PORTER HEDGES LLP

NEGOTIATING IMPORTANT CONTRACT PROVISIONS

Presented to:

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October 13, 2015

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IMPORTANT CONTRACT PROVISIONS

1. Pay-If-Paid (a/k/a Contingent Payment Clause)
2. Indemnity
3. Statutory Releases
4. Dispute Resolution (Mediation and Arbitration)

1) Pay-If-Paid
a/k/a Contingent Payment Clause

WHAT IS A CONTINGENT PAYMENT CLAUSE?

- A provision that shifts the risk of non-payment from one party to another.
- Effect: General Contractor does not have to pay Subcontractor until Owner pays General Contractor.
- Often called "pay-if-paid" clause.

CONTINGENT PAYMENT CLAUSES

- "Subcontractor agrees to assume the risk that the Owner may fail to pay for the Subcontractor's Work. The Contractor shall have no obligation to pay the Subcontractor for its Work unless Owner has first paid Contractor for the Subcontractor's Work. Contractor's receipt of payment from the Owner is a condition precedent to any obligation of Contractor to pay Subcontractor."

CONTINGENT PAYMENT CLAUSES

- Traditionally enforceable
- As long as clause is clear and includes words like:
  - **"If"**
  - **"On condition that"**
  - **"Condition precedent"**
  - **"Assumes the risk of non-payment"**

CONTINGENT PAYMENT STATUTE

- Texas Business & Commerce Code §56.001 *et seq.*
- Applies to contracts after September 1, 2007
- Statute cannot be waived
- Law does not apply to design contracts, residential construction, or road construction projects, among others

GENERAL CONTRACTORS

- ***Cannot enforce Contingent Payment Provisions if:***
  - **Non-payment is the result of the General Contractor's failure to perform; or**
  - **Fails to Respond to Subcontractor's timely written objection to clause; or**
  - **Enforcement of clause would be "unconscionable"**

GENERAL CONTRACTORS

- Can Enforce Contingent Payment Provisions if:
  - **Timely respond to subcontractors notice of objection (within 5 days of notice);**
  - **Show that Owner is withholding payment because Subcontractor failed to perform;**
  - **Show that Owner is not withholding payment because General Contractor failed to perform; and**
  - **Show that enforcement is not "unconscionable"**

GENERAL CONTRACTORS

- Proving not unconscionable
  - **Exercise due diligence regarding the Owner's ability to pay for the work**
    - **FOR PRIVATE WORK**
      - **OWNER INFO, LOANS, BONDING, LIENABILITY**
    - **FOR PUBLIC WORK**
      - **OWNER INFO, BONDS, APPROPRIATIONS**
  - **Make effort to collect for subcontractor**
  - **Assign rights to collect to subcontractor**

SUBCONTRACTORS

- Notice of Objection
  - Submit "complete" pay application
  - Prove general contractor's "receipt" of pay application
  - Wait 45 days after sending pay application
  - Send written notice of objection to contingent payment clause (for each pay application)
  - If no response from General Contractor within 10 days
    - then Subcontractor entitled to payment directly from General Contractor

SUBCONTRACTORS

- Response to Notice of Objection
  - GC must respond in writing
  - Within 5 days of receipt of sub notice
  - No "complete" pay application
  - Failure to comply with subcontract or specifications
  - Wait until receipt of notice of objection to point out problems?
  - If no response from General Contractor within 5 days
    - then Subcontractor entitled to payment directly from General Contractor

HYPOTHETICALS

- Suppose the owner fails to pay the contractor for work performed by both Subcontractor A and Subcontractor B, because Subcontractor B defaulted, delayed the project so badly that the owner has a claim for damages that exceeds the sum of the amounts due both subcontractors. The owner withholds the entire amount of the contractor's pay request, and neither Subcontractor A nor Subcontractor B gets paid. The fact is non-payment was Subcontractor B's fault, not the contractor's fault. Can the contractor still enforce a contingent payment clause in Subcontractor A's subcontract to avoid payment to Subcontractor A?

HYPOTHETICALS

- NO.
- The owner's non-payment is due to the "obligations of the contractor not being met" – albeit obligations assumed by Subcontractor B under its Subcontract to the Contractor. Thus, one defaulting subcontractor could leave the contractor vulnerable, unable to enforce its contingent payment clause against other non-defaulting subcontractors. This makes the careful selection of capable subcontractors all the more critical.

HYPOTHETICALS

- Suppose that a subcontractor fails to include all necessary supporting documentation with a pay application in accordance with the payment requirements of the subcontract, as a result of which the subcontractor's later notice of objection is ineffective to stop the enforcement of a contingent payment clause as to that payment application. Can the subcontractor remedy its failure to properly object by re-submitting a correct pay application, and re-asserting its objection to the enforcement of the contingent payment clause?

HYPOTHETICALS

- YES.
- As long as the subcontractor has at least waited 45 days from the date of submission of a complete and proper pay application before objecting, as required by Section 35.521(c), there appears to be no other time constraint on when a subcontractor can object to the enforcement of contingent payment clause.

HYPOTHETICALS

- **Does a contractor have to get an owner to confirm when non-payment is due to a subcontractor's default in order to countermand a subcontractor's notice of objection to the enforceability of a contingent payment clause?**

HYPOTHETICALS

- **NO.**
- **The statute does not require the owner's confirmation as to the reason for nonpayment. If an owner refuses to acknowledge whether a subcontractor's default is the reason for non-payment, the contractor can assert in its response to the subcontractor that both the contractor and the owner have a valid basis for withholding payment due to the failure of the subcontractor to meet its contractual requirements, as provided in §35.521(e). Obviously, documentation on the project becomes even more important under this statute, because the general contractor has a very short window within which to respond to a subcontractor's objection in order to preserve the enforceability of the contingent payment clauses.**

HYPOTHETICALS

- **If a subcontractor's objection to a contingent payment clause becomes effective because of another subcontractor's default, will the subcontractor's subsequent failure to give further notices objecting to enforcement of the contingent payment clause result in the clause being enforceable as to the subcontractor's future pay applications?**

- **NOT NECESSARILY.**
- **While one effective notice can block enforcement of contingent payment clause as to materials and labor furnished thereafter, the contingent payment clause is "reinstated" as to any later payment applications if the owner or contractor pays the subcontractor's payment application that was the subject of the notice.**

HYPOTHETICALS

- **Is there a deadline by which a subcontractor must give notice objecting to a contingent payment clause if an owner fails to pay for the subcontractor's properly performed work?**

HYPOTHETICALS

- **No.**
- **The only time constraint on the subcontractor's issuance of a notice of objection is the requirement for the expiration of the 45 day period, which operates as a *waiting* period. The subcontractor to whom payment is due can issue a payment at any time after expiration of this waiting period.**

PRACTICAL ADVICE

- Convince Owners of the importance of paying within 45 days
- Narrow the contractual grounds for Owners to withhold payment. Strike any language giving the Owner too much discretion such as "or any other breach", or "at the Owner's sole discretion."
- Get owners to notify GC in writing with reasons before withholding payment
- Limit clauses requiring the GC to continue work even though the Owner has not made payment.

PRACTICAL ADVICE

- Get agreed method for calculating amount to be withheld in the event of a dispute
- Consider requiring subs to submit proof of payment to suppliers and for all materials with each pay application
- Consider adding restrictions on when subs can bill (1 per month on the 20th)
- Consider adding provision requiring 10% retainage to be withheld from all downstream subs
- Clearly define the right to offset sub payments

PRACTICAL ADVICE

- Consider using pay-when-paid clause with subs
- Consider defining reasonable time for payment as the later of: 90 days, or 30 days after any lawsuit or arbitration between Owner and GC is resolved.
- Consider adding assignment of GC's right to collect from Owner as alternative means of payment to sub

PRACTICAL ADVICE

- Gather evidence of financial responsibility
- Attempt to have payments made within 45 days
- Negotiate Protections with the Owner
- Respond to Notices of Objection
- Attempt to Collect or Assign
- Don’t forget lien rights

2) Indemnity

INDEMNITY PROVISIONS

- Broad Form
- Intermediate
- Fair Notice Requirements
  - Express Negligence Rule
  - Conspicuous Test

ANTI-INDEMNITY STATUTE

- Prohibits a person (the "Indemnitor") from indemnifying another person (the "Indemnitee") from claims or damages which are caused by the Indemnitee's negligence or other fault
- Indemnity clauses are void and unenforceable to the extent they violate this prohibition

ANTI-INDEMNITY STATUTE

- Applies to:
  - "construction contracts" for "construction projects" where an indemnitor is provided or procures insurance subject to Chapter 151 or Title 10 of the Insurance Code; and
  - agreements "collateral to or affecting a construction contract"

ANTI-INDEMNITY STATUTE

- "Construction contracts" – very broad definition including:
  - design contracts;
  - performance bonds;
  - subcontracts….

