Contractual Right to Offset Money Owed on Other Projects: I can do that … right?

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I. Introduction

A. Contract Offset Provisions

Offset provisions can save an owner from going under on multiple projects where one project – often the first one to commence – is going way south, way fast. For clarity, in this paper we will use the term "offset" or "cross-project offset" to refer to an upstream party withholding payment on one project in light of a default or other issue on another project. Sometimes other authors use the word "setoff" to capture this same meaning. A common scenario we will keep in mind is where – for Project A – Owner and Contractor sign a contract granting Owner the right to withhold payment from Contractor on Project B, or any other project; such a clause might look something like the following:

> Notwithstanding any terms contained in this Contract or any Supplement to the contrary, in addition to all remedies available at law or in equity, [Owner] may, at its option, withhold or deduct the amount of money due from [Contractor] under this Contract from the monies [Owner] may be obligated to pay to [Contractor] under any other Contract or Supplement between [Owner] and [Contractor].[1]

This paper will not discuss contractual provisions allowing, or barring, "offset" for damages incurred on a single project,[2] which provisions are often more properly described as recoupment.[3]

B. Failed 2023 Texas Legislation and Remaining Issues

This past Legislature, there was a failed attempt to effectively void – or at least severely limit – contractual cross-project offset provisions in construction contracts. A few other states have in fact passed recent legislation accomplishing this task.[4] But the Texas legislation – House Bill

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1 This language is taken from *Everlast Construction LLC v. McDonald's USA, LLC*, discussed in more detail below. No. 7:19-CV-112, 2020 WL 7658077, at *4 (S.D. Tex. 2020).

2 *E.g.*, AIA B101-2017 § 11.10.2.2 ("The Owner shall not withhold amounts from the Architect's compensation to impose a penalty or liquidated damages on the Architect, or to offset sums requested by or paid to contractors for the cost of changes in the Work, unless the Architect agrees or has been found liable for the amounts in a binding dispute resolution proceeding.").

3 BLACK'S LAW DICTIONARY 1310, 1648 (Deluxe 11th Ed. 2019). *See, e.g.*, Garza v. Allied Finance Co., 566 S.W.2d 57, 62 (Tex. Civ. App.—Corpus Christi 1978, no writ) ("Recoupment, one form of a counterclaim, is a 'demand arising from the same transaction as the plaintiff's claim,' while an offset arises out of a transaction different than the one forming the basis of plaintiff's claim.") (citing 3 Moore's Federal Practice P 13.02 n. 1, p. 13-54 (2d ed. 1974)).

4 *E.g.* VA. CODE. ANN. § 43-13 (2024) (entitled "Funds paid to general contractor or subcontractor must be used to pay persons performing labor or furnishing material" and stating "Any contract or subcontract provision that allows a contracting party to withhold ***funds due under one contract*** or subcontract for alleged claims or damages ***due on another contract*** or subcontract ***is void*** as against public policy.") (emphasis added); In re McGill, 623 B.R. 876, 896 (Bankr. D. Colorado 2020) (Conduct on part of bankrupt principal of subcontractor on public works project – after signing contract on subcontractor's behalf that made him well aware of his duties to sub-subcontractors and materialmen with regard to disbursed funds and with knowledge of subcontractor's own precarious condition – in depositing funds received from general contractor into subcontractor's bank account and then using them to pay various expenses, including payroll and expenses incurred on other projects, without seeing that sub-subcontractor was paid, was sufficient to

No 2928 – only made it out of committee and then effectively died on the House floor without consideration. HB 2928's limited legislative history reveals it was attempting to address the alleged issue that "[c]oncerns have been raised that some general contractors may withhold payments to subcontractors based on disputes on another project."[5] Representatives of the Texas Construction Association testified in favor of the bill, while representatives for AGC-Texas Building Branch, Texas Building Owners and Managers Association, and AGC of Texas-Highway, Heavy, Utilities, and Industrial Branch registered against the bill.[6] Had HB 2928 passed, it would have revised the Texas Prompt Pay Act for Private Project (Property Code Chapter 28) and the Texas Trust Fund Act (Texas Property Code Chapter 162) as follows:

> SECTION 1. Section 28.003, Property Code, is amended by adding Subsection (c) to read as follows:
> (c) For purposes of this section, a good faith dispute does not include a dispute relating to a contract, work order, contractual arrangement, or any other agreement between the parties that is not related to the contract for construction under which payment is requested or required.
> SECTION 2. Section 162.031, Property Code, is amended by adding Subsection (a-1) to read as follows:
> (a-1) A trustee who retains or otherwise diverts trust funds due to a dispute, including an alleged default, arising under a construction contract other than the contract in connection with which the trust funds were received by or placed under the control or direction of the trustee has misapplied the trust funds.
> SECTION 3. The changes in law made by this Act apply only to a contract that is entered into on or after the effective date of this Act.
> SECTION 4. This Act takes effect September 1, 2023.[7]

The failure of HB 2928 to pass means that Texas – unlike a few other states noted above – has yet to expressly void contractual project offset provisions via statute. But issues remain. We will see that cross-project offset provisions can be a powerful weapon for those attempting to rely on them. But sometimes that weapon can backfire.

Below we will discuss various legal issues that come into play with contractual offset provisions and the right to offset generally. We will conclude with suggested contract language and other practice tips that can help address these issues in some – but certainly not all – situations. First we begin the general right (if any) to offset across projects and the potential need for express contract language related thereto. Throughout the paper, for brevity's sake, we will refer to the prime contractor that is the same company on both Project A and B as "Contractor," same for

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establish that he had knowingly used trust funds in manner that was certain to deprive sub-subcontractor of those funds and supported award of treble damages against him, such as could be excepted from discharge on "fiduciary defalcation" theory.) (citing 11 U.S.C.A. § 523(a)(4); COLO. REV. STAT. ANN. §§ 18-4-401, 38-26-109(3)).

