the existence of adequate financial arrangements to pay for the improvements; and

(2) has done the following:

(A) made reasonable efforts to collect the amount owed to the contingent payor; or

(B) made or offered to make, at a reasonable time, an assignment by the contingent payor 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 reasonable cooperation to the contingent payee's collection efforts, if the assigned cause of action is not subject to defenses caused by the contingent payor's action or failure to act.

(l) A cause of action brought on an assignment made under Subsection (k)(2)(B) is enforceable by a contingent payee against an obligor or a primary obligor.

(m) A contingent payor is considered to have exercised diligence for purposes of Subsection (k)(1) under a contract for a private project governed by Chapter 53, Property Code, if the contingent payee receives in writing from the contingent payor:

(1) the name, address, and business telephone number of the primary obligor;

(2) a description, legally sufficient for identification, of the property on which the improvements are being constructed;

(3) the name and address of the surety on any payment bond provided under Subchapter I, Chapter 53, Property Code, to which any notice of claim should be sent;

(4) if a loan has been obtained for the construction of improvements:

(A) a statement, furnished by the primary obligor and supported by reasonable and credible evidence from all applicable lenders, of the amount of the loan;

(B) a summary of the terms of the loan;

(C) a statement of whether there is foreseeable default of the primary obligor; and

(D) the name, address, and business telephone number of the borrowers and lenders; and

(5) a statement, furnished by the primary obligor and supported by reasonable and credible evidence from all applicable banks or other depository institutions, of the amount,

source, and location of funds available to pay the balance of the contract amount if there is no loan or the loan is not sufficient to pay for all of the construction of the improvements.

(n) A contingent payor is considered to have exercised diligence for purposes of Subsection (k)(1) under a contract for a public project governed by Chapter 2253, Government Code, if the contingent payee receives in writing from the contingent payor:

(1) the name, address, and primary business telephone number of the primary obligor;

(2) the name and address of the surety on the payment bond provided to the primary obligor to which any notice of claim should be sent; and

(3) a statement from the primary obligor that funds are available and have been authorized for the full contract amount for the construction of the improvements.

(o) A contingent payor is considered to have exercised diligence for purposes of Subsection (k)(1) under a contract for a public project governed by 40 U.S.C. Section 3131 if the contingent payee receives in writing from the contingent payor:

(1) the name, address, and primary business telephone number of the primary obligor;

(2) the name and address of the surety on the payment bond provided to the primary obligor; and

(3) the name of the contracting officer, if known at the time of the execution of the contract.

(p) A primary obligor shall furnish the information described by Subsection (m) or (n), as applicable, to the contingent payor not later than the 30th day after the date the primary obligor receives a written request for the information. If the primary obligor fails to provide the information under the written request, the contingent payor, the contingent payee, and their

sureties are relieved of the obligation to initiate or continue performance of the construction contracts of the contingent payor and contingent payee.

(q) The assertion of a contingent payment clause is an affirmative defense to a civil action for payment under a contract.

(r) This section does not affect a provision that affects the timing of a payment in a contract for construction management or for the construction of improvements to real property if the payment is to be made within a reasonable period.

(s) A person may not waive this section by contract or other means. A purported waiver of this section is void.

(t) An obligor or a primary obligor may not prohibit a contingent payor from allocating risk by means of a contingent payment clause.

(u) This section does not apply to a contract that is 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 and wastewater distribution or conveyance facility, wharf, dock, airport runway or taxiway, drainage project, or related type of project associated with civil engineering construction; or

(3) improvements to or the construction of a structure that is a:

(A) detached single-family residence;

(B) duplex;

(C) triplex; or

(D) quadruplex.

SECTION 2. Section 35.521, Business & Commerce Code, as added by this Act, applies only to a contingent payment clause under which payment is contingent on the receipt of payment under a contract or other agreement entered into on or after September 1, 2007.

SECTION 3. This Act takes effect September 1, 2007.

_____ _____

President of the Senate Speaker of the House

I hereby certify that S.B. No. 324 passed the Senate on March 14, 2007, by the following vote: Yeas 30, Nays 0; and that the Senate concurred in House amendment on May 21, 2007, by the following vote: Yeas 30, Nays 0.

_____

Secretary of the Senate

I hereby certify that S.B. No. 324 passed the House, with amendment, on May 17, 2007, by the following vote: Yeas 140, Nays 0, two present not voting.

