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.

House Bill No. 1146 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.

SECTION-BY-SECTION 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) 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, not meeting its contractual obligations, but provides an exception if the contingent payee has not met its contractual obligation.

Sec. 35.521(c) prohibits a contingent payor from enforcing a contingent payment clause after the contingent payor receives written notice from the contingent payee objecting to further enforceability. The written notice is only effective if sent after the 45th day after the contingent payee submits a written request for payment to the contingent payor.

Sec. 35.521(d) defines the effective date of the notice under Sec. 35.521(c). The effective date is related to one of the various prompt payment statutes as determined by the type of project.

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

Sec. 35.521(f) provides that the notice in Sec. 35.521(c) 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(g) 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(h) 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(i) 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(j) 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.

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

Sec. 35.521(l) provides that the assignment of a cause of action under Sec. 35.521(k) is enforceable against an obligor or primary obligor.

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) or (n)upon request of the contingent payor and relieves the contingent payor and contingent payee of contractual obligations if the primary obligor fails to furnish the information.

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.

Sec. 35.521(u) provides that the section does not apply to contracts solely for design services, the construction or maintenance of a road or highway, or construction or improvements to a structure that is less than 10,000 square feet and is a single family residence, duplex, triplex, or quadruplex.

SECTION 2. Effective date: September 1, 2005, as to those contracts containing contingent payment clauses entered into on or after the effective date.

<u>EFFECTIVE DATE</u>

September 1, 2005