Litigation Alert

CONTRACTUAL RISK SHIFTING: COMMERCIAL CONSTRUCTION

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Authors:

Mike Logan
Zach Mayer
Roland Hamilton

Introduction

In the commercial construction industry, especially in cycles of downturn in the overall economy, instances often arise in which the owners of projects encounter financial difficulties. This can result in an abandonment of the project by the owner and a failure of the owner to pay the general contractor for, among other things: (1) the general contractor's goods and services; (2) the goods and services provided by subcontractors of the general contractor; and (3) contractual retainage that has been withheld from the general contractor and subcontractors pending substantial completion of the project.

When this occurs, the subcontractors may look to the general contractor to pay outstanding amounts owed to the subcontractors, including contractual retainage withheld. As a result, the general contractor can be placed in a financial predicament, itself having not been paid for the amounts sought by the subcontractors. Contractual language in a subcontract, especially a form contract, regarding the timing of payment to the subcontractors is oftentimes not sufficient to shift the risk of non-payment to the subcontractors. Instead, specific language on the topic is required to be included in the subcontract agreement, as is discussed herein.

Insufficient Contractual Language for Purpose of Shifting Risk of Non-payment to Subcontractor

In Gulf Construction Company v. Self[1], the seminal case in Texas regarding the shifting of the risk of non-payment to subcontractors, the owner encountered financial problems and directed that all construction work cease. In that case, the general contractor relied upon the following contractual provision in an attempt to shift the risk of non-payment by the owner to its subcontractors:

> "When the owner or his representative advances or pays the general contractor, the general contractor shall be liable for and obligated to pay the sub-contractor up to the amount or percentage recognized and approved for payment by the owner's representative less the retainage required under the terms of the prime contract. **Under no circumstances shall the general contractor be obligated or required to advance or make such payments to the sub-contractor until the funds have been advanced or paid by the owner or his representative to the general contractor."**

In Gulf Construction, the Corpus Christ Court of Appeals held that the risk of non-payment by an owner rests on the general contractor who contracted with the owner, rather than on the subcontractors who have no privity of contract with the owner. The risk of non-payment by the owner on a construction contract is not shifted from the contractor to the subcontractor unless there is clear, unequivocal and express agreement between the parties to do so.[2]

Texas Courts have generally held that if a contractual provision merely states that the contractor is not obligated to pay the subcontractor "until" or "when" the general contractor receives payment from the owner, the clause will be interpreted to be a mere covenant as to the "timing" for payment rather than a "condition" of payment. Therefore, if payment is not received from the owner, the general contractor will be required to pay the subcontractor "within a reasonable time."[3]

Contractual Language Required for Shifting of Risk of Non-Payment to Subcontractors

On the other hand, in cases where courts have held that payment by the owner to the general contractor was a condition precedent of payment to the subcontractor, the contractual language was much more specific with regard to payment by the owner being a condition precedent.[4] In these instances, the contractual language expressly provided that payment by the owner to contractor was a condition precedent to the payment to the subcontractor and/or also provided that the subcontractor expressly assumed the risk of non-payment by the owner. The drafting of the contracts in Lakin Enterprises and FaulknerUSA were likely written with the holding of Gulf Construction in mind. Without specific language requiring payment by the owner to be a condition precedent of payment to the subcontractor, Texas courts are unwilling to shift the risk of non-payment away from the general contractor to the subcontractor.

Practical Considerations

As a practical matter, whether a subcontractor is willing to enter into an agreement providing for the shifting of risk of non-payment by the owner of the project will likely depend on a number of factors, including: (1) leverage of the general contractor regarding the volume of work it regularly awards the subcontractor; (2) past working history with the general contractor with regard to timely payment by the owners on the projects; and (3) research by the subcontractor as to the financial stability of the project owner.

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[1] Gulf Constr. Co., Inc., v. Self, 676 S.W.2d 624 (Tex. App. -- Corpus Christi 1984, writ ref'd n.r.e.).

[2] See id. at 630.

[3] See Sheldon L. Pollack, Corp. v. Falcon Ind., Inc., 794 S.W.2d 384, 384 (Tex. App. -- Corpus Christi, 1990, writ denied); See also Bledsoe v. Miller, 496 S.W.2d 140, 142 (Tex. Civ. App.—El Paso 1973, no writ).

[4] See Lakin Enterprises, Inc. v. Sebastian, 2009 WL 428, 491 (Tex. App. -- Dallas 2009) and FaulknerUSA, LP v. Alaron Supply Co., Inc., 322 S.W.3d 357 (Tex. App. -- El Paso 2010).