_____

Chief Clerk of the House

Approved:

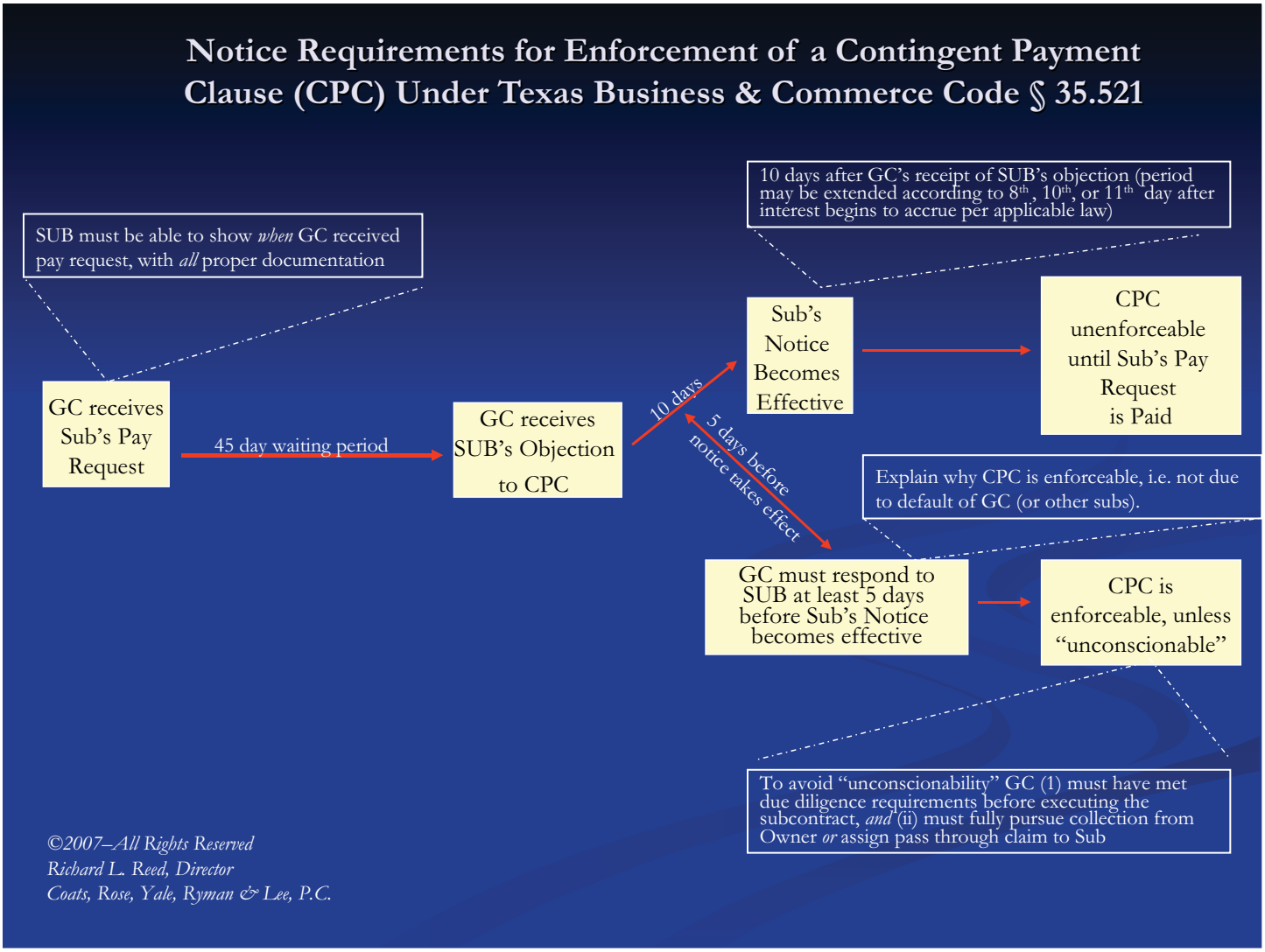
_____

Date

_____

Governor

Prepared by Rick Reed
of
Coats, Rose, Yale, Ryman & Lee, P.C.
San Antonio, Texas



Appendix III

HOW TO DETERMINE WHEN A SUBCONTRACTOR'S NOTICE OF OBJECTION TO A CONTRACTOR'S CONTINGENT PAYMENT CLAUSE BECOMES EFFECTIVE

Prepared by George Baldwin
of
Ford, Nassen, & Baldwin, P.C.
Austin-Dallas

Section 35.521(d) of the Texas Business & Commerce Code dictates the date when a written notice of objection from a subcontractor to a general contractor becomes effective. Before beginning the calculations to determine the effective date, one must know whether the project at issue is a private, state or federal endeavor. The following is an attempt to summarize this complex and tangled section into plain English. The written notice of objection becomes effective on the *latest* of the following dates:

A. All Projects: 10 days after the general contractor receives the notice.
B. Private Projects: 9 days after payment is due.
C. Federal Projects / Progress Payments: 22 days after the general contractor's receipt of the written request for payment.
D. Federal Projects / Retainage Payments: 38 days after final acceptance.
E. State of Texas Projects: 11 days after the date the payment becomes overdue.