ANTI-INDEMNITY STATUTE

- As long as the contract is for design, alternation, renovation, remodeling, repair, maintenance or furnishing material or equipment for a building, structure, appurtenance or other improvement.
- Applies to Public and Private projects
- Includes Demolition and Excavation

ANTI-INDEMNITY STATUTE

- "Construction project" – means the construction, remodeling, maintenance or repair of improvements to real property.
  - Does not include a single-family house, townhouse, duplex or land development directly related thereto
- Insurance Subject to this Chapter = CIPs
- Title 10 – Property and Casualty Insurance by carriers authorized to do business in Texas

ANTI-INDEMNITY STATUTE

Tex. Ins. Code §105.102:

> "Except as provided by Section 151.103, a provision in a construction contract, or in an agreement collateral to or affecting a construction contract, is void and unenforceable as against public policy to the extent that it requires an indemnitor to indemnify, hold harmless, or defend a party, including a third party, against a claim caused by the negligence or fault, the breach or violation of a statute, ordinance, governmental regulation, standard, or rule, or the breach of contract of the indemnitee, its agent or employee, or any third party under the control or supervision of the indemnitee, other than the indemnitor or its agent, employee, or subcontractor of any tier."

ANTI-INDEMNITY STATUTE

- Applies to claims arising from the Indemnitee's sole negligence
- Applies to claims arising from the Indemnitee's partial negligence
- Extends to the obligation to defend another from claims

ANTI-INDEMNITY STATUTE

- Unanswered Question: What happens if an Indemnitee is found not negligent but was alleged to have been negligent?

ANTI-INDEMNITY STATUTE

- Employee Bodily Injury Exception
  - An upstream party can require a downstream party to indemnify for the upstream party's sole or partial negligence or other fault where the downstream party or its subcontractor's employee is injured

ANTI-INDEMNITY STATUTE

- Example Language:
- **TO THE FULLEST EXTENT PERMITTED BY LAW, SUBCONTRACTOR SHALL INDEMNIFY, DEFEND AND HOLD HARMLESS CONTRACTOR, OWNER, AND ARCHITECT AND EACH OF THEIR OFFICERS, DIRECTORS, AGENTS, REPRESENTATIVES, EMPLOYEES AND ANY PARTY ANY OF THEM HAS CONTRACTUALLY AGREED TO INDEMNIFY (COLLECTIVELY, THE "INDEMNIFIED PARTIES") FOR AND AGAINST ALL CLAIMS, LOSSES, EXPENSES, COSTS, DEMANDS, SUITS, CAUSES OF ACTION, AND DAMAGES, INCLUDING WITHOUT LIMITATION, ATTORNEYS' FEES AND EXPENSES, FOR BODILY INJURY OR DEATH OF ANY EMPLOYEE OF SUBCONTRACTOR, ITS AGENTS, OR ITS SUBCONTRACTORS OF EVERY TIER, EVEN IF THE BODILY INJURY OR DEATH IS CAUSED BY OR ALLEGED TO HAVE BEEN CAUSED BY THE NEGLIGENCE, FAULT OR STRICT LIABILITY OF ANY OF THE INDEMNIFIED PARTIES.**

ANTI-INDEMNITY STATUTE

- Example Language Continued:

- For all claims not addressed in the above paragraph, Subcontractor shall indemnify, defend and hold harmless Contractor, Owner, and Architect, and each of their officers, directors, agents, representatives, employees and any party any of them has contractually agreed to indemnify (collectively, the "indemnified parties"), for and against all claims, losses, expenses, costs, demands, suits, causes of action, and damages, including without limitation, attorneys' fees and expenses, of any nature whatsoever arising out of or related to this Agreement or the Work to be performed under this Agreement, but only to the extent of the negligence or other fault of the Subcontractor, its agents, representatives, employees or subcontractors of any tier.

ANTI-INDEMNITY STATUTE

- Extends to Additional Insured endorsements
  - Current forms that provide for coverage for an indemnitee's partial negligence will not be enforceable to the extent that it provides coverage prohibited by statute
  - Does not apply to OCIPs or CCIPs

ANTI-INDEMNITY STATUTE

- Exclusions:
  - 1) *municipal* public works projects;
  - 2) residential construction (single-family house, townhouse, duplex or "land development directly related thereto");
  - 3) OCIPs and CCIPs;
  - 4) breach of contract or warranty that exists independent of indemnity obligation;

ANTI-INDEMNITY STATUTE

- Exclusions continued:
  - 5) general agreements of indemnity required by sureties;
  - 6) copyright infringement claims;
  - 7) joint defense agreements entered after claims are made; and
  - 8) agreements subject to TOAIA.

ANTI-INDEMNITY STATUTE

- Requires all OCIPs and CCIPs that provide CGL coverage to provide completed operations coverage for no less than three years
- This statute cannot be waived by contract

ANTI-INDEMNITY STATUTE

- Applies to:
  - "original contracts" entered into on or after January 1, 2012 (and all of the subcontracts that follow); and
  - consolidated insurance programs for projects beginning on or after Jan. 1, 2012.

ANTI-INDEMNITY STATUTE

- What you need to do to address this change:
  - Revise your contract forms to comply with the statute; and
  - Discuss this change and its effects on insurance coverage with your insurance broker.

3) Statutory Releases

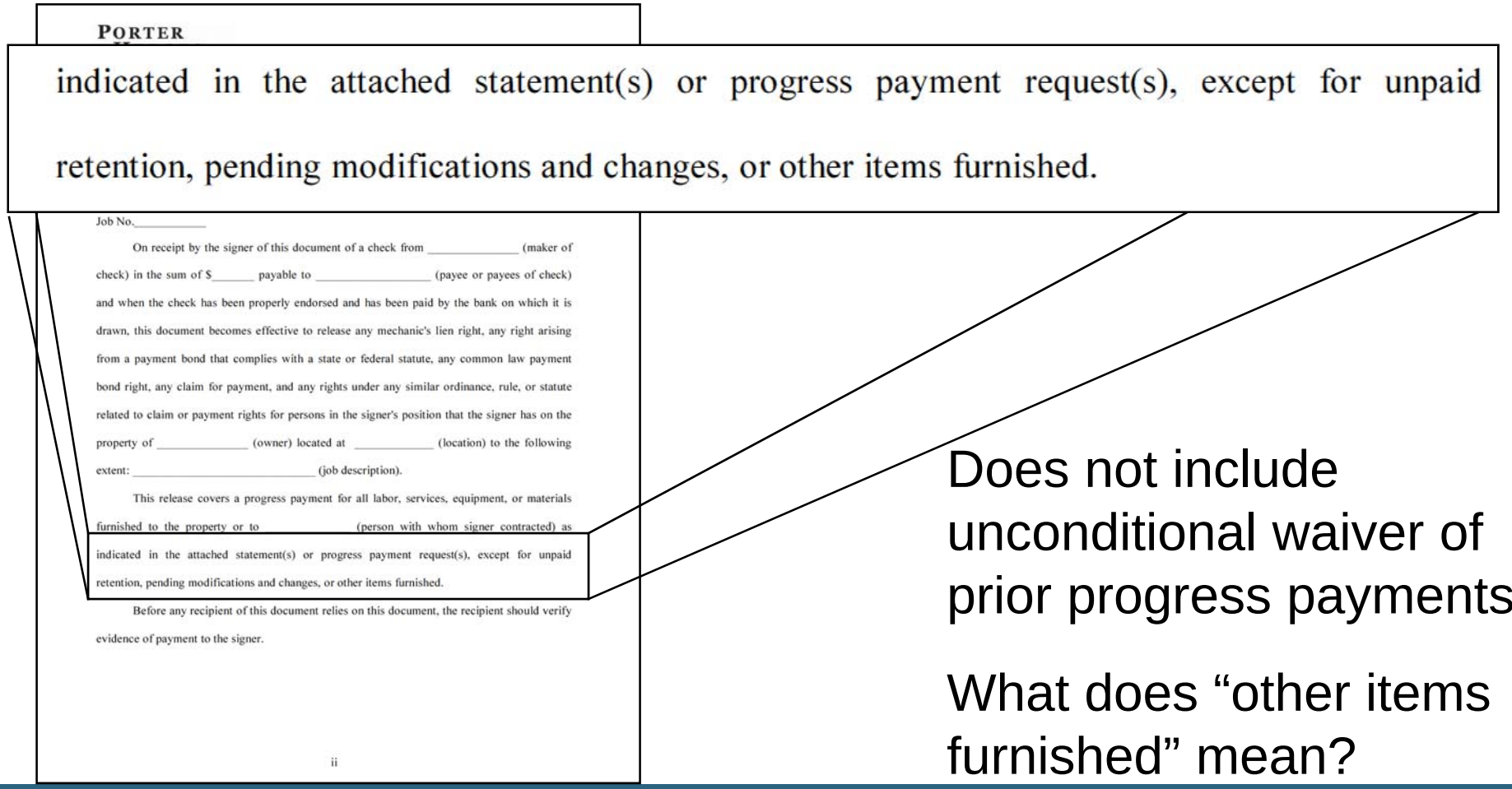
WAIVERS AND RELEASES

- Tex. Prop. Code – Subchapter L
- Establishes 4 statutory lien waiver forms that are required to be used on private projects:
  - Conditional Waiver and Release on Progress Payment
  - Unconditional Waiver and Release on Progress Payment
  - Conditional Waiver and Release on Final Payment
  - Unconditional Waiver and Release on Final Payment
- Any waiver/release of a lien or payment bond claim is unenforceable unless it is executed and delivered in accordance with the new statute

WAIVERS AND RELEASES

- Use the conditional waivers when payment is not made simultaneous to providing the executed waiver
- The recipient of one of the statutory conditional waivers should verify payment has been made before relying upon the conditional release

WAIVERS AND RELEASES



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indicated in the attached statement(s) or progress payment request(s), except for unpaid retention, pending modifications and changes, or other items furnished.

