CONSTRUCTION AND THE LAW IN TEXAS

Remedial Damages Clauses Across Multiple Projects
Are Cross Default Provisions Enforceable?

General contractors who subcontract portions of the work on their projects almost always include clauses in their subcontract terms and conditions that allow the contractor to withhold payment from a subcontractor in the event the subcontractor's performance causes the contractor to experience a loss. Frequently, these remedial damages clauses include language that permits the contractor to withhold sums from the project on which the subcontractor caused losses occurred, as well as other projects where the subcontractor may also be performing work for the contractor. When such a clause contains that language, it can be described as a cross-default provision. Cross-default provisions purportedly allow a contractor to reach across from one project to another to secure indemnification.

Cross-default provisions are commonly included in Master Service Agreements (MSA). A single MSA may govern the work performed on several separate projects, usually under individual "work orders". In these situations it is not uncommon for an upstream contractor to include contractual provisions that allow it to back charge a particular downstream subcontractor for costs incurred on one project, against the funds owed to that same downstream subcontractor on another unrelated project.

Upon initial examination, one would assume that the right to offset losses on one project against proceeds of another is a completely valid contractual right. However, this right may not be as easily enforceable or lawful as first impressions might provide. Contractors should proceed with caution when attempting to exercise rights under cross-default provisions. Acting without caution or before establish sufficient basis for asserting claims under a cross-default provision may expose the contractor to potentially severe consequences.

While cross-default provisions are generally enforceable, Texas has two commonly invoked statutes, which may prevent the enforcement of cross-default provisions. The two statutes that potentially provide these defenses against cross-default provisions are Chapter 28 of the Texas Property Code (the Prompt Payment Act) and Chapter 162 of the Texas Property Code (the Trust Fund Statute). These statutes provide defenses to the enforcement of cross-default provisions.

A subcontractor relying on these laws in defense of a cross-default claim by a contractor may be able to assert an affirmative claim under these statutes. Further, that claim may be able to negate or invalidate a cross-default provision. As a defensive claim, the subcontractor may be able to seek statutory interest for nonpayment and seek civil or criminal penalties under the Trust Fund Statute. The Trust Fund Statute not only exposes the upstream contractor to exemplary damages, but also provides a mechanism for the claimant to pursue the contractor's corporate representatives individually.

The more common and lesser of these "two evils" is the Prompt Payment Act. Rights exercised under a cross-default provision may provide a downstream subcontractor with a claim to statutory interest under the Prompt Pay Act at a rate of 18 percent per year for private project and 6 percent for public projects, although that rate may vary as interest rates change.

In defense of a Prompt Payment Act claim, the contractor must assert that a bone fide dispute exists regarding the subcontractor's entitlement to the withheld funds. Typically, this is not a difficult argument for a contractor. However, it becomes trickier to prove when the bone fide dispute occurred on a different project. In other words, does the bone fide dispute exception apply to each separate project, or does the exception apply globally to all projects between the subcontractor and contractor? Texas courts have not directly addressed this issue.

The lesser utilized but potentially more serious statute is the Trust Fund Statute. That law states that funds allocated for a construction project are trust funds for all downstream subcontractors and suppliers. Because of this statute, it may be unlawful to use a cross default provision on a job in which the offending subcontractor has performed properly. In other words, if subcontractor causes a loss on project A but has performed without loss or incident on project B, it may be unlawful to enforce the cross-default provision on project B as the funds that are intended to flow downstream on project B are trust funds for that subcontractor and any lower tier entities under that subcontractor.

In addition to stating that all construction funds are trust funds, the Trust Fund Statute also makes the contractor a trustee of those funds once they are received. If the contractor, or an employee thereof, misappropriates trust funds, the act provides for criminal penalties. Misapplication of trust funds occurs when "a trustee who, intentionally or knowingly or with intent to defraud, directly or indirectly retains, uses, disburses, or otherwise diverts trust funds without first fully paying all current or past due obligations incurred by the trustee to the beneficiaries of the trust funds, has misapplied the trust funds."

"Current or past due obligations" as used in the Act is defined as "those obligations incurred or owed by the trustee for labor or materials furnished in the direct prosecution of the work under the construction contract prior to the receipt of the trust funds and which are due and payable by the trustee no later than 30 days following receipt of the trust funds."

Knowing the law contains the above language, consider the following scenario: If the sub has contractually agreed to the cross-default back-charge provision and the subcontractor acknowledges that it owes a back charge on project A, is there a "current or past due obligation" on project A? Under a subcontract with cross-default language, would the obligation be due and payable under project A?" If not, perhaps taking money from project B would be allowed. Unless, he money taken on B was due and owing and it was being diverted from downstream sub-subcontractors or suppliers who may not have signed the cross-default clause. The unpaid funds on B are arguably an unpaid obligation to the unpaid sub-subcontractors and suppliers of the subcontractor that contracted for the cross-default provision with because its downstream entities are also beneficiaries.

Not only is the application of the statute confusing, at least one Texas court has determined that parties cannot contract around a criminal statute. Because the Trust Fund Act has criminal penalties and is, in part, a criminal statute, a contractor's cross-default provision may be unenforceable. Accordingly, any use of the cross-default provision, regardless of whether funds are due and owing may be unlawful.

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