To successfully navigate and utilize this Section, one needs to calculate the effective date according to option "A. All Projects" and also calculate the effective date according to one of the other four options, depending on whether the project is public or private, state or federal, and if federal, whether the dispute is over a progress payment or for retainage. After calculating these two dates, remember that the effective date is the latest of these two dates.

For example, let's assume you are a concrete supplier for the general contractor, Acme GC, on a project to build an office building for the TxDOT (road projects are not subject to the statute). On January 1st, you hand deliver to Acme an application for payment in accordance with your supply contract. On February 1st, Acme informs you that you won't be paid because of a contingent payment clause in the contract, and that Acme has not yet been paid by TxDot. On February 15th, 46 days after the pay application was submitted in accordance with the agreement, you can mail a notice of objection to Acme. Now the question is: when does this notice of objection become effective? To figure that out, you need to calculate the date for option "A. All Projects": 10 days after the general contractor receives the notice. Assuming your pay application was complete when you submitted it, and you waited the 45 days, and you sent your notice of objection with a return receipt, you will know when Acme received your notice. For this scenario, let's assume that Acme received the notice in 3 days, on February 18th. Adding 10 days to February 18th, the effective date for option "A. All Projects" is February 28th. The next step is to now determine which of the other four later date options governs your project. In this scenario, involving the construction of a TxDot project, option "E. State of Texas Projects" is the correct option. For state of Texas projects, the effective date would be 11 days after the date the payment becomes overdue. For this hypothetical, we'll assume the contract

dictates that payment is due one month from the date of the pay request, which was sent by you and received by Acme on January 1st. Therefore, the payment became overdue one month and one day later, on February 2nd. Adding 11 days to February 2nd, you get an effective date of February 13th according to option E. Now, remember, the statute says that the effective date is the latest of these dates: either February 28th according to option A or February 13th according to option E. Picking the latest of these days, your effective date is February 28th. This is the date that commences the time frame when the contingent payment clause will NOT be enforceable (unless the contractor has, at least 5 days earlier, notified Acme that the contingent payment clause will be enforceable because the non-payment was due to a default by TxDOT' or Acme and not due to a default attributable contractor). These are the types of calculations that will need to be completed for each and every notice of objection to a contingent payment clause given to the general contractor, for each and every pay application that is not paid within 45 days, . Always keep in mind that the effective date is variable according to the particular type of contract and the specific type of project.

Select Portions of Applicable Law

Texas Business & Commerce Code Section § 35.521. Agreement for Payment of Construction Contractor

(d) For purposes of Subsection (c), the written notice becomes effective on the latest of:

(1) the 10th day after the date the contingent payor receives the notice;

(2) the eighth day after the date interest begins to accrue against the obligor under:

(A) Section 28.004, Property Code, under a contract for a private project governed by Chapter 28, Property Code; or

(B) 31 U.S.C. Section 3903(a)(6), under a contract for a public project governed by 40 U.S.C. Section 3131; or

(3) the 11th day after the date interest begins to accrue against the obligor under Section 2251.025, Government Code, under a contract for a public project governed by Chapter 2251, Government Code

Texas Property Code § 28.004. Interest on Overdue Payment.

(a) An unpaid amount required under this chapter begins to accrue interest on the day after the date on which the payment becomes due.

(b) An unpaid amount bears interest at the rate of 1 1/2 percent each month.

(c) Interest on an unpaid amount stops accruing under this section on the earlier of:

(1) the date of delivery;

(2) the date of mailing, if payment is mailed and delivery occurs within three days; or

(3) the date a judgment is entered in an action brought under this chapter.

31 USCS § 3903. Regulations

(a) The Director of the Office of Management and Budget shall prescribe regulations to carry out section 3902 of this title [31 USCS § 3902]. The regulations shall--

(6) in the case of a construction contract, provide for the payment of interest on--

(A) a progress payment (including a monthly percentage-of-completion progress payment or milestone payments for completed phases, increments, or segments of any project) that is approved as payable by the agency pursuant to subsection (b) of this section and remains unpaid for--

(i) a period of more than 14 days after receipt of the payment request by the place or person designated by the agency to first receive such requests; or

(ii) a longer period, specified in the solicitation, if required to afford the Government a practicable opportunity to adequately inspect the work and to determine the adequacy of the contractor's performance under the contract; and

(B) any amounts which the agency has retained pursuant to a prime contract clause providing for retaining a percentage of progress payments otherwise due to a contractor and that are approved for release to the contractor, if such retained amounts are not paid to the contractor by a date specified in the contract or, in the absence of such a specified date, by the 30th day after final acceptance

Texas Government Code § 2251.025. Interest on Overdue Payment.

(a) A payment begins to accrue interest on the date the payment becomes overdue.