Job No._____

On receipt by the signer of this document of a check from _____ (maker of check) in the sum of $_____ payable to _____ (payee or payees of check) and when the check has been properly endorsed and has been paid by the bank on which it is drawn, this document becomes effective to release any mechanic's lien right, any right arising from a payment bond that complies with a state or federal statute, any common law payment bond right, any claim for payment, and any rights under any similar ordinance, rule, or statute related to claim or payment rights for persons in the signer's position that the signer has on the property of _____ (owner) located at _____ (location) to the following extent: _____ (job description).

This release covers a progress payment for all labor, services, equipment, or materials furnished to the property or to _____ (person with whom signer contracted) as indicated in the attached statement(s) or progress payment request(s), except for unpaid retention, pending modifications and changes, or other items furnished.

Before any recipient of this document relies on this document, the recipient should verify evidence of payment to the signer.

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Does not include unconditional waiver of prior progress payments.

What does “other items furnished” mean?

WAIVERS AND RELEASES

- Substantial compliance is required
- Any provision that expands or restricts the rights or liabilities provided by this act shall be disregarded and the provisions of this statute substituted
- Any contract or agreement that attempts to waive the right to file or enforce a lien or bond claim is void

WAIVERS AND RELEASES

- Took effect January 1, 2012

WAIVERS AND RELEASES

Exclusions:

- contracts or subcontracts for labor only or for labor and materials for construction or "land development" of residential projects
  - Residential contracts for material only must still use the statutory waivers

WAIVERS AND RELEASES

Exclusions continued:

- Accord and satisfaction of an identified dispute (settlement agreement prior to litigation or arbitration);
- Agreements concerning pending actions in court or arbitration proceedings; and
- Agreements executed after a lien affidavit is filed or a bond claim has been made.

4) Dispute Resolution

MEDIATION

- Vehicles for Resolution:
- Mediation:
  - Often contractually required as a condition precedent to arbitration or litigation
  - Less expensive then Litigation or Arbitration
  - Informal process
  - Experienced Mediator
  - Preparation is the key to resolution:
    - Opening Statement
    - Exhibits / Prepared Law
    - Summarize damages
    - Written settlement agreement

MEDIATION

When to Mediate:

- There is no clear time
- This is a judgment call because the longer you wait the more informed you will be but the more expenses will have accrued

Rules for Mediation

- Always have the Mediator develop rules for the mediation

Mediator Selection

- Select an experienced mediator skilled in the area of construction disputes

ARBITRATION

- Arbitration:
  - Performed as the result of a contractual agreement or by agreement of the parties (by submission)
  - Experienced Arbitrators
  - Arbitrator's award is final and cannot be appealed
  - May be cheaper and faster then trial
  - Reduce risk of irrational, runaway jury verdicts

COMPARISON OF ARBITRATION AND LITIGATION

Factors	Arbitration	Court
Decision by Jury	No	Yes
Jury/Panel Selection	Real Control	Limited Control

COMPARISON OF ARBITRATION AND LITIGATION

Factors	Arbitration	Court
Decision by Technical Panel	Yes	No
Joinder	No	Yes
Final Decision or Appeals	Final	Appeals

COMPARISON OF ARBITRATION AND LITIGATION

Factor	Arbitration	Court
Time to Resolution	18 months	2-3 years
Schedule Control	Good	Poor

COMPARISON OF ARBITRATION AND LITIGATION

Factors	Arbitration	Court
Cost Control	Good	Poor
Arbitrator Cost	Daily	None
Administration	Monthly	None
Filing Fee	Based on Disputed $	Fixed Fee

COMPARISON OF ARBITRATION AND LITIGATION

Factors	Arbitration	Court
Discovery	Limited	Expanded
Evidence Rules	No/Maybe	Yes
Admission of Evidence	Everything Comes In	Complex Rules

COMPARISON OF ARBITRATION AND LITIGATION

Factors	Arbitration	Court
Rules of Procedure	Limited/ Published/ Make up Your Own Rules	Yes
Confidentiality	Yes	No

COMPARISON OF ARBITRATION AND LITIGATION

Factors	Arbitration	Court
Need Attorney	Most cases	Always
Need Clause in Contract	Yes [at every tier]	No
Preferable to specify FAA or your State's Act	Yes	N/A

- AIA A201 - 15.4 Arbitration
  - Arbitration no longer automatic; must be chosen by agreement
    - Question as to whether the FAA or TAA would apply (*see Volt Information Sciences, Inc. v. Bd. of Trustees of the Leonard Stanford Junior University*, 489 U.S. 468 (1989))
    - A201 selects FAA, yet also applies Texas law (*see Teal Constr. V. Darren Casey Interests*, 46 S.W.3d 417 (Tex.App.—Austin 2001))
    - Judicial review of arbitration awards limited to the grounds set forth in FAA §§ 10-11 exclusively, parties may not agree to expand judicial review (*see Hall St. Assoc. v. Mattel, Inc.*, 128 S.Ct. 1396 (2008))

- Joinder Issues
  - Practical problems arise where parties are forced to arbitrate some claims and litigate other elements of the same dispute simultaneously
  - Can the surety be joined to the dispute?
  - Can suppliers, subcontractors, the owner, etc…?
  - Add clause stating that if some, but not all necessary parties or issues cannot be joined in the arbitration, then all parties are excused from the arbitration

- Specify Arbitration Procedures
  - Contract for discovery
    - Whether written discovery will be allowed
    - How many depositions will be allowed
    - How documents are to be exchanged
  - What rules of procedure will govern?
  - How many arbitrators will there be?
  - What qualifications must arbitrators have?

- Specify Recoverable Damages
  - Are expert witness fees recoverable?
  - Can attorney's fees and expenses be awarded?
  - Can the arbitrators award injunctive relief?
  - What kind of interest is recoverable?
  - Are arbitrator fees and arbitration expenses recoverable?

PORTER HEDGES LLP

PERFECTING LIEN RIGHTS ON PRIVATE PROJECTS

Presented to:

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LIEN LAWS IN TEXAS

- Texas has some of the most complex statutory liens laws in the country
- Today's presentation is focused on commercial construction projects in Texas

HOW TO SEND THE PROPER NOTICE AND FILE THE PROPER AFFIDAVIT

- The procedures for perfecting a lien depend on the claimant's position in the construction "food chain"
- Notice requirements in the Property Code are mandatory for first tier subcontractors/suppliers and lower tiers but notice is not required of an original contractor prior to filing a lien
- **Every claimant must know its place in the "food chain" on each project**

THE TIERS

- An original contractor is defined as “a person contracting with an owner either directly or through the owner’s agent.”
- A subcontractor is defined as “a person who has furnished labor or materials to fulfill an obligation to an original contractor or to a subcontractor to perform all or part of the work required by an original contract.”
    - This includes suppliers

TWO TIERS OF SUBS FOR NOTICE PURPOSES

- The first-tier subcontractors are those subcontractors and suppliers having an agreement with the original contractor.
- Second-tier subcontractors and suppliers and lower tiers do not have an agreement with the original contractor.
- Material suppliers can either be in the first or second tier, depending on whether they have a contract with the original contractor or with a subcontractor.
- Texas has no limit on the number of tiers down the food chain a claimant can be and still be eligible to perfect

THE NOTICE

Sending proper and timely notices performs two functions:

- Notices are necessary for any lien Claimant (other than a general contractor) to perfect a statutory lien.
- Notices (that include the proper language) serve to trap funds in the owner's possession.

