

BILL ANALYSIS

S.B. 324
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Business & Industry
Committee Report (Amended)

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 primary contractor will include a provision in its subcontract agreement that makes its obligation to pay the subcontractor conditional upon the general or primary contractor's receipt of payment from the owner. With such a clause in a subcontract, the intent is that the general or primary 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 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 significant risk a general contractor may take on with large projects). Some general contractors and many subcontractors believe that these clauses are used to unfairly subject 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.

S.B. 324 clarifies the circumstances in which contingent payment clauses will not be enforceable under Texas law.

RULEMAKING AUTHORITY

This bill does not expressly grant any additional rulemaking authority to a state officer, institution, or agency.

ANALYSIS

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

Sec. 35.521. AGREEMENT FOR PAYMENT OF CONSTRUCTION SUBCONTRACTOR. (a) Defines "contingent payee," "contingent payment clause," "contingent payor," "improvement," "obligor," and "primary obligor."

(b) Prohibits a contingent payor or its surety from enforcing a contingent payment clause to the extent that the obligor's nonpayment is the result of a failure on the part of the contingent payor to meet its contractual obligations, unless the nonpayment is the result of a contingent payee's default on its contractual requirements.

(c) Prohibits a contingent payor or its surety from enforcing a contingent payment clause as to work performed or materials delivered after he or she has received written notice objecting to the further enforceability thereof, except as provided

by Subsection (f). Specifies that the notice becomes effective as provided by Subsection (d). Sets forth the timeframe and manner in which such a notice is to be delivered.

(d) Sets forth the timeframe in which a written notice described in Subsection (c) becomes effective.

(e) Specifies the conditions under which a notice described in Subsection (c) does not prevent enforcement of a contingent payment clause.

(f) Specifies that the enforcement of a contingent payment clause, to the extent that the funds are not collectable as a result of the primary obligor's successful assertion of a defense of sovereign immunity, is not precluded by a written notice under Subsection (c) if the contingent payor has exhausted all its rights and remedies under Chapter 2251 (Payment For Goods and Services), Government Code. Specifies that this subsection does not create or validate a defense of sovereign immunity nor extend a defense or right that did not exist before the effective date of this section.

(g) Reinstates the contingent payment clause as to work performed or materials furnished, subject to the provisions of this section, after the receipt of payment of the unpaid indebtedness by the contingent payee.

(h) Prohibits a contingent payor or its surety from enforcing a contingent payment clause if the contingent payee is considered to be in direct contractual relationship, described under Section 53.026 (Sham Contract), Property Code.

(i) Prohibits a contingent payment clause from being used as a basis for invalidation of the enforceability or perfection of a mechanic's lien under Chapter 53 (Mechanic's, Contractor's, or Materialman's Lien), Property Code.

(j) Prohibits a contingent payor or its surety from enforcing a contingent payment clause if the enforcement is proven by the asserting party that the enforcement would be unconscionable. Provides that the party that asserts the enforcement of a contingent payment clause is unconscionable has the burden of proving the clause is unconscionable.

(k) Sets forth specific guidelines by which the enforcement of a contingent payment clause is not unconscionable.

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

(m) Provides that a contingent payor has 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 certain information in writing. Specifies the information that the contingent payor must send to the payor to show that it has exercised diligence.

(n) Provides that a contingent payor has exercised diligence for purposes of Subsection (k)(1) under a contract for a public project governed by Chapter 2253 (Public Work Performance and Payment Bonds), Government Code, if the contingent payee receives certain information in writing. Specifies the information that the contingent payor must send to the payor to show that it has exercised diligence.

(o) Provides that a contingent payor has 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 certain information in writing.

Specifies the information that the contingent payor must send to the payor to show that it has exercised diligence.

(p) Requires the primary obligor to furnish the information described in Subsection (m) or (n), as applicable, to the contingent payor not later than the 30th day after the date that the primary obligor receives a written request for this information. Specifies that the contingent payor, contingent payee, and their sureties are relieved of their obligation to initiate or continue performance of the construction contracts thereof, if the primary obligor fails to provide the information under the written request.

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

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

(s) Prohibits a person from waiving this section by contract or other means, and voids any purported waiver thereof.

(t) Prohibits an obligor or primary obligor from prohibiting a contingent payor from allocating risk by means of a contingent payment clause.

(u) Specifies the contracts to which this section does not apply.

SECTION 2. Makes application of this Act prospective.

SECTION 3. Effective date: September 1, 2007.

EFFECTIVE DATE

September 1, 2007.

EXPLANATION OF AMENDMENTS

Committee Amendment No. 1 provides that the provisions of the bill do not apply to a subcontract under a prime contract that is in excess of \$10 million.