(b) The rate of interest that accrues on an overdue payment is the rate in effect on September 1 of the fiscal year in which the payment becomes overdue. The rate in effect on September 1 is equal to the sum of:

(1) one percent; and

(2) the prime rate as published in the Wall Street Journal on the first day of July of the preceding fiscal year that does not fall on a Saturday or Sunday.

(c) Interest on an overdue payment stops accruing on the date the governmental entity or vendor mails or electronically transmits the payment. In this subsection, "governmental entity" does not include a state agency.

(d) This subsection applies only if the comptroller is not responsible for issuing a warrant or initiating an electronic funds transfer to pay the principal amount owed by a state agency to a vendor. The accrual of interest on an overdue payment to the vendor:

(1) stops on the date the agency mails or electronically transmits the payment; and

(2) is not suspended during any period that a payment law prohibits the agency from paying the vendor.

(e) This subsection applies only if the comptroller is responsible for issuing a warrant or initiating an electronic funds transfer to pay the principal amount owed by a state agency to a vendor. Interest on an overdue payment to the vendor:

(1) stops accruing on its distribution date; and

(2) does not stop accruing during any period that a payment law prohibits the comptroller from issuing the warrant or initiating the transfer.

Appendix IV

SAMPLE FORMS FOR CONTRACTOR TO EXERCISE DUE DILIGENCE IN OBTAINING INFORMATION FROM OWNERS RELATING TO FINANCIAL ABILITY TO PAY FOR WORK*

A. CONFIRMATION OF FUNDING TO PAY FOR WORK - **FOR PRIVATE OWNERS**
(1 Page)

B. CONFIRMATION OF FUNDING TO PAY FOR WORK – **FOR PUBLIC OWNERS**
(2 Pages)

C. OWNER FINANCIAL QUESTIONNAIRE [Source: AGC Guidelines for Obtaining Owner Financial Information (AGC Document 290.1).]

***NOTE: WHILE THE FORMS IN APPENDICES IV(A) AND (B) ARE BASED ON THE STATED STATUTORY REQUIREMENTS TO ESTABLISH DILIGENCE, IT MAY BE APPROPRIATE TO SEEK SPECIALIZED ADVICE ABOUT USE OF THE FORM IN APPENDIX IV(C) OR OTHER REQUESTS TO OBTAIN MORE DETAILED INFORMATION CONCERNING THE OWNER'S ABILITY TO PAY FOR A MAJOR EQUITY AND/OR BOND FINANCED PROJECT.**

Appendix IV(A) - CONFIRMATION OF FUNDING TO PAY FOR WORK – **FOR PRIVATE OWNERS**

TO: _____ (Owner)

FROM: _____ (Contractor)

PROJECT: _____ (Project)

Date of Contractor's Request: _____, ____

Pursuant to the requirements of Texas Business & Commerce Code, §35.521, please provide to us, within thirty (30) days from the date you have received this request the following information to be furnished to Contractor's subcontractors to demonstrate the financial viability of the Owner as the Primary Obligor, and the availability of funding and the existence of adequate financial arrangements to pay for improvements for the Project:

1. Your full legal name, physical and mailing address, and business telephone number:
   _____
   _____
   _____
   _____
   (___) ___ - _____

2. Please state below or attach the legal description of the real property on which the improvements are to be constructed, together with the volume and page number of the county real property records where Owner's title is recorded. ___ *Check here if you prefer to attach a copy of owner's recorded title to the real property, containing its property legal description.*

3. If one or more loans have been arranged to fund the Project, please state the following for *each* such loan. For any loans that have not been arranged but are anticipated to fund the Project, please provide as much of the following information as is currently known or anticipated for *each* such loan.

   A. Name, address and business telephone number of the lender:
   _____
   _____
   _____
   _____
   (___) ___ - _____

   B. Name, address and business telephone number of the borrower:
   _____
   _____
   _____
   _____
   (___) ___ - _____

   (For each partnership or limited liability company involved in a borrower's organization, please provide contact information for each member or general partner, as applicable.)

   C. Amount of such loan which will be available to pay for the construction of the improvements.

   $_____

   OR

   ___ See attached true and correct copy of loan agreement furnished in lieu of summary.

D. Summary of loan terms, e.g. repayment terms, equity funding requirements, financial covenants or conditions which may give rise to default, and other terms relevant to availability of funding.

_____
_____
_____
_____.

- OR -

___ See attached true and correct copy of loan agreement furnished in lieu of summary.

E. Is the loan in default or are you aware of any circumstances indicating a default under the loan agreement is foreseeable? ___ Yes ___ No

If *yes*, please explain: _____
_____
_____.

(Attach additional pages or repeat for each such loan as necessary.)