Deadlines for these notices are directly related to the Claimant's classification on the construction tiers.

ORIGINAL CONTRACTORS

1. **No Notice:** An original contractor is not required to send a notice before filing a mechanic's lien affidavit. The only notice required of an original contractor is the notice that must be sent after filing the lien affidavit. *(See below).*

2. **The Lien Affidavit:** An original contractor must file an Affidavit in the real property records in the county in which the property is located **not later than the 15th day of the fourth calendar month after** the following events:

   (1) The month in which the original contract was materially breached or terminated, or

   (2) The last day of the month in which the original contract is completed, finally settled, or abandoned.

ORIGINAL CONTRACTORS (cont.)

3. **The Notice To Owner After the Lien Affidavit is Filed:** The Claimant must send a copy of the Affidavit by registered or certified mail to the owner or reputed owner at the last known business or residence address not later than five (5) calendar days after the date the Affidavit is filed.

4. **Practice Tip**: As a practical matter, it is best to send notice to the Owner on the same day the lien is filed in order to avoid failing to comply with this requirement.

FIRST-TIER SUBCONTRACTORS AND SUPPLIERS

The Notice:

- The first-tier subcontractor must send a letter by certified mail, return receipt requested, to the owner and the original contractor informing them of the unpaid claim not later than the 15th day of the third calendar month following *each month* in which labor was performed or material delivered.
- This notice is referred to as the "third month notice." It is also called a "fund trapping" notice if the proper fund trapping language is used. The claimant should use the statutory language set out in § 53.056 in order to properly "trap" funds in the owner's possession.

FIRST-TIER SUBCONTRACTORS AND SUPPLIERS (cont.)

To "trap" funds, the notice to the owner must state that:

> *"If this claim remains unpaid, you may be personally liable and your property may be subjected to a lien unless:*
>
> *(1) you withhold payments from the contractor for payment of the claim; or*
>
> *(2) the claim is otherwise paid or settled."*

FIRST-TIER SUBCONTRACTORS AND SUPPLIERS (cont.)

The effect of fund trapping:

- A claimant can obtain a lien on the property *and* subject the property owner to personal liability to the extent the owner receives the requisite notice and fails to withhold any further amounts from the contractor sufficient to cover the stated claim.
- In other words, when the owner receives the notice, any unpaid contract funds are "trapped" (up to the amount of the claim stated in the notice).

FIRST-TIER SUBCONTRACTORS AND SUPPLIERS (cont.)

Practice Tip. If the owner has already paid out all the contract funds when he receives the fund trapping notice letter, there will be no contract funds trapped. Therefore, it is to a claimant's advantage to send the fund trapping letter to the owner as soon as a payment problem becomes evident.

FIRST-TIER SUBCONTRACTORS AND SUPPLIERS (cont.)

The Lien Affidavit:

- The first-tier subcontractor must file an Affidavit in the real property records of the county where the project is located **not later than the 15th day of the fourth calendar month after the last day of the last month in which the first-tier subcontractor performed labor or supplied material.**

The Notice to Owner After the Lien Affidavit is Filed:

- The Claimant must send a copy of the Affidavit by registered or certified mail to (1) the owner or reputed owner at the owner's last known business or residence address, *and* (2) the original contractor at the original contractor's last known business or residence address not later than **five** calendar days after the date the Affidavit is filed.

SECOND-TIER (AND LOWER) SUBCONTRACTORS AND SUPPLIERS

The Notice to the Original Contractor:

- Second-tier (and lower) subcontractors/suppliers must send a letter by certified mail, return receipt requested, to the original contractor informing it of the unpaid claim **not later than the 15th day of the second month** following ***each month*** in which the second-tier subcontractor has supplied labor or materials.
- This notice is sometimes referred to as the "second month notice."

SECOND-TIER (AND LOWER) SUBCONTRACTORS AND SUPPLIERS (cont.)

The Notice to the Owner:

- The second-tier subcontractor must also send a letter by certified mail, return receipt requested, to the owner or reputed owner informing it of the unpaid claim not later than the 15th day of the third month following each month in which the second-tier subcontractor's labor was performed or material delivered (the "third month notice").
- Second-tier claimants are urged to use the "fund trapping" language set forth in § 53.056.

SECOND-TIER (AND LOWER) SUBCONTRACTORS AND SUPPLIERS (cont.)

The Fund Trapping Notice to the Owner Must State That:

"If this claim remains unpaid, you may be personally liable and your property may be subjected to a lien unless:

(1) you withhold payments from the contractor for payment of the claim, or

(2) the claim is otherwise paid or settled."

SECOND-TIER (AND LOWER) SUBCONTRACTORS AND SUPPLIERS (cont.)

- Practice Tip. As a practical matter, the second and third month notice should be combined into one letter which is sent to the Owner, the general contractor and the first- and second-tier subcontractors.
- However, ***the notice must go out by the second month notice deadline to perfect a claim***.
- The best rule of thumb is for the claimant to always send notice to everyone up the food chain from the claimant.

SECOND-TIER (AND LOWER) SUBCONTRACTORS AND SUPPLIERS
(cont.)

The Lien Affidavit:

After all proper notices have been sent, the second-tier subcontractor must file an Affidavit in the real property records of the county where the project is located **not later than the 15th day of the fourth calendar month after the last day of the last month in which the second-tier subcontractor performed labor or supplied material.**

SECOND-TIER (AND LOWER) SUBCONTRACTORS AND SUPPLIERS
(cont.)

The Notice to Owner and Original Contractor After the Lien Affidavit is Filed:

The Claimant must send a copy of the Affidavit by registered or certified mail to: (1) the owner or reputed owner at the owner's last known business or residence address, *and* (2) the original contractor at the original contractor's last known business or residence address, not later than **five** (5) calendar days after the date the Affidavit is filed.

STATUTORY RETAINAGE

- Section 53.101 of the Property Code requires the owner of a project to withhold 10% of the contract price of the work or 10% of the value of the work, as retainage during the project and for thirty (30) days after completion of the work.
- If the owner fails to retain the 10%, a Claimant who complies with the statute has a lien against the property, at least to the extent of the amount that should have been retained.
- While, generally, an owner's liability will not exceed the required retainage, the owner can be liable for retainage plus trapped funds if funds were "trapped" by proper notices sent pursuant to § 53.056.

STATUTORY RETAINAGE (cont.)

- In order to properly perfect a claim on the retained funds (or the amount which should have been retained), a Claimant must:
  - (1) send all notices required by Chapter 53 and
  - (2) except as allowed by Section 53.057(f) (discussed later) file an Affidavit claiming a lien not later than the 30th day after the earliest of the date:
    - the work is completed;
    - the original contract is terminated; or
    - the original contractor abandons performance under the original contract.
- If the Claimant fails to give proper notice and perfect the lien, the owner's property will not be liable.

HOW TO CALCULATE "COMPLETION" PROPERLY

- In 2003, the Texas Supreme Court held that a subcontractor's deadline for filing a Lien Affidavit to perfect a claim for retainage runs from the date the original contract is completed, terminated or abandoned (even if the subcontractor did not know when (or even if) the original contract was completed, terminated or abandoned).
- In 2005, the Texas Legislature added §53.107 to the Property Code, which requires an owner to provide written notice to a subcontractor who has sent a lien notice or who has requested written notice from an owner whenever an original contract is either terminated or abandoned.

NOTICE OF COMPLETION

Section 53.107:

- Requires owners to provide notice to claimants that the original contractor has been terminated or has abandoned the project **not later than the 10th day** after such event if:
  - the claimant has given notice to the owner under Sections 53.056, 53.057 or 53.058; or
  - the claimant sent the owner by certified or registered mail a written request for notice of termination or abandonment.

NOTICE OF COMPLETION
(cont.)

The notice must contain the following:

1. the name and address of the owner;
2. the name and address of the original contractor;
3. a description, legally sufficient or identification, of the real property on which the improvements are located;
4. a general description of the improvements agreed to be furnished under the original contract;
5. a statement that the original contract has been terminated or that performance under the contract has been abandoned;
6. the date of the termination or abandonment; and

NOTICE OF COMPLETION
(cont.)

7. a conspicuous statement that a claimant may not have a lien on the retained funds unless the claimant files an affidavit claiming a lien not later that the **40th** day after the date of the termination or abandonment.

- Provides that if an owner that is required to send notice to a subcontractor under this section and fails to do so, the subcontractor is not required to comply with Section 53.207 to claim retainage and may claim a lien by filing a lien affidavit as prescribed by Section 53.052.

WORD TO THE WISE

While §53.107 helps those claimants who: 1) have sent their lien notices and 2) those who send a request for notice to the Owner, for those claimants who do **not** send a §53.107 request but who perform work on a project and then leave while the work is going, they must still keep up with when the original contractor completes, abandons or is terminated.