5 HOUSE RESEARCH ORGANIZATION, BILL DIGEST, Tex. H.B. 2928, 88th Leg., R.S. (2023).

6 *Id.*

7 Tex. H.B. 2928, 88th Leg., R.S. (2023).

"Owner" as well as a subcontractor ("Subcontractor") who works for Contractor on both Project A and B.

II. Express Contract Right to Offset

For starters, what if there no cross-project offset clause in the contract between Owner and Contractor (or Contractor and Subcontractor, on down the line)? In this instance, does Owner still have an offset right on Project B if Contractor is clearly in default on Project A? There is a good chance Owner does not, though we have not found a Texas case on point. There was arguably what could loosely be described as a "common law" right to offset in other states and on federal projects many decades ago, captured in a 1947 United States Supreme Court case involving a payment bond surety dispute.[8]

But this vague "common law" right must now be viewed in the context of, and probably trumped by, more specific state court jurisprudence regarding contract rights. As Bruner and O'Connor note, despite the 1947 Supreme Court opinion, offset " has not been universally adopted by the states."[9] Texas courts follow the general rule that "[t]he owner's obligation to make progress payments and the contractor's right to stop the work if such payments are not made ***depend on the provisions of the contract documents***."[10] If Owner does not have an express project offset provision, Contractor has a colorable argument Owner cannot withhold payments on Project B for deficiencies on Project A. Subcontractor might also make the same argument against Contractor trying to offset on Project B. Another potential issue for Owner: if there's a performance bond on Project B, Contractor's surety – asserting all defenses available to its principal (Contractor) – might also make this same argument, arguing there is a prior material breach by the bond obligee (Owner) and thus the surety is relieved of its performance bond obligations for Project B.[11]

It is also worth noting that many "standard" or "industry" contracts arguably lack an express contractual right to offset on other projects. As just one example, the American Institute of Architects ("AIA") standard general conditions arguably only expressly allow withholding of payment from Contractor in situations such as where Contractor has furnished defective work related to the project at hand (Project B in our scenario), lien claims are filed, or there is reasonable

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8 U.S. v. Munsey Trust Co. of Washington, D.C. 332 U.S. 234, 239 (1947) (noting "[t]he government has the same right 'which belongs to every creditor, to apply the unappropriated moneys of his debtor, in his hands, in extinguishment of the debts due to him.'); *see also* BLACK'S LAW DICTIONARY 1310 (Deluxe 11th Ed. 2019).

9 3 Bruner & O'Connor Construction Law § 8:66, *Setoff rights under prompt payment law* (August 2023).

10 Tex. Bank & Trust Co. v. Campbell Bros., Inc., 569 S.W.2d 35 (Tex. App.—Dallas 1978, writ dism'd) (emphasis added); *see also* Pelco Constr. Co. v. Chambers County, 495 S.W.3d 514, 523 (Tex. App.—Houston 2016, pet. denied) (holding county did not cite express "authority" in the contract to allow it to withhold retainage from payments to contractor).

11 Gulf Liquids New River Project, LLC v. Gulsby Engineering, Inc., 356 S.W.3d 54 (Tex. App.—Houston [1st Dist.] 2011, no pet.) (noting, among other surety defenses, that "an 'owner default' by nonpayment is a defense to the surety's liability.").

evidence Contractor cannot complete Project B. The most recent AIA general conditions – the AIA A201 2017 – provide:

> **§ 9.4.2** The issuance of a Certificate for Payment will constitute a representation by the Architect to the Owner, based on the Architect's evaluation of the Work and the data in the Application for Payment, that, to the best of the Architect's knowledge, information, and belief, ***the Work[12] has progressed to the point indicated, the quality of the Work is in accordance with the Contract Documents, and that the Contractor is entitled to payment in the amount certified***. The foregoing representations are subject to an evaluation of the Work for conformance with the Contract Documents upon Substantial Completion, to results of subsequent tests and inspections, to correction of minor deviations from the Contract Documents prior to completion, and to specific qualifications expressed by the Architect. However, the issuance of a Certificate for Payment will not be a representation that the Architect has (1) made exhaustive or continuous on-site inspections to check the quality or quantity of the Work; (2) reviewed construction means, methods, techniques, sequences, or procedures; (3) reviewed copies of requisitions received from Subcontractors and suppliers and other data requested by the Owner to substantiate the Contractor's right to payment; or (4) made examination to ascertain how or for what purpose the Contractor has used money previously paid on account of the Contract Sum.
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> **§ 9.5 Decisions to Withhold Certification**
> **§ 9.5.1** ***The Architect may withhold a Certificate for Payment in whole or in part, to the extent reasonably necessary to protect the Owner, if in the Architect's opinion the representations to the Owner required by Section 9.4.2 cannot be made***. If the Architect is unable to certify payment in the amount of the Application, the Architect will notify the Contractor and Owner as provided in Section 9.4.1. If the Contractor and Architect cannot agree on a revised amount, the Architect will promptly issue a Certificate for Payment for the amount for which the Architect is able to make such representations to the Owner. ***The Architect may also withhold a Certificate for Payment*** or, because of subsequently discovered evidence, may nullify the whole or a part of a Certificate for Payment previously issued, ***to such extent as may be necessary***

[12] AIA A201 2017 Section 1.1.3 defines "Work" as follows: "The term 'Work' means the construction and services required by the Contract Documents, whether completed or partially completed, and includes all other labor, materials, equipment, and services provided or to be provided by the Contractor to fulfill the Contractor's obligations. The Work may constitute the whole or a part of the Project." Section 1.1.1 defines the "Contract Documents" as follows: "The Contract Documents are enumerated in the Agreement between the Owner and Contractor (hereinafter the Agreement) and consist of the Agreement, Conditions of the Contract (General, Supplementary and other Conditions), Drawings, Specifications, Addenda issued prior to execution of the Contract, other documents listed in the Agreement, and Modifications issued after execution of the Contract. A Modification is (1) a written amendment to the Contract signed by both parties, (2) a Change Order, (3) a Construction Change Directive, or (4) a written order for a minor change in the Work issued by the Architect. Unless specifically enumerated in the Agreement, the Contract Documents do not include the advertisement or invitation to bid, Instructions to Bidders, sample forms, other information furnished by the Owner in anticipation of receiving bids or proposals, the Contractor's bid or proposal, or portions of Addenda relating to bidding or proposal requirements."