4. Please attach a copy of each lender's loan commitment letter or other written statement confirming the existence and amount of each loan disclosed above.

- OR -

___ See attached true and correct copy of loan agreement furnished in lieu of summary.

5. To the extent that the Owner will not finance the entire contract amount from the loan(s) described above, please attach a statement of the (a) amount, (b) source, and (c) location of all other funds available to pay for the Project.

6. Please attach written confirmation from each bank or other depository institution of all other funds available for construction.

NOTE: OWNER HEREBY CONFIRMS THE ABOVE INFORMATION IS TRUE AND CORRECT, AND IN CONSIDERATION OF THIS CERTIFICATION, CONTRACTOR AGREES TO MAINTAIN, AND SHALL REQUIRE ALL SUBCONTRACTORS TO MAINTAIN, THE CONFIDENTIALITY OF THE INFORMATION PROVIDED BY OWNER AND OWNER'S LENDER.

Date of Owner's Response: _____

OWNER

By: _____

Name: _____

Title: _____

(To be completed by Contractor, if applicable.) The name and address of Contractor's **Payment Bond Surety** to whom a claim may be sent:

_____
_____
_____
_____

Appendix IV(B) - CONFIRMATION OF FUNDING TO PAY FOR WORK - **FOR PUBLIC OWNERS**

TO: _____ (Owner)

FROM: _____ (Contractor)

PROJECT: _____ (Project)

Date of Contractor's Request: _____, ____

Pursuant to the requirements of Texas Business & Commerce Code, §35.521, please provide to us, within thirty (30) days from the date you have received this request the following information to be furnished to Contractor's subcontractors to demonstrate the financial viability of the Public Owner as the Primary Obligor, and the availability of funding and the existence of adequate financial arrangements to pay for improvements for the Project:

1. Your full legal name, physical and mailing address, and business telephone number:
   _____
   _____
   _____
   _____
   (___) ___ - _____

   For Federal construction only, name of **Contracting Officer**: _____

2. Are funds are available and has funding been authorized for the full contract amount for the construction of the improvements? ___ Yes ___ No

   If *no*, please explain: _____
   _____
   _____
   _____.

   Date of Public Owner's Response: _____

PUBLIC OWNER

By: _____

Name: _____

Title: _____

(To be completed by Contractor only.) The name and address of Contractor's **Payment Bond Surety** to whom a claim may be sent:

_____
_____
_____
_____

CONSENSUSDOCS 290.1

OWNER FINANCIAL QUESTIONNAIRE

Contractors have a legitimate interest in knowing that sufficient funds are available for the project owner to make payments in accordance with the construction contract terms. This standard form questionnaire is intended to assist the project owner in providing the necessary information to the contractor.*

This document was developed through a collaborative effort of entities representing a wide cross-section of the construction industry. The organizations endorsing this document believe it represents a fair and reasonable consensus among the collaborating parties of allocation of risk and responsibilities in an effort to appropriately balance the critical interests and concerns of all project participants.

These endorsing organizations recognize and understand that users of this document must review and adapt this document to meet their particular needs, the specific requirements of the project, and applicable laws. Users are encouraged to consult legal, insurance and surety advisors before modifying or completing this document. Further information on this document and the perspectives of endorsing organizations is available in the ConsensusDOCS Guidebook.

I. Project Owner

a. Name of Project Owner (Include address and telephone and facsimile numbers.)

b. Legal Structure of Project Owner

__Corporation __Partnership __Individual __L.L.C. __L.L.P. __Other

(Describe)_____

c. If Project Owner is a Partnership

1. Name(s) of General Partners

2. Name(s) of Partners authorized to bind Partnership

d. If Project Owner is a Corporation

1. State of Incorporation _____

2. Names of individuals authorized to sign on behalf of Corporation (Attach corporate resolution.)

e. List previous projects (Provide name, location, and approximate project cost.)

f. Bank reference(s) and contact person(s)

g. Dun & Bradstreet rating: _____

II. Project Information

a. Project Name & Number: _____

b. Name of Project Owner's Authorized Representative: _____

c. Project location: _____

d. Nature of Completed Project: _____

e. Method of Construction __GC __Prime __D/B __CM __PM __Other ___

f. Name and address of Architect/Engineer

g. Date Bid Due: _____Time: _____

h. Bond Required: Bid: _____Perf/Payment: _____Other: _____

i. Liquidated Damages: _____

j. Completion Time: _____

k. Engineer's Cost Estimate: _____

l. Payments/Retainages _____

m. Conditioned Bid Allowed? _____

III. Land Information

a. Project Owner's interest in land (fee simple, lease, etc.): _____

b. Name of Party holding legal title to land on which Project is to be constructed (if other than Project Owner): _____

c. Legal description of property (Add separate sheet if more space is required.)