YOU MAY NEED TO SEND A FUND TRAPPING NOTICE IMMEDIATELY WHEN YOU PERFORM WORK AT THE END OF A PROJECT

- Absent a fund trapping notice, the requirement that the owner must hold retainage for 30 days after completion serves to effectively shorten the time for giving a fund trapping notice for work completed at the end of the project.
- The owner, in the absence of a fund trapping notice, may release funds without liability after the expiration of 30 days after completion of the work.
- So the effective deadline for sending a fund trapping notice is the shorter of: (1) 30 days after the project is completed or (2) the fifteenth day of the third month following each month in which all or part of the Claimant's labor was performed or material delivered.

CONTRACTUAL RETAINAGE NOTICE

- When a *subcontractor or supplier* provides labor or material under an agreement that provides for retainage, and wishes to perfect a lien for such contractual retainage held by the general contractor or other downstream party, the claimant must sent notice to (1) the owner or reputed owner and, if applicable, (2) the general contractor no later than the ***earlier*** of:
  - (1) the 30th day after the date the *claimant's* agreement providing for retainage is completed, terminated or abandoned; OR
  - (2) the 30th day after the *original contract* is terminated or abandoned

CONTRACTUAL RETAINAGE NOTICE

- The notice must generally state the existence of a requirement for retainage and contain:

  (1) the name and address of the claimant; AND

  (2) If the agreement is with a subcontractor, the name and address of the subcontractor.

- No further notice is required to perfect a lien on contractual retainage if the Claimant provides the above described notice and timely files its lien Affidavit.

FILING A LIEN ON RETAINED FUNDS

- Claimant has a perfected lien on contractually retained funds if it sends the notice required by Section 53.057 *and*
  - files the lien affidavit within **30 days** after the earlier of the date (a) the work is completed, (b) the original contract is terminated or (c) the original contractor abandons the project; OR
  - files a lien affidavit not later than the earliest of:
    - the date required by 53.052 (15th day of 4th month);
    - The 40th day after completion *if the owner sends the claimant notice of an affidavit of completion;* (con't)

FILING A LIEN ON RETAINED FUNDS

(con't.)

- the 40th day after the date of termination or abandonment of the original contract *if the owner sent the claimant notice of such termination or abandonment* as required; OR

- the 30th day after *the owner sent the claimant a written notice of demand for the claimant to file an affidavit claiming a lien* after receiving the notice of contractual retainage.

FILING A LIEN ON RETAINED FUNDS

- The Owner's "written demand for a claimant to file a lien affidavit" must contain the following:
  - Owner's name and address and a legal description of the real property;
  - a statement that the claimant must file a lien affidavit within 30 days after the date the demand is sent; and
  - is effective only for the amount of contractual retainage earned as of the day the demand was sent

FILING A LIEN ON RETAINED FUNDS

- The claimant must send a copy of the filed lien affidavit by registered or certified mail to the owner or reputed owner at its last known address **within 5 days** of filing with the county clerk.
- First tier subcontractors (and lower) must also send a copy of the filed affidavit to the original contractor at the original contractor's last known address within the same time period.

WHAT DOES COMPLETION MEAN?

- Punch list work required to complete the contract scope of work extends the date of completion and therefore, the deadline to file a mechanic's lien.
- However, performing warranty work does NOT extend the completion date
- "Completion" is defined as "the actual completion of the work, including any extras or change orders reasonably required or contemplated under the original contract, *other than warranty work or replacement or repair of the work* performed under the contract"

DEMAND FOR PAYMENT TO OWNER

- Per 53.083 of the Property Code, a derivative claimant may make demand on the owner for payment
- Such demand:
  - Must be given in the time the claimant would have to secure a lien claim
  - Must give notice to the owner that all or part of the claim has accrued under 53.053 or is past due
  - Must also be sent to the original contractor

DEMAND FOR PAYMENT TO OWNER

(con't.)

- The original contractor has 30 days to notify the owner if he disputes the claim
  - If the original contractor fails to notify the owner that the claim is disputed within this period, he is deemed to have assented and the owner "shall" make payment to the claimant
- Practice Tip. ALL derivative claimants should include demand language to the owner in all second month and third month notices.

SPECIAL FABRICATORS SHOULD TAKE ADVANTAGE OF THE EARLY NOTICE PROVISIONS

Early Notice:

- A contractor, subcontractor, or material supplier who supplies specially fabricated material is given extra protection.
- A fabricator of specially fabricated material must send notice by registered or certified mail to the last known business or residence address of the owner (for first-tier fabricators) and to the original contractor (for second-tier fabricators) not later than the 15th day of the second month after the month in which the Claimant receives and accepts the order for the material
- The notice must contain (1) a statement that the order has been received and accepted; and (2) the price of the order.
- Essentially, the Property Code requires a fabricator of specially fabricated material to give the owner and, if necessary, the original contractor, additional time in which to halt production or become liable for a properly perfected lien.

SPECIAL FABRICATORS SHOULD TAKE ADVANTAGE OF THE EARLY NOTICE PROVISIONS (cont.)

The Regular Second or Third Month Notice:

- In addition to the early notice, the Claimant must give the regular or second or third month notice if delivery has been made or if the normal delivery time for the job has passed.
- If the fabricator only gives the notices required by §53.056, but has failed to provide the preliminary notice required by §53.058, then a lien will only be valid and perfected as to the materials actually delivered to the job.

SPECIAL FABRICATORS SHOULD TAKE ADVANTAGE OF THE EARLY NOTICE PROVISIONS (cont.)

File Lien Affidavit:

After the proper notice has been sent, the Claimant for specially fabricated materials must file an Affidavit in the real property records of the county where the project is located not later than the 15th day of the fourth calendar month from:

1. The last day of the last month in which materials were delivered;
2. The last day of the last month in which delivery of the last of the material would normally have been required at the job site; or
3. The last day of the month of any material breach or termination of the contract by the owner, original contractor or subcontractor under which the special fabricated material was furnished.

THE CONSTITUTIONAL LIEN

- The Texas Constitution provides a self-executing lien;
- Can only be used by an original contractor in direct privity of contract with the owner;
- The original contractor need not comply with the requirements of Chapter 53 of the Property Code
- Although a constitutional lien exists without the necessity of filing a lien affidavit, it is limited;
- A constitutional lien cannot be enforced against a good-faith purchaser of the property who had no knowledge of the lien claim;

THE CONSTITUTIONAL LIEN (cont.)

- In order to preserve such a claim against a subsequent good-faith purchaser, Claimants are encouraged to file a Lien Affidavit in the county records for the property in question. The filing of the Lien Affidavit will put prospective purchasers of the property on notice of the lien.
- Due to the limitations of the constitutional lien, Claimants should not rely on it to protect their rights.
- The constitutional lien is only valid for articles or buildings and the land necessary to its enjoyment.

THE CONSTITUTIONAL LIEN (cont.)

- Suppliers of materials such as refrigerators which are not incorporated into the project may not acquire a constitutional lien, even if ordered by the Contractor.
- A statutory lien should always be perfected in order to preserve claims.
- The constitutional lien is a remedy of last resort for the original contractor who fails to timely perfect the statutory lien.

THE "REQUEST FOR INFORMATION"

Claimants should ask for the information they need when the project begins. Pursuant to §53.159, a Claimant should make a written request of the owner, original contractor and/or subcontractor, as applicable, for needed information.

A. Claimants can get the following information **from *an Owner*** within 10 days after receipt of the request:

1. A legal description of the property;
2. Whether there is a surety bond and if so, the name and address of the surety and a copy of the bond;
3. Whether there are any prior recorded liens or security interests on the real property, and if so, the name and address of the person having the lien or security interests; and
4. The date on which the original contract for the project was executed.

THE "REQUEST FOR INFORMATION" (Cont.)

B. Claimants can get the following information **from a *general contractor*** within 10 days after the receipt of the request:

1. the name and last known address of the person to whom the original contractor furnished labor or materials for the construction project;

2. whether the original contractor has furnished or has been furnished a payment bond for any of the work on the construction project and if so, the name and last known address of the surety and a copy of the bond; and

3. The date on which the original contract for the project was executed.

THE "REQUEST FOR INFORMATION" (Cont.)

C. Claimants can get the following information **from a *subcontractor*** within 10 days after the receipt of the request:

1. the name and last known address of each person from whom the subcontractor purchased labor or materials for the construction project, other than those materials that were furnished to the project from the subcontractor's inventory;

2. the name and last known address of each person to whom the subcontractor furnished labor or materials for the construction project; and

3. whether the subcontractor has furnished or has been furnished a payment bond for any of the work on the construction project and if so, the name and last known address of the surety and a copy of the bond.

THE "REQUEST FOR INFORMATION" (Cont.)