in the Architect's opinion to protect the Owner from loss for which the Contractor is responsible, including loss resulting from acts and omissions described in Section 3.3.2,[13] because of

.1 ***defective Work*** not remedied;

.2 ***third party claims filed or reasonable evidence indicating probable filing*** of such claims, unless security acceptable to the Owner is provided by the Contractor;

.3 ***failure of the Contractor to make payments properly to Subcontractors*** or suppliers for labor, materials or equipment;

.4 ***reasonable evidence that the Work cannot be completed*** for the unpaid balance of the Contract Sum;

.5 ***damage to the Owner or a Separate Contractor[14]***;

.6 ***reasonable evidence that the Work will not be completed within the Contract Time, and that the unpaid balance would not be adequate*** to cover actual or liquidated damages for the anticipated delay; or

.7 ***repeated failure to carry out the Work*** in accordance with the Contract Documents.

The EJCDC (Engineers Joint Contract Documents Committee) form has similar, somewhat broader, provisions for owner "set-offs" that nevertheless arguably do not expressly provide for offsets stemming from deficiencies on other projects.[15] Perhaps Owner under the AIA A201 Section 9.5 above could argue Contractor's failure to properly perform on Project A is "reasonable evidence that the Work cannot be completed" as to Project B, among other possible arguments. At a minimum, ambiguity exists as to whether Owner (or any other party) can withhold on Project B due to defaults on Project A under these standard "industry" forms. The safer bet is to have an express project offset provision in the contracts at issue.

Such an express cross-project offset provision can be a powerful tool for Owner (or whichever party downstream is trying to enforce its offset provision) to potentially significantly limit its damages and avoid the legal issues noted above. Nevertheless, the party trying to withhold payment on Project B pursuant to cross-project offset provision must still proceed with caution. In Texas – and likely other states with similar statutes – a host of other issues may arise under (1) the Texas Trust Fund Act; (2) lien and bond statutes; and (3) Texas Prompt Payment Acts. We will address these in the order just provided, starting with the Texas Trust Fund Act.

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13 A201 Section 3.3.2 provides: "§ 3.3.2 The Contractor shall be responsible to the Owner for acts and omissions of the Contractor's employees, Subcontractors and their agents and employees, and other persons or entities performing portions of the Work for, or on behalf of, the Contractor or any of its Subcontractors."

14 To be clear, a Separate Contractor is not a contractor on another project but, rather, contractor engaged by the owner for the same project covered by the prime contractor's contract. AIA A201-2017 Section 6.1.1 provides: "The term 'Separate Contractor(s)' shall mean other contractors retained by the Owner under separate agreements. The Owner reserves the right to perform construction or operations ***related to the Project*** with the Owner's own forces, and with Separate Contractors retained under Conditions of the Contract substantially similar to those of this Contract, including those provisions of the Conditions of the Contract related to insurance and waiver of subrogation." (emphasis added).

15 *E.g.*, EJCDC C-700 2013 § 15.01E.

III. Texas Trust Fund Act Issues

The core components of the Texas Trust Fund Act ("TFA"; Property Code Chapter 162) applicable to this discussion are as follows. The TFA states "Construction payments are trust funds under this chapter if the payments are made to a contractor or subcontractor or to an officer, director, or agent of a contractor or subcontractor, under a construction contract for the improvement of specific real property in this state."[16] If a loan is in place for the project (it often is), loan receipts may also constitute trust funds in the hands of the project owner: "Loan receipts are trust funds under this chapter if the funds are borrowed by a contractor, subcontractor, or owner or by an officer, director, or agent of a contractor, subcontractor, or owner for the purpose of improving specific real property in this state, and the loan is secured in whole or in part by a lien on the property."[17] A contractor, subcontractor – or owner or an officer, director, or agent of a contractor, subcontractor – or an owner, who receives trust funds or who has control or direction of trust funds, are expressly defined as a "trustee" of the trust funds.[18] Any artisan, laborer, mechanic, contractor, subcontractor, or materialman "who labors or who furnishes labor or material for the construction or repair of an improvement on specific real property" in Texas is expressly defined as a "beneficiary" of "any trust funds paid or received in connection with the improvement."

With these definitions in mind, a core component of the TFA provides:

> Sec. 162.031. MISAPPLICATION OF TRUST FUNDS. (a) 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.
>
> (b) It is an affirmative defense to prosecution or other action brought under Subsection (a) that the trust funds not paid to the beneficiaries of the trust were used by the trustee ***to pay the trustee's actual expenses directly related to the construction or repair of the improvement*** or have been retained by the trustee, after notice to the beneficiary who has made a request for payment, as a result of the trustee's reasonable belief that the beneficiary is not entitled to such funds or have been retained as authorized or required by Chapter 53.[19]

Back to the emphasized text above shortly. "Current or past due obligations" are defined by the TFA 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

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16 TEX. PROP. CODE § 162.001(a) (2024).

17 *Id*. § 162.001(b).

18 *Id*. § 162.002.