d. Title holder's organizational structure __Corporation __Partnership __Individual __L.L.C. __L.L.P. __Other (Describe) _____

e. Name and address of title insurance company

IV. Financial Information --Sources of Project Funding

a. Construction Loans

1. Name and address of Lender(s) (Include lending officer's name and telephone and facsimile numbers.)

2. Type of loan(s) _____

3. Amount of loan(s) _____

4. Term of loan(s) _____

b. Government Funding (direct or government guaranteed)

1. Name of governmental agency _____

2. Name and address of agency contact person(s) _____

3.Type of funding __Grant __Loan __Bond Issue

If a grant, name of Grantee _____

4. Program under which funding provided _____

5. Amount of funding _____

6. Term of grant or loan _____

7. Name and address of Trustee of Bond Funds _____

c. Other sources of funds (Owner's equity, syndication proceeds, etc.)

V. Copies of the following are to be provided with this Questionnaire

a. Owner's Certified Financial Statement

b. Construction Loan Agreement

c. Lender's "Set-Aside" Letter acknowledging amount of loan proceeds to be applied only to construction draws

d. Owner/Architect Agreement

e. Owner's Property Insurance Policy and/or Builder's Risk Policy

f. Architect's Professional Liability Policy

The Owner hereby represents that the information given in response to this Questionnaire is, to the best of the Owner's knowledge, true and correct and is provided with the understanding that the Contractor is entitled to rely upon the accuracy of such information.

Note: Notice of any change in the above information must be given to the contractor within five (5) Days of such change.

Owner……

Date _____

*The information requested in this form is intended to comply with the financial information requirements of the ConsensusDOCS 200 and the 2007 edition of AIA Document A201.

Appendix V

GENERAL SUMMARY OF TEXAS COMMON LAW ON ENFORCEABILITY OF CONTINGENT PAY CLAUSES

Prepared by J. C. Spencer and Tim Matheny
of
Ford, Nassen, & Baldwin, P.C. Austin-Dallas

The following is a summary of the views and standards Texas appeal courts have taken when addressing the issue of enforcing a contingent payment clause in construction contracts. Understandably, general contractors prefer a contingent payment clause in the event an owner fails to pay them. Conversely, subcontractors do not like contingent payment clauses because of the delays in payment that can (and have) occurred. However, Texas courts have not been eager to enforce contingent payment clauses. General contractors have been held to a very high standard before the courts are willing to enforce contingent payment clauses at the appellate level

While Texas appellate courts have addressed the issue, the Texas Supreme Court has never considered such a clause. No Texas court ever laid down in detail what "magic" words are necessary to give a contingent payment clause effect. Several cases, however, offer guidance. They will all be discussed below. The six Texas appellate courts that have directly addressed the enforceability of a contingent payment clause in a construction contract are listed in **Appendix V-1,** below.

Essentially the standard boils down to a matter of contract interpretation and whether the **intent of the clause and the parties is clearly expressed** in the contract. The courts want the clause to clearly state that the owner's payment to the general contractor is a *condition precedent* to payment to the subcontractor.

Texas courts have looked to an often cited federal case that sets out the jurisprudential foundation on which payment clauses have since been drafted. *See Thos. J. Dyer Co. v. Bishop Internat'l Engineering Co.*, 303 F.2d 655 (6th Cir. 1962). Under the rules laid down in *Dyer*, nonpayment by the owner is a risk typically born by the general contractor. The court reasoned

that, based on the typical expectations in the contracting relationship, a subcontractor looks primarily to the financial stability of the general contractor. Thus, an owner's unwillingness or inability to pay will not typically defeat a subcontractor's claim for payment. The *Dyer* court went on to state that this risk could be transferred by contract; however, this must be done with an "an express condition clearly showing that to be the intention of the parties." *Dyer,* 303 F.2d at 661.

One Texas appellate court adopted and expounded upon the rules laid down in *Dyer*. In *Wisznia*, the Corpus Christi Court of Appeals looked at a payment clause in an architect's contract that stated "the engineer shall be paid in the same proportionate manner as the architect is being paid by the [owner]." *Wisznia v. Wilcox*, 438 S.W.2d 874 (Tex. Civ. App.—Corpus Christi 1969). Addressing the architect's argument that this language created a contingent payment clause, the court stated that "whether the parties to a transaction intended to make the payment of money conditional must be gathered from the four corners of the instrument . . . the situation of the parties . . . and the subject matter and the purposes to be accomplished." Citing *Dyer*, the court held that payment was not contingent on receipt of funds from the owner and, "if such was not to be the case, it should have been so expressed in **unequivocal terms** dealing with the possible insolvency." *Dyer*, 1962 U.S. App. LEXIS at 18, *Emphasis added*.