D. In addition, the owner, surety or general contractor can ask **a *claimant*** for:

1. his contract or purchase order;

2. any billing, statement or payment request that is unpaid; and

3. the estimated amount due for each calendar month the Claimant has provided labor or material.

NOTE: if the person from whom the information is sought does not have a direct contractual relationship with the person requesting the information, the person supplying the information can require payment of actual costs up to $25

CONTENTS OF THE LIEN AFFIDAVIT

A Lien Affidavit must be signed by the person claiming the lien or by another person on the claimant's behalf and must contain the following:

a. A sworn statement of the amount of the claim;

b. The name and last known address of the owner or reputed owner;

c. A general statement of the kind of work done and materials furnished by the Claimant and for a Claimant other than an original contractor, a statement of each month in which the work was done and materials furnished for which payment is requested;

d. The name and last known address of the person by whom the Claimant was employed or to whom the Claimant furnished the materials or labor; (cont.)

CONTENTS OF THE LIEN AFFIDAVIT (Cont.)

e. The name and last known address of the original contractor;

f. A description, legally sufficient for identification, of the property sought to be charged with the lien;

g. The Claimant's name, mailing address, and if different, physical address; and

h. For a Claimant other than an original contractor, a statement identifying the date each notice of the claim was sent to the owner and the method by which the notice was sent.

NOTE: It is crucial that the Affidavit meet the requirement of a sworn statement. The Affidavit must state that it was "subscribed and sworn to", not just acknowledged, and the Affidavit must be sworn to before a notary.

PORTER HEDGES LLP

ENFORCING PERFECTED LIEN RIGHTS ON PRIVATE PROJECTS

October 13, 2015

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ENFORCING PERFECTED LIEN RIGHTS

Judicial Foreclosure:

- In order to enforce a perfected mechanic's and materialman's lien, a lawsuit must be filed seeking the foreclosure of the lien.
- A mechanic's lien can *only* be foreclosed on the judgment of a court of competent jurisdiction.
- The judgment entered in such a proceeding shall foreclose the lien and order the sale of the property subject to that lien.

ENFORCING PERFECTED LIEN RIGHTS (Cont.)

Jurisdiction:

- A suit to foreclose a lien on real property may be filed in district court in all counties.
- Suits to foreclose liens on real property in Harris, Tarrant, El Paso, and Dallas Counties may also be filed in that county's statutory county courts at law.

ENFORCING PERFECTED LIEN RIGHTS (Cont.)

Limitations – Non-Residential:

- On non-residential construction projects, a Claimant must file suit on the lien:
  - **within TWO years after the last day the Claimant could have filed the lien affidavit** under Texas Property Code §53.052 OR
  - **within ONE year after completion, termination, or abandonment of the work under the *original contract* under which the lien is claimed, whichever is later.**

ENFORCING PERFECTED LIEN RIGHTS (Cont.)

Priorities – Inception of the Lien:

- The time of inception of a mechanic's lien for a claimant *other than* an architect, engineer, surveyor, or landscaper is the earlier of:

  1) the commencement of visible construction of the improvements on the land on which the improvements are to be located, or

  2) the first delivery of materials to the land on which the improvements are to be located, or

  3) the recording of an affidavit of commencement pursuant to Texas Property Code Sec. 53.124(c).

ENFORCING PERFECTED LIEN RIGHTS (Cont.)

Priorities – Inception of the Lien:

- In order for the "commencement of construction" to be sufficient to constitute the inception of the lien, it must:

  1) be conducted on the land to be improved itself,

  2) be visible on that land, and

  3) constitute either an activity defined as an "improvement" under Texas Property Code Sec. 53.001 or excavation for or laying of the foundation or structure of the building.

- The clearing of the construction site is not sufficient to constitute commencement of construction for inception purposes.

ENFORCING PERFECTED LIEN RIGHTS (Cont.)

Priorities – Inception of the Lien:

- The materials delivered to the improvement site must be materials that will be used during the construction or incorporated into the permanent structure.
- The time of inception of a mechanic's and materialman's lien claimed by an *architect, engineer, surveyor, or landscaper* is the date of the recording of the affidavit or lien.

ENFORCING PERFECTED LIEN RIGHTS (Cont.)

Priorities – Relation Back Doctrine:

- This doctrine determines the priority of liens that have been filed.
- All mechanic's and materialman's liens relate back to their time of inception regardless of when the affidavit claiming the lien was actually recorded or when the work resulting in the lien claim was performed
  - *Except for*, as previously discussed, architect's, engineer's, surveyor's, and landscaper's liens, where the time of inception for their liens is decided by the date the lien Affidavit is actually recorded.

ENFORCING PERFECTED LIEN RIGHTS (Cont.)

Priorities – Relation Back Doctrine:

- This means ALL mechanic's and materialman's liens (with the exception of architect's, engineer's, surveyor's, and landscaper's liens) are on an equal footing regardless of when the affidavit claiming the lien was actually recorded or when the work resulting in the lien claim was performed.
- All mechanic's and materialman's liens have priority over any lien, mortgage or encumbrances recorded or arising *after* the date of inception of the mechanic's and materialman's lien.

ENFORCING PERFECTED LIEN RIGHTS (Cont.)

Priorities – Summary:

- Except for liens claimed by architects, engineers, surveyors, and landscapers, all perfected mechanic's and materialman's liens are on equal footing regardless of the date of the filing of the affidavit claiming the lien.
  - There is no "race to the courthouse" situation
  - A properly recorded mechanic's lien affidavit that is recorded in April is equal to one properly recorded in June for the same project.
- If the proceeds of a foreclosure sale of property are insufficient to discharge all properly perfected mechanic's and materialman's liens in full, the various liens share *pro rata* in the proceeds.

ENFORCING PERFECTED LIEN RIGHTS (Cont.)

Priorities – Removables:

- Perfected liens on improvements that can be removed without material injury to the land, pre-existing improvements, or improvements to be removed from the structure are granted a preference over all other liens.
- This preference even extends to deeds of trust filed *prior to the inception of the mechanic's lien*.
- A lien as to such removables can only be foreclosed by the order of a court with competent jurisdiction.
- The claimant is not entitled to self-help repossession in regard to these items.

ENFORCING PERFECTED LIEN RIGHTS (Cont.)

Priorities – Removables:

- However, a claimant cannot remove a removable unless it can be proven that the claimant furnished the removable that it seeks to remove, i.e., unless it can identify its materials.
  - For example, a lumber supplier cannot remove the air conditioning unit because the lumber supplier did not provide it to the project.
- The original contractor is entitled to remove all removables provided by it and its subcontractors and suppliers since the entirety of the construction was provided pursuant to his contract with the owner.

ENFORCING PERFECTED LIEN RIGHTS (Cont.)

Priorities – Removables:

So what constitutes a "removable"??

- It is a question of fact for a jury to decide
- Decided on a case-by-case basis.

In determining whether an item is removable, the court considers:

1. The manner of its attachment to the land or existing improvements;
2. The extent to which removal of the item would require repairs, modifications or protection of the land or existing improvements;
3. The status of construction at the time removal is sought; and
4. The function of the improvements sought to be removed.

ENFORCING PERFECTED LIEN RIGHTS (Cont.)

Priorities – Removables:

The following is a non-inclusive list of items that the courts have, in the past, held to be **removables**:

1. Garbage disposals and dishwashers.
2. Air conditioning and heating system equipment such as furnaces, air conditioning coil, compressor, thermostat, and condensing unit.
3. Windows and doors that can be removed by temporarily taking out surrounding brick without causing ultimate damage to a residence.
4. Lighting fixtures, cabinets, chimes, buttons, mail boxes and lamps.
5. Picture screen, ticket booth, neon sign, and speaker pools at drive-in movie.
6. Pumps fastened to beds of concrete.

ENFORCING PERFECTED LIEN RIGHTS (Cont.)

Priorities – Removables:

Removables (cont.)

7. Carpets, appliances, air conditioning and heating components, smoke detectors, burglar alarms, light fixtures, and door locks.
8. Mirrors.
9. Pumps, compressors, fans for air conditioning and heat systems, toilets, basins, doors, windows, light fixtures, wall switches, electrical control panels, building hardware, and cabinets.
10. Highway billboard signs.

ENFORCING PERFECTED LIEN RIGHTS (Cont.)

Priorities – Removables:

The following is a non-inclusive list of items that the courts have, in the past, held to be **non-removable**:

1. Concrete roof tiles.
2. Window frames.
3. Certain types of cabinets.
4. Plastering and painting.
5. Lumber used in construction of a house.
6. Bricks utilized in the construction of a fireplace and chimney.
7. Roofing tiles.
8. A shell home.
9. Duct work for air conditioning and heating systems, copper plumbing, piping, sheet rock, electrical wiring and conduit, electromagnetic insulation, glass brick interior wall, and suspended ceiling.

