

## **BILL ANALYSIS**

C.S.H.B. 541  
By: Chisum  
Business & Industry  
Committee Report (Substituted)

### **BACKGROUND AND PURPOSE**

"Contingent payment clauses" are payment provisions in construction contracts that shift financial risks of non-payment from one party to another. They make the payment for work performed by a contractor or subcontractor conditional upon receipt of payment by another person. Typically, the general or prime contractor will include a provision in its subcontract agreement that makes its obligation to pay the subcontractor conditional upon the general or prime contractor's receipt of payment from the owner. With such a clause in a subcontract, the intent is that the general or prime contractor does not have to pay the subcontractor until and unless the contractor receives payment from the owner.

These clauses are commonly used in the construction industry by general contractors and some subcontractors in order to spread their credit risk to their "downstream" subcontractors. Many general contractors and some subcontractors believe that the right to spread the risk of owner default on some proportional basis is a legitimate business decision and is essential to their economic viability (considering the sometimes significant risk a general contractor may take on large projects). Some general contractors and many subcontractors believe that these clauses are used to subject unfairly the subcontractors to risks that they cannot control (they have no privity with the owner and have limited ability to perform meaningful due diligence on the owner's creditworthiness). These clauses have the potential to be used by unscrupulous contractors to avoid payment to subcontractors where the owner has legitimately withheld payment from the contractor because of the contractor's (not the subcontractor's) default. In that case, the subcontractor would be precluded from seeking payment from the contractor even though the subcontractor properly performed its subcontract obligations.

There has been a growing trend in other jurisdictions to ban or restrict the use of these clauses in construction contracts. Although still in a small minority, a few states have, either by court decision or legislative action, made these clauses unenforceable as being against public policy. In two reported cases in Texas dealing with the enforceability of these clauses, the Courts did not hold that such clauses are void as against public policy. In both cases, however, the Courts found reasons not to enforce the clauses. Consequently, there is some uncertainty as to the enforceability of these clauses under current Texas law.

CSHB 541 seeks to clarify the circumstances in which contingent payment clauses will not be enforceable under Texas law.

### **RULEMAKING AUTHORITY**

It is the committee's opinion that this bill does not expressly grant any additional rulemaking authority to a state officer, department, agency, or institution.

### **ANALYSIS**

SECTION 1. Amends Subchapter D, Chapter 35, Business & Commerce Code, by adding Section 35.521, as follows:

Sec. 35.521(a) defines "contingent payment clause", "contingent payor", "contingent payee," "improvement", "obligor" and "primary obligor".

Sec. 35.521(b) provides that the statute does not apply to contracts that are solely for design services.

Sec. 35.521(c) prohibits a contingent payor from enforcing a contingent payment clause if the nonpayment by the contingent payor is the result of the contingent payor or a contractor or subcontractor of the contingent payor.

Sec. 35.521(d) prohibits a contingent payor from enforcing a contingent payment clause after the tenth day after the date on which the contingent payor receives written notice from the contingent payee objecting to further enforceability. The written notice is only effective if sent after the 30th day after the accrual of unpaid indebtedness.

Sec. 35.521(e) defines the date for the accrual of indebtedness for purposes of sending the notice under Sec. 35.521(d) and makes the accrual effective only if a written payment request was submitted by the contingent payee in accordance with the contract requirements between it and the contingent payor.

Sec. 35.521(f) provides circumstances under which the notice in Sec. 35.521(d) will not prevent the enforcement of a contingent payment clause.

Sec. 35.521(g) provides that the notice in Sec. 35.521(d) will not prevent the enforcement of a contingent payment clause if funds are not collectible due to the primary obligor successfully asserting a defense of sovereign immunity and provided that the contingent payor has exhausted its remedies under contract and under Chapter 2251, Government Code.

Sec. 35.521(h) provides that, upon receipt of payment giving rise to the notice, the contingent payment clause is reinstated as to work performed or materials furnished after receipt of the payment.

