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BUSINESS INSIGHTS

THE NEW TEXAS CONTINGENT PAYMENT CLAUSE STATUTE—A SUMMARY FOR SUPPLIERS

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Pagel, Davis & Hill, P.C. (“PDH”) is a Houston based law firm with a diversified practice that includes a focus on providing the services required for many companies serving the construction industry. Mr. Pagel, the President and Senior Shareholder of PDH, serves as outside general counsel to WTCA—Representing the Structural Building Component Industry.

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WHAT ARE CONTINGENT PAYMENT CLAUSES?

- Commonly found in subcontracts where payment to the subcontractor is “contingent” on the contractor’s receipt of payment by the owner
- Also commonly found in supplier agreements with contractors
- If these provisions are accepted and the contractor is not paid neither is the supplier paid
- Because they are so one-sided, void as a matter of public policy in some states—but not in Texas
- “Pay-when-Paid” does not equal “Pay-if-Paid”
- Pay-when-Paid merely leaves the time of payment uncertain—eventually the fact of an owner’s non-payment becomes irrelevant, and the contractor must still pay the supplier
- Pay-if-Paid makes the supplier’s payment absolutely conditional on the owner’s payment to the contractor.

EXAMPLE: “Supplier agrees that payment by the Owner to the Contractor, shall be an express condition precedent to any payment obligation that Contractor may have to Supplier”

NOTES:

NEW “CONTINGENT PAYMENT CLAUSE LEGISLATION IN TEXAS.

- Pay-if-paid clauses are now subject to statute in Texas as of September 1, 2007

- Codified as §35.521 of the Texas Business & Commerce Code.

- DOES NOT apply to contracts solely for:
 - Design services
 - Construction or improvements to single family residence, duplex, triplex or quadraplex

- The statute uses new terms

“Contingent payee”—a subcontractor or supplier who contracts with a general contractor and the contract provides that payment to the subcontractor or supplier is “contingent” upon the general contractor’s receipt of payment from the owner

“Contingent payor” is the general contractor

“Obligor” is the party who is to make payment to the general contractor—usually the owner

“Contingent payment clause’ means a provision in a contract 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”

NOTES:

- Pay-when-paid provisions are not covered by the statute
- A contingent payment clause cannot be used to invalidate the enforcement of a mechanic's lien for labor performed or materials furnished
- A party cannot be forced to waive its rights under the new statute
- **BEST PRACTICES:** The statute does not preclude suppliers from refusing to accept a contingent payment clause—this is a matter of negotiation.

Suppliers may also choose to negotiate a pay-if-paid (which is a contingent payment clause covered under the statute) to a pay-when-paid.

HOW A SUPPLIER MAY GIVE NOTICE OBJECTING TO A CONTINGENT PAYMENT CLAUSE

- Notice Requirements:
 - May send a written notice objecting to enforcement of a contingent payment clause ONLY AFTER 45 days has passed from the submission of an invoice and supplier has not been paid
 - The objection must be specific to the supplier's request for payment
 - Notice cannot be sent before the 45 days
 - Must be received by the contractor
 - The invoice must have been submitted per the terms of the agreement between supplier and contractor

- A notice of objection, once effective precludes the contractor's enforcement of a contingent payment clause for all purposes until the supplier gets the payment of the debt giving rise to its effective written notice of objection.

- Separate notice required for each invoice on which payment has not been received.

- An effective notice blocks enforcement of the contingent payment clause as to materials and labor furnished thereafter, the contingent payment clause is "reinstated" once the supplier is paid the invoices that were the subject of the notice of objection.

NOTES:

HOW DOES A NOTICE OF OBJECTION BECOME EFFECTIVE

- Generally the supplier's notice of objection will become effective within 10 days and the contractor may "countermand" within 5 days.
- The contractor can countermand the supplier and advise in writing that the supplier's notice of objection "does not prevent enforcement of the contingent payment clause" but the contractor must be able:
 - to establish that the owner's non-payment is not due to the contractor's failure to meet its own obligations, and
 - is due to the objecting supplier's failure to meet its obligations.
- Statute also states that the contractor cannot enforce a contingent payment clause if doing so would be "unconscionable"
- The statute does not define what is unconscionable but does establish a "safe harbor" as to actions contractors can take BEFORE and AFTER to protect against a claim that the contingent payment clause is unconscionable
- The unconscionability of a contingent payment clause will turn on whether the contractor has taken certain steps to provide the supplier with meaningful information about an owner's ability to pay AND after the fact to pursue the collection of funds due the supplier if the owner refuses to pay for the supplier's work.
- How will contractors respond to the unconscionability requirement:
 - By providing subcontractors and suppliers with loan and other sources of funds information regarding the owner's funding of construction of the project AND
 - After the fact when an owner does not pay a contractors by either (a) making reasonable effort to collect what the supplier is owed by assigning or (b) offering to assign a pass-through claim against the owner

CONCLUSION—WHAT DOES ALL THIS MEAN

- The new statute does seem to establish some ground rules that, if followed, SEEM to:
 - Preserve the contractor's ability to ask subcontractors and suppliers to share in the risk of an owner's financial failure
 - Protect subcontractors and suppliers against unscrupulous enforcement of a contingent payment clause if the owner's non-payment is the contractor's fault
 - Allows subcontractors and suppliers to obtain information about the owner's ability to fund a project
 - Subcontractors and suppliers have a statutorily protected right to block the contractor's enforcement of a contingent payment clause

SAMPLE SUPPLIER LETTER—ASSERTING NOTICE OF OBJECTION TO CONTINGENT PAYMENT CLAUSE:

As of _____, more than 45 days has expired since our invoices for the month of _____ were delivered to you for your review, approval and payment. Additional copies of these invoices are attached. We have not received payment for our billed work, nor have we received any explanation as to why payment is being withheld. If you are withholding payment of these invoices on the basis of a contingent payment clause in our agreement because the owner has withheld payment from you for our work, this letter is our formal notice that we object to the enforcement of that clause in accordance with Section 35.521 (c) of the Texas Business & Commerce Code. If you contend that our invoices fail in any respect to comply with the requirements of our agreement, or that you are entitled to withhold payment because of a deficiency in our materials or work, we request that you immediately and specifically advise us of any such failure or deficiency. This request is made pursuant to our statutory right to require prompt payment of amounts due us under our agreement..

If you contend that you received this notice less than 45 days after the date you received the above-referenced invoices, we request that you confirm in writing the actual date that you contend you received our invoices. If you do not provide us with this information within 5 days of your receipt of this notice, you will be presumed to have agreed that you have been in possession of our invoices in proper form for at least 45 days prior to your receipt of this notice. Unless and until you demonstrate otherwise, we will consider this notice effective with respect to the aforementioned invoices.

Please also consider this letter our request that you provide us with all type of information you are required to provide to us under and inaccordance with the provisions of Section 53.159 of the Texas Property Code, including the name and last known address of the person to whom you furnished labor or materials for the construction project; and whether you have furnished or have been furnished a payment bond or performance bond for any of the work on the project and if so, the name, last known address and toll free telephone of the surety and a copy of the bond(s). Our request that you furnish this information to us shall not be considered a waiver fo our right to assert that the enforcement of any contingent payment clause in our agreement would be unconscionable, nor shall this notice waive our right under Section 35.521(p) of the Texas Business & Commerce code to stop our work at any time we may deem it necessary to do so to protect our interests.

Sincerely,