Texas courts have worked hard to avoid the forfeiture caused by such clauses. In *Gulf Construction*, the Corpus Christi court looked at contract language stating, "under no circumstances shall the general contractor be obligated or required to advance or make payments to the sub-contractor until the funds have been advanced or paid by the owner. . ." *Gulf Construction Co., Inc. v. Mid-Continent Casualty Co.,* 676 S.W.2d 624 (Tex. App.—Corpus Christi 1984). While the intent of this clause appeared to be risk-shifting to the subcontractor, the court held otherwise. Stating that the payment clause merely affected the time for payment and not the obligation to pay, the court noted that the contract did not state that: (1) the general contractor was relieved of its payment obligation "if" the money were not received from the owner; or (2) the payment to subs shall be made "out of" funds received by the contractor. The only operative language used was "until", which merely affected the time for payment.

Six years later, citing *Gulf*, the same court again found the following language inoperative: "Contractor will pay subcontractor [the contract sum] . . . for which payment has been made by owner or lender to contractor." *Sheldon L. Pollack Corp. v. Falcon Industries, Inc.*, 794 S.W.2d 380 (Tex. App.—Corpus Christi 1990).

Only four other appellate courts have addressed contingent payment clauses in the construction context — Houston, Eastland, San Antonio[3] and Amarillo[4] — and, surprisingly, only **one** court has ever upheld such a clause Houston).[5]

The Eastland court found against a contingent payment clause by harmonizing the contract. *See Prickett v. Lendell Builders, Inc.*, 572 S.W.2d 57 (Tex. Civ App.—Eastland 1978). The contract unequivocally stated that the contractor would pay the contract price to the subcontractor in consideration for its work. The contract also stated that "payment shall be made monthly, within five (5) days after Contractor . . . is paid for the same work by [the lender]." *Prickett,* 1978 Tex. App. LEXIS at 3. The court stated, "by examining the contract in its entirety we hold the condition precedent clearly applied to the monthly progress payments and when such payments would be made, not to the issue of whether such payments would be made." *Prickett,* 1978 Tex. App. LEXIS at 5.

After review of the Texas cases addressing contingent payment clauses, two trends emerge. First, in each case, the contract language in question was underdeveloped. The lawyers in each case attempted to argue that the payment clause in question created a condition precedent to payment when, in fact, such intent was often far from clear. Whether the parties actually intended to shift the risk of nonpayment could not be gleaned from the contract language alone. Even in cases with clear language, the courts have consistently rejected a contingent payment interpretation. Second, the courts consistently stated that they want an unequivocal expression and conditional language. Many subcontracts do not employ such language and do not

---

[3] *II Deerfield L.P. v. Henry Building, Inc.*, 41 S.W.3d 259 (Tex. App.—San Antonio 2001), discussed below

[4] *Pyramid Constructors, L. L. P. v. Sunbelt Controls, Inc.*, 2005 Tex. App. LEXIS 1568

[5] *North Harris County Junior College Dist. v. Fleetwood Constr. Co.*, 604 S.W.2d 247 (Tex. Civ. App.—Houston [14th Dist.] 1980).

unequivocally state that the owner's payment to the general contractor is a condition precedent and that the subcontractor is relying on the owner's payment.

Appendix V-1

TEXAS CASE LAW HISTORY: CONTINGENT PAYMENT CLAUSES

Wisznia v. Wilcox
438 S.W.2d 874 (Tex. Civ. App.—Corpus Christi 1969, *writ ref'd n.r.e.*)
(superseded by statute on other grounds)
CONTINGENT PAYMENT CLAUSE NOT ENFORCED

Holding that the contract did not contain a contingent payment provision, the Corpus Christi Appellate Court examined a payment clause in an architect's contract that stated "the engineer shall be paid in the same proportionate manner as the architect is being paid by the [owner]." *Wisznia*, 438 S.W.2d 876. Addressing the architect's argument that this language created a contingent payment clause, the court stated that "whether the parties to a transaction intended to make the payment of money conditional must be gathered from the four corners of the instrument . . . the situation of the parties . . . and the subject matter and the purposes to be accomplished." *Id*. The court then held that it was "clear from such language, taken together with the entire contract, that it was the intention of the parties that engineer would be paid by the architect for the labor and services rendered, and that the obligation to pay was absolute. If such was not to be the case, it should have been so expressed in unequivocal terms dealing with the possible insolvency of [the owner]. *Id*.