ENFORCING PERFECTED LIEN RIGHTS (Cont.)

Priorities – Leased Property:

- A claimant can perfect a mechanic's and materialman's lien against leasehold improvements.
- The extent of a leasehold interest, and thus the leasehold improvements, is determined by the terms of the lease agreement itself.
- **The rights of a contractor or materialman can be no greater than those of the person with whom he has contracted.**
- As such, contracts with a lessee of real property cannot give any rights against the lessor or his title to the realty.

ENFORCING PERFECTED LIEN RIGHTS (Cont.)

Priorities – Leased Property:

- Many leases contain a reversionary interest provision, which provides that the tenant, upon termination of the lease, shall surrender the premises and all improvements thereon to the landlord.
  - Improvements could include HVAC equipment, interior walls, lighting, doors, floor and wall coverings, cabinets and built ins
  - Lease agreements frequently provide that all improvements become the property of the landlord when constructed or become the landlord's property upon the termination of the lease
- The inclusion of a reversionary interest provision in a lease agreement can defeat a mechanic's and materialman's lien if the lease is terminated prior to foreclosure of the lien.

PORTER HEDGES LLP

MANAGING CHANGE ORDERS

Presented to:

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October 13, 2015

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Overview of Contract Law

Overview of Contract Law

Contract Formation

Under Texas law, the elements of a contract are:

(1) an offer;

(2) acceptance in compliance with the terms of the offer;

(3) a meeting of the minds;

(4) a communication that each party has consented to the terms of the agreement;

(5) execution and delivery of the contract with an intent that it become mutual and binding on both parties; and

(6) consideration.

This list is often shortened to three traditional elements:
(1) an offer; (2) an acceptance; and (3) consideration.

Overview of Contract Law

Critical Parts of Construction Contracts

Purpose - to list and explain each party's expectations and duties in an effort to balance risks and prevent future misunderstandings.

In order to fulfill these purposes, a construction contract should address, at a minimum, the following items:

(1) Price and Payment Schedule;

(2) Description of Labor and Materials and Scope of Work;

(3) Completion Deadlines and Definitions of Completion;

(4) Authority to Bind; and

(5) Documents Constituting the Agreement

Overview of Contract Law

Contract's Scope of Work

• Virtually every construction contract will address the "scope of work."

• The precise meaning of "scope of work" is important, because payment for changes is available only if the contractor performed work beyond, or different from, that specified in its contract.

• In order to determine whether a particular task is within the scope of work or constitutes a change, a party must look to the contract documents.

Overview of Contract Law

Requirement of a Writing

- Construction contracts, like other commercial agreements, often contain a provision that requires all subsequent modifications to the contract to be in writing
- Try to get modifications *IN WRITING* in order to avoid, or at least minimize, disputes regarding the existence and scope of any contract modifications
- You should expect a court or an arbitrator to enforce the provision requiring the change order to be in writing

Overview of Contract Law

Requirement of a Writing

It is the general rule that a provision in a construction contract stating that changes, alterations or deviations must be ordered in writing, **is valid and binding** upon the parties and, therefore, so long as such a provision remains in effect, no recovery can be had for the alterations done without a written order in compliance therewith.

D.H. Overmyer Co. v. Harbison, 453 S.W.2d 368, 370 (Tex. Civ. App.-El Paso 1970, no writ); *see also Uhlir v. Golden Triangle Dev. Corp.*, 763 S.W.2d 512 (Tex. App.-Forth Worth 1989, writ denied) (contractor could not recover under contract for extras which were not agreed to in writing); *Kittyhawk Landing Apt. III v. Anglin Constr. Co.*, 737 S.W.2d 90 (Tex. App.-Houston [14th Dist.] 1987, writ ref'd n.r.e.) (same).

Exceptions to Written Change Orders

Exceptions

Exceptions To The Written Change Order Requirements:

- Quantum Meruit
- Waiver
- Breach of Contract
- Oral Contract
- Promissory Estoppel

Exceptions

Quantum Meruit

• *Quantum meruit* is an equitable remedy that allows the contractor to recover the reasonable value of labor, services, and materials provided when there is no specific contract covering the work.

• When recovery is premised on *quantum meruit*, the crucial inquiry is whether the alleged extra work was required of the contractor by the original agreement.

Exceptions

Quantum Meruit

- *Black Lake Pipe Line Co. v. Union Constr. Co.*
- *Angroson, Inc. v. Indep. Comm., Inc.*

Elements of a quantum meruit claim include proof of:

1. valuable services that were rendered or materials furnished;
2. for the person sought to be charged;
3. which services and materials were accepted by the person sought to be charged, used, and enjoyed by him;
4. under such circumstances as reasonably notified the person sought to be charged that the plaintiff was expecting to be paid by the person sought to be charged.

Exceptions

Waiver

- Texas courts define the concept of waiver as follows:

> A waiver takes place where one dispenses with the performance of something which he has a right to exact, and occurs where one in possession of any right, whether conferred by law or by contract, with full knowledge of the material facts, does or forbears to do something, the doing of which or the failure or forbearance to do which is inconsistent with the right or his intention to rely upon it. Waiver, of course, is a matter or question of intention.

Exceptions

Waiver

Evidence of waiver, generally:

(1) an express renunciation of a known right;

(2) silence or inaction, coupled with knowledge of the right, for such an unreasonable period of time as to indicate an intention to waive the right; or,

(3) conduct of the party knowingly possessing the right of such a nature as to mislead the other party into an honest belief that the waiver was intended or assented to.

Exceptions

Waiver

Texas Constr. Assoc., Inc. v. Balli

Chambless v. J.J. Fritch

Tribble & Stephens Co. v. Consolidated Serv.

Exceptions

Prior Breach of Contract

Board of Regents of the University of Texas v. S & G Constr. Co.

It was the duty of the Board of Regents to provide the necessary plans and specifications under the terms of the contract. Its effort here to raise the spectrum of the change-order provision begs the question. Its breach set in motion the resulting tide of damages which the change-orders could in no way have fully stemmed. The Board cannot now escape the results of its failure by such diversion. Consequently, we hold that such a failure to provide "correct plans and specifications and additional instructions and detail drawings as were necessary to carry out the work called for in the contract . . ." was a breach of the contract resulting in the damage to appellee [contractor] found by the jury.

N. Harris Cty. Jr. College Dist. v. Fleetwood Constr.

Exceptions

Oral Contract

Buxani v. Nussbaum

Note difference in measure of recovery:

Quantum Meruit: reasonable value of services and materials provided

vs.

Oral Contract: agreed-on price or an amount figured by the procedure set forth in the original contract for valuing additional work.

Exceptions

Promissory Estoppel

No Texas courts have addressed this exception.

Similar to waiver, quantum meruit.

Confirming Oral Directives

Dear _____,

This is to confirm your oral direction of [date] to perform the following work: [describe]

Based upon your representation that we will be adequately compensated, we will immediately start to perform the extra work and will expect our contract price to be increased by $[amount].

[or]

This work is not included in our contract price and we will expect a prompt change order increasing our contract amount by $[amount].

[or]

This work is not included in our contract price and we will immediately undertake to perform it on the assumption that there will be an equitable adjustment in the contract price.

Very truly yours,
Trusting Construction Co.

Modification of Construction Contracts

Modification of Construction Contracts

Common Factors Leading to Modification

(1) changes in scope caused by owner changes;

(2) differing site conditions;

(3) substitutions;

(4) value engineering;

(5) defective plans and specifications;

(6) incomplete design; and

(7) schedule delays.

Change Orders in General

A change order is the written instrument which states that the owner, architect, and/or contractor agree on a change in the work and the degree to which the contract time and price will be adjusted.

- Puts parties to a construction project on notice
- Establishes cost, time change
- Complies with contract

Authority to Enter into Binding Change Orders

Vitally important to know which individuals are (and, more importantly, which individuals are not) authorized to agree to change orders.

Barron v. Golden Triangle Constructors, Inc.

Authority to Enter into Binding Change Orders

Consider the following in a subcontract:

"Extra" work, or "claims" invoiced as "extra" work, or "claims" which have not been issued as a written change order by _____, will not be authorized for payment nor shall become a part of the subcontract. **DO NOT PERFORM ANY EXTRA WORK WITHOUT A PROPERLY EXECUTED CONSTRUCTION CHANGE DIRECTIVE AND/OR CHANGE ORDER FROM _____,** signed by the Project Manager or officer of _____. Superintendents of _____ are not authorized to give verbal or written change orders.