19 *Id*. § 162.031 (emphasis added).

funds.[20] "Direct cost" is defined as "a cost included under a construction contract that is specific to the construction of the improvement that is the subject of the contract."[21] Conversely, "indirect cost" means a cost included under a construction contract that is not specific to the construction of the improvement that is the subject of the contract.[22]

With the above in mind, let's say Contractor has the same plumbing subcontractor ("Subcontractor") on Project A and Project B. Subcontractor has unquestionably performed defective work on Project A, necessitating Contractor pay an extra $100,000 to correct such work on Project A. Contractor wants to offset the $100,000 amount from Subcontractor's payment owed on Project B, even though Subcontractor's work is unquestionably defect-free on Project B. Can Contractor do this? Contractor will argue that it simply has not diverted any trust funds because, per Section 162.031(a), Contractor has not diverted "trust funds without first fully paying all current or past due obligations (obligations "incurred or owed by the trustee for labor or materials furnished, as noted above) incurred by the trustee to the beneficiaries of the trust funds." This will be a tougher argument for Contractor if it does not have a cross-project offset provision in its contracts with Subcontractor. If Contractor does have such a contract provision, its argument becomes stronger because Contractor can argue – per the express terms of the contractual offset provision – it has no obligations incurred or owed to the Subcontractor as to the $100,000.

But Subcontractor, and certainly its sub-subcontractors[23] (if any), will counter that Section 162.031(a) states Contractor must first fully pay "all current or past due obligations incurred by the trustee ***to the beneficiaries of the trust funds***," that is, regardless of what the contract says, the protection of the beneficiaries (Subcontractor and any sub-subs) comes first. Subcontractor and any sub-subcontractors should also argue that – if there is at least a question as to the TFA's construction on this point – Texas courts have indicated the TFA should be construed broadly in favor of laborers and materialmen.[24]

But let's say Subcontractor and the sub-subcontractors on Project B win against Contractor on the issue of whether Contractor even diverted any trust funds to begin with under Section 162.031(a). What if Contractor argues the affirmative defense under Section 162.031(b), namely, "the trust funds not paid to the beneficiaries of the trust were used by the trustee to pay the trustee's actual expenses directly related to the construction or repair of the improvement." Subcontractor and the sub-subcontractors will argue of course this defense does not apply because withholding

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20 *Id*. § 162.005(2).

21 *Id*. § 162.005(3).

22 *Id*. § 162.005(4).

23 Note the sub-subcontractors might have standing to sue Contractor under the TFA, despite a lack of privity between the two. *E.g.*, Dealers Elec. Supp. Co. v. Scoggins Constr. Co., Inc., 292 S.W.3d 650, 659 (Tex. 2009) ("Thus, as long as a prime contractor pays its sub-contractor for the labor or materials supplied, and does not otherwise misapply trust funds, the prime contractor is—to the extent funds were paid to the subcontractor—protected under the Trust Fund Act from a later claim by the subcontractor's la-borers or materialmen for unpaid labor or sup-plies.").

24 RepublicBank Dallas, N.A. v. Interkal, Inc. 691 S.W.2d 605, 607 (Tex. 1985); Panhandle Bank & Trust Co. v. Graybar Electric Co., 492 S.W.2d 76, 81-82 (Tex. Civ. App.—Fort Worth 1974, writ ref'd n.r.e.).

$100,000 from Project B, to pay for issues on Project A, is not payment of Contractor's actual expenses "directly related to the construction or repair" of Project B.

But confusion, and perhaps some ammo for Contractor, has been added to the analysis of the Section 162.031(b) affirmative defense by a slew of federal opinions – and a seminal 1988 Texas Attorney General Opinion – stating that Contractor can spend trust funds on "general business overhead" before paying beneficiaries on Project B.[25] Legal commentators have disagreed with these holdings.[26] In an excellent, recent article in the State Bar Construction Law Journal, the authors deftly noted that including overhead within 162.031(b)'s "actual expenses" was "difficult to square with the legislative change from the phrase 'reasonable overhead expenses' to 'actual expenses directly related to the construction or repair of the improvement[.]'" in the 1987 changes to the TFA and "it is impossible to square with the Bill Analysis behind H.B. 1160 [1987 changes to the TFA], which stated that the bill's purpose was to 'delete the exception [affirmative defense] for reasonable overhead.'"[27] While one may disagree with the above federal caselaw, nevertheless it is out there for Contractor (or others trying to avoid the TFA argument in enforcing a cross-project offset); one case goes as far to surprisingly say "[n]or must these [trust] funds be spent only on the project for which they were received—they may be spent ***on other projects <u>or</u> on expenses related to general business overhead***."[28]

We have found no Texas case law on this TFA / cross-project offset issue. But at least one other state court – the Federal Western District of New York, in *United Maintenance v. Amherst Painting, Inc.*[29] – noted that offsetting payments due to failures on other projects violated New York's Trust Fund Act. The court noted: "[t]he policy reasons for allowing the contractor to set off sums due from the subcontractor apply only to claims for sums due ***with respect to the project in question, not unrelated projects***"[30] and that "the relief available in a Lien Law trust action encompasses the contractor's right as trustee to offset against the trust fund amount sums due from

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25 Op. Tex. Att'y Gen. No. JM-945 (1988)) ("The law interpreting section 162.031(b) does not require such an explicit level of proof tying particular expenditures to the improvements at issue. Construction trust funds may be used for overhead and other 'directly related' expenses."); Taylor Pipeline Constr., Inc. v. Directional Rd. Boring, Inc., 438 F. Supp. 2d 696, 715 (E.D. Tex. 2006); Swor v. Bartley Tex. Builders Hardware Inc., (In re Swor), 347 Fed. App'x 113, 117 (5th Cir. 2009) (trust funds may be spent on "general business overhead") (citing Boyle, 819 F.2d at 592); Ratliff Ready-Mix, L.P. v. Pledger (In re Pledger), Bankr. No. 11-61151-CAG, Adv. No. 12-6005-CAG, 2013 WL 796626, at *6 (Bankr. W.D. Tex. March 4, 2013), aff'd, 2015 WL 294829 (5th Cir. 2015) (citing Nicholas, 956 F.2d at 110; Swor, 347 Fed. App'x at 117)

26 Wayne R. Barnes, *Correcting a False Step: Rethinking Overhead for the "Actual Expenses" Affirmative Defense to the Texas Construction Trust Fund Act*, 67 Baylor L. Rev. 1, 46 (Winter 2015) ("The way forward would be for the appropriate courts to disagree with, or overrule as appropriate, the case law allowing overhead.").