Prickett v. Lendell Builders, Inc.
572 S.W.2d 57 (Tex. Civ App.—Eastland 1978, *no writ h.*)
CONTINGENT PAYMENT CLAUSE NOT ENFORCED

The Eastland court found against a contingent payment clause by harmonizing the contract. The contract unequivocally stated that the contractor would pay the contract price to the subcontractor in consideration for its work. *Prickett*, 572 S.W.2d 59. The contract also stated that "payment shall be made monthly, within five (5) days after Contractor . . . is paid for the same work by [the lender]." *Prickett*, 572 S.W.2d 58. The court stated, "by examining the contract in its entirety we hold the condition precedent clearly applied to the monthly progress payments and when such payments would be made, not to the issue of whether such payments would be made." *Prickett*, 572 S.W.2d 59.

North Harris County Junior College Dist. v. Fleetwood Constr. Co.
604 S.W.2d 247(Tex. Civ. App.—Houston [14th Dist.] 1980, *writ ref'd n.r.e.*).
CONTINGENT PAYMENT CLAUSE ENFORCED

The Houston appellate court explained that a contingent payment clause may be enforceable where the parties clearly intend "that payment be made only after full payment to the contractor." The court held that the contract language at issue made clear this intention: ". . . Contractor may, at its option on each payment, retain . . . the percentage specified in the Contract Documents, of each estimate until final payment (which final payment shall be made after completion of the work covered by this contract and written acceptance thereof by the Architect, and full payment therefore by Owner). . ." *North Harris*, 604 S.W.2d 255. The court distinguished that case from *Wisznia*, explaining that the *Wisznia* contract clearly expressed the parties' intent that payment

"nevertheless be made within a reasonable time" even where a condition precedent did not occur. *North Harris*, 604 S.W.2d 255.

Gulf Construction Co., Inc. v. Mid-Continent Casualty Co.
676 S.W.2d 624 (Tex. App.—Corpus Christi 1984, *writ ref'd n.r.e.*)
CONTINGENT PAYMENT CLAUSE NOT ENFORCED

Holding that the contract did not contain a contingent payment clause, the Corpus Christi Appellate Court again looked at contract language stating, "under no circumstances shall the general contractor be obligated or required to advance or make payments to the sub-contractor until the funds have been advanced or paid by the owner. . ." *Gulf Construction*, 676 S.W.2d at 627. While the intent of this clause appeared to be risk-shifting to the subcontractor, the court held otherwise. Stating that the payment clause merely affected the time for payment rather than the obligation to pay, the court noted that the contract did not state that: (1) the general contractor was relieved of its payment obligation "if" the money were not received from the owner; or (2) the payment to subs shall be made "out of" funds received by the contractor. The only operative language used was "until", which merely affected the time for payment. *Gulf Construction*, 676 S.W.2d 629.

Sheldon L. Pollack Corp. v. Falcon Industries, Inc.
794 S.W.2d 380 (Tex. App.—Corpus Christi 1990, *writ denied*).
CONTINGENT PAYMENT CLAUSE NOT ENFORCED

The Corpus Christi Court of Appeals again did not interpret the following contractual language as an operative contingent payment clause: "Contractor will pay subcontractor [the contract sum] . . . for which payment has been made by owner or lender to contractor." *Sheldon*, 794 S.W.2d 383. Following *Gulf*, the court held "that the language…of the contract…was a covenant which modified the time and manner of payment, and not a condition of liability." *Sheldon*, 794 S.W.2d 384.

Pyramid Constructors, L. L. P. v. Sunbelt Controls, Inc.
2005 Tex. App. LEXIS 1568 (Tex. App.—Amarillo 2005, *no pet. h.*)
CONTINGENT PAYMENT CLAUSE NOT ENFORCED – EXCEPTION FOUND

The Amarillo court held that an exception to the contingent payment clause was invoked, thus payment to the subcontractor was due. The contract language read: "All payments to Subcontractor…shall be made by [contractor] Pyramid solely out of funds actually received by Pyramid from Owner. Subcontractor acknowledges that it is sharing to the extent of payments to be made to Subcontractor in the risk that Owner may fail to make one or more payments to Pyramid for all or a portion of Subcontractor's work with the sole exception that if Owner fails to pay Pyramid on account of default solely attributable to Pyramid under that contract between Owner and Pyramid, and not partially due to an act or omission of Subcontractor, then such payment shall be nevertheless due from Pyramid to Subcontractor." *Pyramid*, 2005 Tex. App. LEXIS 1568, 7-6.

The court held that the exception[6] created by the above provision rendered payment due to the subcontractor despite the Owner's nonpayment to contractor Pyramid. It concluded that the Owner "failed to pay the remaining retainage to Pyramid because it contended there was a failure of performance under its contract with Pyramid, and no act or omission of Sunbelt was involved. Under the unambiguous language of the subcontract, on those facts, payment was "nevertheless" due Sunbelt." *Pyramid*, 2005 Tex. App. LEXIS 1568, *8 (court's emphasis).

[6] Note the similarity between the exception recognized by the *Pyramid* court and the Section 35.521(b) contractual failure by the contingent payor (GC) exception.