Public Statutes Governing Change Orders

Sources of Law Governing Change Orders

Texas Local Government Code (contracts with cities and counties)

§ 252.048 Change Orders

(a) If changes in plans and specifications are necessary after the performance of the contract is begun or if it is necessary to decrease or increase the quantity of work to be performed or of materials, equipment, or supplies to be furnished, the governing body of the municipality may approve change orders making the changes.

(b) The total contract price may not be increased because of the changes unless additional money for increased costs is appropriated for that purpose from available funds or is provided for by the authorization of the issuance of time warrants.

Sources of Law Governing Change Orders

Texas Local Government Code

§ 252.048 Change Orders

(c) If a change order involves a decrease or an increase of $50,000 or less, the governing body may grant general authority to an administrative official of the municipality to approve the change orders.

(d) The original contract price may not be increased under this section by more than 25 percent. The original contract price may not be decreased under this section by more than 25 percent without the consent of the contractor.

Sources of Law Governing Change Orders

Texas Government Code (contracts with state agencies)
§ 2166.257 Contract Payment Administration

(a) On receipt of notice and itemized statements from the commission, the comptroller shall:

(1) account for prior expenditures on behalf of a project as expenditures from the project's appropriation, based on the amount of those expenditures certified by the commission; and

(2) reserve from a project's appropriation an amount estimated by the commission to be sufficient to cover contingencies over the amounts obligated by contract or otherwise for:

(A) planning, engineering, and architectural work;

(B) site acquisition and development; and

(C) construction, equipment, and furnishings contracts.

Texas Government Code
§ 2166.257 Contract Payment Administration

(b) The money reserved under Subsection (a)(2) may be used only if:

(1) the design professional or contractor recommends and justifies the proposed contingency expenditures by submitting a change order request;

(2) the proposed change order request is approved by the design professional;

(3) the proposed change order request is approved by the using agency and the agency makes a formal request for the allocation of money from the contingency reserve; and

(4) the director of facilities construction and space management appointed under Section 2152.104 investigates the nature of the change order and concurs in the necessity of the proposed expenditure or refuses to concur not later than the 15th day after the date of receiving the request.

Sources of Law Governing Change Orders

Texas Government Code
§ 2166.257 Contract Payment Administration

(c) If the director of facilities construction and space management refuses to concur in a proposed contingency expenditure, the using agency may appeal to the commission. The commission's findings are final. The commission shall adopt rules on the procedures for an appeal under this subsection.

(d) If an approved change order results in a reduction of construction cost, the amount of the contingency reserve shall be increased by the amount of the reduction.

(e) The comptroller shall issue warrants to pay progress payments and final payments on construction under this chapter on the commission's written approval.

Advice for Dealing with Public Entities

- A contractor should thoroughly investigate all city charter and code provisions in order to determine proper lines of authority in approving change orders because it is very difficult to recover against a public body in the absence of an approved written change order by an authorized representative of the public body.
- The contractor is in a Catch-22 because to wait for formal approval of a public change order can seriously delay a project.
- Although most public bodies will honor their commitments, and although legal theories are available to attempt recovery for extra work, contractors must understand and assess the risks of proceeding without formal approval.

The AIA Change Order Process

Introduction

- The American Institute of Architects ("AIA") Construction Contract forms all contain Change Order provisions.
- The forms essentially provide that changes in the Work may be accomplished after the execution of the Contract, without invalidating the Contract, by Change Order, Construction Change Directive, or order for a minor change in the Work.

Dealing with Change Order Problems

It has become all too commonplace on complex commercial construction projects, for a contractor to find himself in a very uncomfortable position at the end of the project.

The AIA Change Order Process

Assume the project in issue is a twenty-floor hospital renovation project. The contract has an original contract price of $20,000,000.00. The project is scheduled to last for 2 years. Six months into the project, the owner and architect issue a letter requesting that the contractor submit a price to change two floors, which were originally designed as administration offices, to two floors of patient care rooms. The contractor submits his change proposal price of $1,500,000.00 prior to beginning any of the changed work. The architect and/or owner reject the contractor's price, issue a CCD and instruct the contractor to proceed with the changed work.

The AIA Change Order Process

The contractor begins the changed work. The contractor also continues to negotiate the price of the work with the architect. What is the basis for reaching the price of the CCD work? Typical AIA contract language says that the CCD can be calculated on one of the following bases: (1) lump sum; (2) unit price; (3) cost-plus a fee; or (4) if there is a disagreement, the architect shall determine the amount based on reasonable expenditures, including costs of labor, materials, rental cost of equipment, insurance and bonds, and additional costs of supervision and field office personnel directly attributable to the change.

The AIA Change Order Process

If the CCD is resolved, then a change order is signed and the change order enters the regular billing process. If the architect makes a determination of the undisputed portion of the CCD, then that amount can be placed in the monthly pay applications. In some instances, the architect doesn't render a decision until after the Project is completed. In other instances, the architect may decide that no additional compensation has been justified. In any event, with few exceptions, the contractor is not permitted to stop if the architect's decision is not acceptable to the contractor.

The AIA Change Order Process

If a CCD is issued, the contractor must proceed unless the work in question is so far beyond the scope of the contract as to be a "cardinal" change. A truly fundamental change in a construction contract can trigger the Cardinal Change Doctrine.

A cardinal change is an alteration in the construction work so drastic that it effectively requires the contractor to perform duties materially different from those originally agreed to. Although change orders and cardinal changes both concern alterations and modifications to an agreement, a cardinal change is a drastic change that allows the contractor to refuse to proceed with the changed work.

The AIA Change Order Process

How does a contractor know when a change is a cardinal change? Realistically, the case law on cardinal changes is unpredictable and the decisions are rare. The only prudent way for the contractor to protect itself is to address the definition of cardinal change at bid time through exclusions and in the contract provisions relating to change orders and construction change directives.

Modifications You Can Make

A few examples of common modifications to CCD provisions include:

The AIA Change Order Process

- Define a cardinal change by setting a certain percentage of the base contract price, for example 20%, as a maximum amount of unresolved CCD's allowed.

This will allow the Contractor to refuse to work on any future CCD's until the pending CCD's have been resolved to below 20% of the base contract price.

The AIA Change Order Process

- Incorporate industry pricing standards/manuals and multipliers into the CCD calculation methods.

Negotiation is much more likely to be successful if the standards for the calculation of CCD's are clearly laid out before a dispute even appears.

The AIA Change Order Process

- Limit the number of days that can pass before a final decision is made by the Architect on the amount to be paid under the CCD.

Ask for decision deadlines based upon contractor's estimate of the amount of the CCD. The smaller the amount, the quicker the turnaround should be.

The AIA Change Order Process

- Request that mediation or arbitration of pending CCD issues be added to the CCD provisions in the Contract. Request the right to require mediation or arbitration of CCD issues within thirty days of a written demand, even if before completion of the Project.

The AIA Change Order Process

For example, the following language (italics) can be added to a typical CCD clause:

Upon receipt of a Construction Change Directive, the Contractor shall promptly proceed with the change in the Work involved and advise the Architect of the Contractor's agreement or disagreement with the method, if any, provided in the Construction Change Directive for determining the proposed adjustment in the Contract Sum or Contract Time.

Owner agrees that Contractor shall not be required to proceed with any further CCD's if the total amount of unresolved CCD work exceeds 20% of the amount of the original Contract price.

The Architect shall issue its final determination of cost and time impact for any CCD within twenty (20) days of the Contractors' submission of its estimated price for the performance of the work requested in the CCD.

The AIA Change Order Process

Contractor and Owner shall have the right to request mediation of any unresolved CCD's within thirty (30) days of the Architect's final determination of the cost and time impact of any CCD. If the Mediation does not result in an agreement on the unresolved CCD, then Contractor and Owner shall have the right to demand Arbitration of the unresolved CCD issue in accordance with the Construction Industry Arbitration Rules of the American Arbitration Association. If any such arbitration is requested prior to substantial completion of the Project, then the parties agree that such arbitration shall be on submission before one arbitrator and as set forth in the Fast Track Procedures of the Construction Industry Arbitration Rules of the American Arbitration Association, irrespective of the amount involved.

(See www.adr.org for a full description of these Fast Track procedures).

Liens for Change Order Work

A contractor or subcontractor who has not been compensated for labor and/or materials provided in the performance of change order work should file a lien or submit a bond claim.

Liens for Change Order Work

As a practical matter, change orders may not be finalized until the time limits for the required lien or bond notices, lien affidavits, and/or bond claims have passed. In addition, if a contractor's billing includes work within the contractor's scope plus extras, the payment for the entire amount can be upheld pending the issuance of a formal change order.

Liens for Change Order Work

For these reasons, it is prudent for a contractor to submit separate pay applications when seeking payment for both contract work and extras during the same period. This way, there should be no hold up on the payment for approved work and the contractor may only have to file a lien for the extra work, in order to protect his interests before the change order is issued.