27 Ben Aderholt, Bethany Beck, Victoria McDaniel-Sonnier, and Louyse Siegel, *State of Texas Construction Trust Fund Act,* State Bar of Texas Constr. L. J. 22, 26-27 and n. 72 (Winter 2022). For further reading on the TFA, I highly recommend this article.

28 *In re* Swor, 347 Fed. Appx. 113, 116 (5th Cir. 2009) (emphasis added).

29 No. 94-CV-874H, 1997 WL 160157 (W.D. N.Y. Feb. 20, 1997).

30 *Id.* at *7 (emphasis added).

the subcontractor to the contractor ***with respect to the project***."[31] This same policy argument for the New York TFA could arguably apply to the Texas TFA.

Further, even if Contractor (or other party trying to enforce its cross-project offset provision) wins on the TFA argument, Contractor may nevertheless have to deal with a slew of lien and bond issues, as discussed in the next section below.

IV. Lien and Bond Claims (and Contingent Payment Clauses)

A. Lien Claims

It does not take much imagination to see the amount of chaos that could be created by withholding payment on Project B pursuant a cross-project offset clause and defaults on Project A. For example, where the Owner withholds on Project B, Contractor is not paid in full on one of its progress payments for Project B and does not pay its subcontractors. The subcontractors demand payment; Contractor might argue it has no obligation to pay the subcontractors based on a contingent payment clause in its subcontracts. This leaves the subcontractors with no option but to file liens and lawsuits against Project B, and Owner demands Contractor comply with its statutory and contractual indemnity obligations, as will be discussed below. It is worth noting that any subcontractor of any tier on Project B might be able to file a lien against the project, so long as it meets its burden of proof discussed below.[32] The decision to withhold on Project B could significantly impact each of these parties, as discussed below.

A.i. The Derivative Claimant

From the derivative claimant's perspective (the subcontractor or sub-subcontractor of any tier making the lien claim), the options available when an offset provision comes into play are fairly straightforward. The lien rights of a derivative claimant, such as a subcontractor are dependent upon its compliance with the perfection procedures of Texas Property Code Chapter 53[33] and demonstrating the value of the claimant's work as furnished to the applicable project, as noted below. The offset provisions in the written contract between Owner and Contractor generally should not impact the derivative claimant's lien rights; most lien claimant's generally do not need to have their own written contract in place to have a right to a lien, so why should the

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31 *Id*. (emphasis added).

32 Bassett v. Mills, 34 S.W. 93, 94 (Tex. 1896). It appears legislation passed in 2021 attempted to more clearly capture, in revisions to Chapter 53, this previously established case law and statutory concept, regarding the application of the lien statute to subcontractors of all tiers, in the revised Chapter 53 definition of "subcontractor." Tex. H.B. 2237, 87th Leg., R.S., §2 (2021) ("(13) 'Subcontractor' means a person who labors or has furnished labor or materials to fulfill an obligation to an original contractor or to a subcontractor of any tier to perform all or part of the work required by an original contract.") (underlines in original bill).

33 Moore v. Brenham Ready Mix, Inc., 463 S.W.3d 109, 115 (Tex. App.—Houston [1st Dist.] 2015, no pet.) ("A subcontractor, or, as in this case, a supplier to a subcontractor, is a derivative claimant and, unlike a general contractor, has no constitutional, common law, or contractual lien on the owner's property. As a result, a subcontractor's lien rights 'are totally dependent on compliance with the statutes authorizing the lien.'") (citing First Nat'l Bank in Graham v. Sledge, 653 S.W.2d 283, 285 (Tex. 1983)).

written contract between Owner and Contractor impact the derivative claimant's lien rights?[34] A significant component of the lien claimant's burden of proof focusses on the "value" of the labor and / or material the claimant furnished to the project,[35] regardless of whether it had a written contract or what the offset provisions are – if any – in the prime contract. But what if Contractor (or Owner) is arguing its offset provision somehow waived the lien rights of downstream claimants (whether Contractor's direct Subcontractor or lower tier non-privity sub-subcontractors)? That argument should generally fail too, since agreements purporting to waiving the right to file a lien are generally void as against public policy, as made clearer by changes to Chapter 53 enacted in 2011.[36]

A.ii. The General Contractor

Contractor facing a contractual offset from Owner and nonpayment claims from its subcontractors finds itself in an unenviable position. Contractor generally would owe a statutory duty to indemnify Owner from mechanic's lien lawsuits[37] in addition to any contractual indemnity obligations Contractor often has in the prime contract. If any derivative claimant's lien foreclosure suit results in a judgment, Owner has the statutory right to deduct the amount of the judgment from the amount due to Contractor.[38] Owner also has the statutory ability to recoup settlement funds

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34 Trammell v. Mount, 4 S.W.377, 377-78 (Tex. 1887) (lien allowed on "verbal contract"). *See also* Elizabeth M. Deballion and David L. Tolin, *Lien Rights of Quantum Meruit Claimants*, State Bar of Texas Construction Law Journal 36, 37 (2016).