Sec. 35.521(I) prohibits a contingent payor from enforcing a contingent payment clause if, under Section 53.026, Property Code, the contingent payee is considered to be in direct contractual relationship with the person from whom the contingent payor is to receive payment.

Sec. 35.521(j) provides that a contingent payment clause may not be used as a basis for invalidating the enforceability or perfection of a mechanic's lien under Chapter 53, Property Code.

Sec. 35.521(k) stipulates that a contingent payment clause will not be enforceable if its effect would be considered unconscionable. The party asserting that a contingent payment clause is unconscionable has the burden to plead and prove that enforcement of the clause would be unconscionable. Circumstances which may be considered in determining whether the enforcement of the clause would be unconscionable are given.

Sec. 35.521(l) provides circumstances, such as ascertaining the financial viability of the primary obligor, making reasonable efforts to collect, and making an assignment of a claim, that may make the enforcement of a contingent payment clause not unconscionable.

Sec. 35.521(m) provides a "safe harbor" for a contingent payor's exercise of diligence under Sec. 35.521(l) for projects governed by Chapter 53, Property Code (Private Projects) if the contingent payor furnishes certain information to the contingent payee.

Sec. 35.521(n) provides a "safe harbor" for a contingent payor's exercise of diligence under Sec. 35.521(l) for projects governed by Chapter 2253, Government Code (Public Projects) if the contingent payor furnishes certain information to the contingent payee.

Sec. 35.521(o) provides a "safe harbor" for a contingent payor's exercise of diligence under Sec. 35.521(l) for projects governed by 40 U.S.C. Section 3131 (Federal Projects) if the contingent payor furnishes certain information to the contingent payee.

Sec. 35.521(p) requires a primary obligor to furnish the information in Subsections (m)-(o) upon request of the contingent payor.

Sec. 35.521(q) provides that the assertion of a contingent payment clause is an affirmative defense to a civil action for payment under a contract.

Sec. 35.521(r) provides that the bill does not affect a provision in a construction contract that affects only the timing for payment, provided that the time period for payment is reasonable.

Sec. 35.521(s) provides that any attempt to waive the terms of the statute will be void.

Sec. 35.521(t) provides that an obligor or a primary obligor may not prohibit a contingent payor from allocating risk by means of a contingent payment clause.

SECTION 2. Effective date: September 1, 2003, as to those contracts containing contingent payment clauses entered into on or after the effective date.

### **EFFECTIVE DATE**

September 1, 2003

### **COMPARISON OF ORIGINAL TO SUBSTITUTE**

Sec. 35.521(a) in the substitute adds definitions for “obligor” and “primary obligor” and excludes architect and engineer from the definition of “contingent payee”.

Sec. 35.521(b) in the substitute adds that the bill does not apply to contracts solely for design services.

Sec. 35.521(d) of the substitute changes from 5 days to 10 days the period of time before the notice received by the contingent payor becomes effective.

Sec. 35.521(e) of the substitute removes the ability of a contingent payee to give a notice of unpaid indebtedness under Sec. 35.521(d) “in any form” and requires that the notice be in a form substantially in accordance with the contract requirements.

Sec. 35.521(f) of the substitute adds circumstances under which the notice in Sec. 35.521(d) will not prevent the enforcement of a contingent payment clause.

Sec. 35.521(g) of the substitute adds protection to the contingent payor against the unenforceability of a contingent payment clause for non-collectible funds due to a primary obligor’s assertion of sovereign immunity.

Sec. 35.521(l)-(p) of the substitute replaces less certain circumstances for unconscionability with a “safe harbor” concept to allow the contingent payor to perform certain duties in an attempt to keep the contingent payment clause enforceable under an allegation that it is unconscionable.

Sec. 35.521(t) of the substitute adds that the obligor or primary obligor may not prohibit a contingent payor from allocating risk by means of a contingent payment clause.

SECTION 2. Effective date: September 1, 2003, as to those contracts containing contingent payment clauses entered into on or after the effective date.

