

Pay "if" paid: New law affecting payment provisions in construction contracts

Recent legislation limits enforceability of contingent payment clauses; provides new rights to contractors, subcontractors

General contractors prefer them and subcontractors avoid them, but we all have to deal with them. The efficient allocation of risk is an unfortunate, yet vital necessity in our industry. Construction contracts are dedicated, in large part, to accomplishing this task through the inclusion of various risk-shifting devices on a variety of items of potential liability. Chief among these is a common provision found in subcontracts called a contingent payment clause, also known as a "pay-if-paid" clause, which shifts the risk of non-payment by the owner from a general contractor to its subcontractors.

Unlike a pay-*when*-paid clause, which allows the general contractor a reasonable amount of time to wait for the owner to pay before having to pay his subcontractors, a pay-*if*-paid clause makes the subcontractor's payment *absolutely conditional* on the owner's payment to the general contractor. In other words, in a situation involving a pay-*if*-paid clause, the subcontractor has no right to payment unless or until the owner pays the general contractor. A typical pay-*if*-paid clause in a subcontract reads as follows:

"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 the 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."

Until September 1, 2007, the interpretation of these clauses was left to the courts, resulting in a great deal of confusion and conflict as to the circumstances under which they could be properly enforced. To remedy this situation, the 2007 Texas Legislature passed Senate Bill 324, which outlines a uniform statutory scheme to be applied when determining the proper enforceability of contingent payment clauses. While the new law restricts the enforcement of these clauses in situations where it would be improper, i.e., where the owner's nonpayment is the general contractor's fault, it also provides a solid framework that, if followed properly, all but ensures the enforceability of the contingent payment clause. The law benefits both general contractors and subcontractors by also allowing both the right to question the owner about his failure to pay and the right to stop work if the owner fails to offer an explanation. These rights may not be waived under any circumstances, even by express agreement of the parties.



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The new law applies only to contingent payment clauses contained in contracts (supply contracts, subcontracts, sub-subcontracts, etc...) entered into on or after September 1, 2007 and does not apply to such clauses contained in contracts for design services, civil projects, or most residential projects. Conveniently, the new law also does not apply to a contract on any project owned by the State of Texas; however, this immunity does not necessarily apply to projects owned by lower-level governmental entities such as school districts, municipalities, or special-purpose districts and authorities.

The law's main restriction on the enforceability of contingent payment clauses is found in Section 35.521(b) of the Texas Business and Commerce Code. Substituting the terms used in the law for those more typical in a general contractor / subcontractor scenario, the restriction reads as follows:

"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."

Simply put, the law prohibits a contractor from invoking the protections of a pay-if-paid clause to the extent that the owner's nonpayment is the contractor's fault. Take note, however, that the law does not restrict enforcement of the contingent payment in those situations where the owner's nonpayment is the result of some other circumstance, i.e., nonpayment due to the owner's insolvency or breach of the prime contract. In those circumstances, the contingent payment clause would still be properly enforceable against the subcontractor or supplier. The law only restricts enforcement by the contractor where the owner's nonpayment is the result of the contractor's own failure to meet the requirements of the prime contract.

There are three other situations where enforcement of a contingent payment clause will be restricted: 1) when the clause is contained in a "sham" contract, i.e., where the general contractor is controlled by the owner; 2) where the subcontractor objects to enforcement of the clause and the contractor fails to notify the subcontractor that the nonpayment is the subcontractor's own fault; and 3) where enforcement of the clause would be "unconscionable." The law contains specific provisions dealing with the latter two situations.

With respect to the second situation involving notice, the statute provides a series of notice requirements that govern the process by which both parties must present and respond to objections to the clause's enforcement. A subcontractor must wait 45 days after



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submitting a pay application (which must have been made in accordance with the terms of the subcontract) before presenting its objection in writing, and a separate notice must be made for each pay application on which payment has not been received. Enforcement of the contingent payment clause is suspended on the day the subcontractor's written notice becomes effective, as determined in accordance with the statute and depending on when the notice is received by the contractor and whether the project's owner is a public or private entity. To defeat a subcontractor's objection, a contractor must respond within 5 days and provide the subcontractor with evidence that the owner's nonpayment 1) is not due to the contractor's own failure to meet its obligations under the prime contract and 2) is due to the subcontractor's failure to meet its obligations under the subcontract.

If a general contractor successfully complies with these notice provisions, the contingent payment clause will be enforceable, unless it can be shown that such enforcement would be "unconscionable." Rather than define what constitutes unconscionability in this context, the law imposes certain requirements that, if met, generate a presumption that enforcement will not be unconscionable. These requirements require a general contractor to exercise due diligence in investigating the owner's ability to pay before entering into a subcontract, and in the event of nonpayment by the owner, a general contractor must make reasonable efforts to collect from the owner or allow the subcontractor to do so himself. A general contractor's compliance with both of these requirements creates a rebuttable presumption that enforcement would not be unconscionable. Subcontractors face a considerable burden in overcoming this presumption; it must be shown that enforcement of the clause would be so unfair that no reasonable, informed person would agree to it.

In summation, this new legislation contains a clear framework for determining the enforceability of pay-if-paid clauses in Texas. The law offers advantages and protections to general contractors and subcontractors alike, provided that all parties have successfully complied with its detailed provisions. It should be stressed that this brief summarization is no substitute for a careful reading of the statute and competent, fact-specific advice provided by a knowledgeable construction law professional.

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