35 *E.g.*, Texas Wood Mill Cabinets, Inc. v. Butter, 117 S.W.3d 98, 105 (Tex. App.—Tyler 2003, no pet.) ("The Texas Constitution grants to mechanics, artisans, and materialmen of every class a lien on the buildings and articles made or repaired by them ***for the value of their labor done thereon***, ***or material furnished therefor***, and requires that the Legislature provide by law for the speedy and efficient enforcement of such liens.") (emphasis added) (citing TEX. CONST. art. XVI, § 37); CVN Group, Inc. v. Delgado, 95 S.W.3d 234, 246 (Tex. 2002) ("Mechanic's liens … protect people or entities who have furnished materials or services for the construction of buildings or other improvements to real property. Strang v. Pray, 89 Tex. 525, 35 S.W. 1054, 1055 (1896). And they are based on the equitable principle that when a person ***increases the value*** of another's land by providing improvements, the improvements should be paid for, and the person making the improvements should, to the extent of the contract price or value of services or materials provided, have a lien on the land to secure payment") (emphasis added); Big Three Welding Equipment Co., Inc. v. Crutcher, Rolfs, Cummings, Inc., et.al., 229 S.W.2d 600, 603 (Tex. 1950) ("The giving of liens to those who furnish materials and labor for works of improvement or construction, with the according of priorities to those liens, is 'based upon the very just consideration that a person who by his labor or material expended on improvements made on the land of another, under contract, express or implied, that this shall be paid for, ***thereby increases its value***, and ought to the extent of the contract price or value of the thing furnished, to have a lien on the land, of which the improvement becomes a part, to secure payment.'") (citing Lippencott v. York, 24 S.W. 275 (Tex. 1893)); Schear Hampton Drywall, LLC v. Founders Commercial, Ltd, 586 S.W.3d 80, 88-89 (Tex. App.—Houston [14th Dist.] 2019, no pet.) (noting lien claimant had the burden to "support its claimed lien amount" by establishing when its work was furnished "***and the reasonable value of its work***.") (emphasis added).

36 TEX. PROP. CODE § 53.286.

37 TEX. PROP. CODE § 53.153 ("If an affidavit claiming a mechanic's lien is filed by a person other than the original contractor, the original contractor shall defend at his own expense a suit brought on the claim.").

38 *Id.* ("If the suit results in judgment on the lien against the owner or the owner's property, the owner is entitled to deduct the amount of the judgment and costs from any amount due the original contractor."); *see also* Weaver v. Jock, 717 S.W.2d 654, 659 (Tex. App.—Waco 1986, writ ref'd n.r.e.) ("Section 53.153(b) of the

paid to Contractor, as Owner may recover any amount paid for which Contractor was liable if the Owner and Contractor settled their claims in full.[39] And Contractor provided a payment bond under Texas Property Code Chapter 53, Subchapter I, Contractor of course may also be ultimately responsible for payments by the surety, under Contractor's general agreement of indemnity with the surety.

A.iii. The Owner

Owner of course should be concerned about liens being asserted against its property and Owner personally. Owner should take steps to protect itself from any lien claims asserted after offsetting funds owed from one project against another. As stated above, Owner may look to Contractor for defense and indemnity owed either under contract or by statute.[40] But of course Contractor's defense and indemnity of Owner is only as good as Contractor; that is, at this stage, there is some chance Contractor is about to go under and will not be able to fulfill its indemnity and defense obligations in whole or in part. Owner should therefor also be prepared to use the offset funds not only to deal with Project A but to directly pay and resolve lien claims on Project B, pursuant to the Texas lien statute.[41] As discussed more in the Practice Tips in Section VI below, Owner may in fact realize that all of the money it thought it was withholding to deal with Project A instead must be used to address lien claims on Project B.

A.iv Contingent Payment Clauses and Lien Claims

What if Contractor has a contingent payment (a.k.a. pay-if-paid) clause in its subcontract with Subcontractor (or Owner has such a clause in the primer contract, with regard to loan proceeds Owner receives for the project)? Texas Business and Commerce Code Chapter 56 generally governs the enforceability of contingent payment clauses for all parties to a construction project,[42] with some exceptions for design services, certain civil and road construction, and certain residential construction.[43] Importantly, Chapter 56 cannot be waived by contract.[44] As to the lien rights of Subcontractor – and subcontractors of every tier – the chapter makes clear a contingent payment clause cannot be used as a basis for invalidation of the enforceability or perfection of a Chapter 53 lien.[45] Additionally, as to lower tier claims against public project payment bonds, case

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Property Code allowed the Weavers to deduct the $66,322.86 judgment obtained by Jock from whatever amount they still owed Nations as the general contractor or, if they had already paid him in full, to recover from Nations any amount of the judgment for which he had been originally liable to Jock.").

39 *Id.*

40 TEX. PROP. CODE § 53.153.

41 TEX. PROP. CODE §§ 53.056, 53.081.

42 TEX. BUS. & COM. CODE § 56.001.

43 TEX. BUS. & COM. CODE § 56.001.

44 TEX. BUS. & COM. CODE § 56.004 ("A person may not waive this chapter by contract or other means. A purported waiver of this chapter is void.").

45 TEX. BUS. & COM. CODE § 56.055 ("USE OF CLAUSE TO INVALIDATE ENFORCEABILITY OR PERFECTION OF MECHANIC'S LIEN PROHIBITED. A contingent payment clause may not be used as

law generally indicates Contractor's surety might not be able to rely on a contingent payment clause as a defense to claims against the payment bond (on which payment bond Contractor of course is principal).[46] More on bond claims below.

Outside of lien / bond issues, Chapter 56 also prohibits Contractor from relying upon a contingent payment clause to the extent Contractor's failure to receive payment from Owner is due Contractor's failure to comply with its contractual obligations (i.e., in this instance, Contractor's failure to perform on Project A);[47] This part of the statute can be viewed generally as just a codification of the common law "prevention doctrine."[48] Either way, even without the foregoing prevention doctrine or other arguments, a non-defaulting subcontractor could often just object and ultimately invalidate the contingent payment clause under Chapter 56.[49] Thus, a contingent payment clause will generally not help Contractor – or other parties attempting to enforce such clauses – with the headaches that can nevertheless arise when trying to enforce a contractual cross-project offset clause.

B. Bond Claims (including Federal Projects)

B.i. Texas Public Projects (McGregor Act)

As to Contractor trying to offset payment against Subcontractor on Project B for alleged default by Subcontractor on Project A, many of the same problems discussed regarding liens will apply for the Contractor. Texas projects owned by Texas governmental, or certain quasi-governmental, entities are governed by Texas Government Code Chapter 2253, also known as the McGregor Act or "Little Miller Act," in reference to the similar federal act discussed below. The McGregor Act "was enacted to protect public-work laborers and materialmen, since a lien cannot generally be asserted against a public improvement."[50] For prime contracts exceeding $25,000, the Act requires the prime contractor to "execute to the governmental entity ... a payment bond" before beginning work.[51] The payment bond must be in the amount of the prime contract for the applicable

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a basis for invalidation of the enforceability or perfection of a mechanic's lien under Chapter 53, Property Code.").

46 *E.g.*, United States ex rel. Walton Tech., Inc. v. Weststar Eng'g, Inc., 290 F.3d 1199, 1208 (9th Cir. 2002) (holding generally sureties may not assert a subcontract's unsatisfied "pay when and if paid" clause as a defense to liability on a Federal Miller Act payment bond because a "subcontractor's right of recovery on a Miller Act payment bond accrues ninety days after the subcontractor has completed its work, not 'when and if' the prime contractor is paid by the government").

47 TEX. BUS. & COM. CODE §§ 56.051, 56.052.

48 Debra R. Davis Ellis & Joseph Paul Horlen, *Contingent Payment Clauses in Construction Contracting*, State Bar of Texas Construction Law Conference, 13-14 (2005) ("The prevention doctrine is a well-defined and historically used defense to enforcement of a condition precedent when the failure of such is the fault of the party attempting to invoke its use) (citations omitted).

49 *Id.* For an outstanding, more detailed discussion regarding the contingent payment statute – as well as White Claw alcoholic hard seltzer beverages – see Will W. Allensworth, *The Contingent Payment Statute: "Rather Complex,"* State Bar of Tex. Constr. Law J., 7 – 22 (Fall 2019) (White Claw discussion at footnote 113).

50 Dealers Elec. Supp. Co. v. Scoggins Constr. Co., Inc., 292 S.W.3d 650 (Tex. 2009).

51 TEX. GOV'T CODE § 2253.021(a)(2).

project. The Act makes clear the payment bond is "***solely for the protection and use of payment bond beneficiaries*** who have a direct contractual relationship with the prime contractor or a subcontractor to supply public work labor or material."[52] Any provision in a Chapter 2253 payment bond that attempts to restrict a right under the Act is automatically "disregarded."[53] "Public work labor" means "labor used directly to carry out a public work."[54] "Public work material" means, among other things, "material used, or ordered and delivered for use, directly to carry out a public work."[55]

The Act provides stringent notice requirements for payment bond claimants but – as the Texas Supreme Court has noted – ***"[i]f the Act's stringent notice requirements are followed***, a payment-bond beneficiary who has not been paid 'may sue the principal or surety, jointly or severally, on the payment bond.'"[56] The Act makes clear that a payment bond claim can still exist for a claimant who does not have a written contract, so long as certain additional procedures are followed.[57] The Texas Supreme Court has made clear the McGregor Act is "intended to be a simple and direct method for claimants who supply labor and materials for public-work projects to give notice and perfect their claims under the Act."[58] Texas courts have long held the Act is "remedial in nature, and should be liberally construed to achieve its purposes."[59] The Texas Supreme Court has held the Act is the exclusive remedy claimants have against the statutory payment bond, but the Act does not preclude such claimants from also asserting a Trust Fund Act cause of action or suing under a joint check agreement.[60]

Given the above, if Contractor offsets payment against Subcontractor on Project B for deficient work by the same Subcontract on Project A, the Subcontractor may still have a valid claim against the payment bond on Project B. Such Subcontractor could argue the Project B payment bond is meant to "solely" benefit claimants like Subcontractor and that each payment bond only relates to the public work at issue. The argument gets easier in this scenario for claimants below Subcontractor, or claimants who did not work on Project A; again their claims tie back only

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52 TEX. GOV'T CODE § 2253.021(c) (emphasis added).

53 TEX. GOV'T CODE § 2253.023(b).

54 TEX. GOV'T CODE § 2253.001(5).

55 TEX. GOV'T CODE § 2253.001(6)(a).

56 *Dealers*, 292 S.W.3d at 653 (emphasis added) (citing TEX. GOV'T CODE § 2253.073(a)).

57 TEX. GOV'T CODE § 2253.043; *see also* Elizabeth M. Deballion and David L. Tolin, *Lien Rights of Quantum Meruit Claimants*, State Bar of Tex. Constr. Law J., 36 n. 6 (2016) ("Availability of quantum meruit as a theory of recovery is also supported by the language of the state bond statutes, which are beyond the scope of this article. For example, Texas Government Code section 2253.043 expressly provides for bond claims where no written agreement exists between the parties. TEX. GOV'T CODE ANN. § 2253.043 (West 2016). Payment bond beneficiaries seeking payment on a public project should therefore consider the *quantum meruit* principles described herein, as they are applicable to all instances requiring proof of implied contract.").

58 *Dealers*, 292 S.W.3d at 653 (citations omitted).

59 *Dealers*, 292 S.W.3d at 653 (citations omitted).

60 *Dealers*, 292 S.W.3d at 651.

to the payment bond for Project B, which is "solely" for their benefit. The problem of course for the Contractor is that – when / if all of these claimants make a claim against the Project B payment bond – the Project B payment bond surety will then likely assert claims against Contractor under the general agreement of indemnity likely in place between Contractor and the payment bond surety.

Further support for the bond claimant's position might be found in case law dealing with the Federal Miller Act, which can loosely be described as the federal parallel to the Texas McGregor Act. One federal Virginia court, detailed further below, held that – regardless of a provision allowing for offset in the subcontract – offset was not permitted on a federal bonded project for non-bonded project debts of the subcontractor. The court reasoned that allowing such offset "would result in a situation directly contrary to the Miller Act's purpose of providing an expeditious remedy to subcontractors on federal construction projects."[61] Given the parallels of the statutory language and intent of the McGregor and Miller Act – including the federal court's emphasis on the "expeditious remedy" provided by the Miller Act and the Texas Supreme Court's similar emphasis on the intended "simple and direct" remedy under the McGregor Act[62] - one could see these federal cases potentially being persuasive in McGregor act cases. The above provides yet another reason for Contractor cautiously enforcing its contractual project offset provision.

B.ii. Federal Projects (Miller Act)

What about federal projects which, like Texas Government Code Chapter 2253 projects, require the prime contractor to put up a payment bond as principal for the benefit of subcontractors and first tier sub-subcontractors?[63] For starters, the federal government has a right to offset payments against an applicable prime contractor on multiple projects, after certain procedures are followed.[64]

But things can get a little tricky after that as for prime contractors trying to rely on a contractual project offset provision to avoid liability from Federal Miller Act payment bond claimants. For example, the Federal Eastern District Court of Virginia – in *U. S. ex. Rel. Acoustical Concepts, Inc. v. Travelers Cas. & Surety Com. Of America* – held that, regardless of a provision in the subcontract allowing for offsets from other projects, such offset was not permitted on federal bonded projects for debts of the subcontractor on a non-federal project.[65] The court held that the prime contractor's payment bond surety on two federal projects could not assert the offset defense based on debts incurred by the same subcontractor on a non-federal project. The court noted,

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61 United States ex rel. Acoustical Concepts, Inc. v. Travelers Cas. & Surety Co. of Am., 635 F. Supp. 2d 434 (E.D. Va. 2009).

62 *Dealers*, 292 S.W.3d at 653 (citations omitted).

63 40 U.S.C.A. §§ 3131-3134 (2024).

64 *E.g.*, 48 C.F.R. § 32.604(b)(6) (noting the federal government's right, following certain procedures, to ultimately "offset the [contractor's] debt against any payments otherwise due the contractor," including other projects).

65 635 F. Supp. 2d 434 ,441 (E.D. Va. 2009).

among other things: "***neither the Miller Act nor the payment bonds make any reference to setoff provisions*** or their effect. This is significant because the ***setoff provisions have the potential to delay and complicate significantly any recovery*** by plaintiff subcontractor on the Miller Act payment bonds. Precisely this is what the Miller Act is aimed to prevent."[66] The court also noted "[w]hether a subcontractor has been paid in full for providing labor and materials must be ***determined by reference to the underlying subcontract*** as it relates to the scope of the work and the payment terms."[67] In addition to the policies raised in the *Acoustical Concepts*, the Miller Act appears to expressly forbid any pre-work contractual waiver of one's rights under the Act, instead only allowing for such a waiver if, among other requirements, such waiver is "executed after the person whose right is waived has furnished labor or material for use in the performance of the contract."[68]

V. Texas Prompt Pay Acts – Private and Public Projects

A. Prompt Pay Act for Private Projects (Texas Property Code Chapter 28)

Texas requires prompt payment to contractors for private work done to improve real property, including repairing and renovating the property. Generally speaking, a prime contractor has the right to be paid 35 days after an owner receives a written payment request. A subcontractor has a right to payment 7 days after the contractor or other subcontractor receives payment.[69]

Generally speaking, there is an exception for a good faith dispute concerning the amount owed for a payment, including whether the work was performed in a proper manner. More specifically, the statute provides:

> Sec. 28.003. EXCEPTION FOR GOOD FAITH DISPUTE; WITHHOLDING.
> (a) ***If a good faith dispute exists concerning the amount owed for a payment requested or required by this chapter*** under a contract for construction of or improvements to a detached single-family residence, duplex, triplex, or quadruplex, the owner, contractor, or subcontractor that is disputing its obligation to pay or the amount of payment may withhold from the payment owed not more than 110 percent of the ***difference between the amount the obligee claims is due and the amount the obligor claims is due. A good faith dispute includes a dispute regarding whether the work was performed in a proper manner***.
>
> (b) ***If a good faith dispute exists concerning the amount owed for a payment requested or required by this chapter*** under a contract for construction of or improvements to real property, excluding a detached single-family residence, duplex, triplex, or quadruplex, the owner, contractor, or subcontractor that is

66 *Id*. at 440 (emphasis added).

67 *Id*. at 438 (emphasis added).

68 40 U.S.C.A. §§ 3133 (c) (3).

69 TEX. PROP. CODE § 28.002.

> disputing its obligation to pay or the amount of payment may withhold from the payment owed not more than 100 percent of the ***difference between the amount the obligee claims is due and the amount the obligor claims is due. A good faith dispute includes[70] a dispute regarding whether the work was performed in a proper manner***.[71]

Section 28.007 also makes clear: "Sec. 28.007. LEGAL CONSTRUCTION. (a) This chapter may not be interpreted to void a contractor's or subcontractor's ***entitlement to payment for properly performed work or suitably stored materials***."[72]

Can one make a claim under the Prompt Pay Act despite the existence of a cross-project offset provision? We have not found a Texas case directly on point. One court came close to specifically addressing the issue but did not quite get there. In *Everlast Construction LLC v. McDonald's USA, LLC*,[73] the district court held a property owner – McDonald's – was permitted to withhold final payment from a general contractor on three projects, where there was a good faith dispute as to whether the contractor had done defective work on the first project. The prime contract, among other things, contained the following offset provision, which unfortunately was not analyzed in detail by the court regarding the prompt pay issue: "[McDonald's] may, at its option, withhold or deduct the amount of money due from [Contractor] under this Contract from the monies [McDonald's] may be obligated to pay to [Contractor] under any other Contract or Supplement between [McDonald's] and [Contractor]."[74]

The general contractor for construction of the three McDonald's restaurants sued McDonald's after it withheld the final payment on each of the three projects. The general contractor alleged breach of contract and violation of Sections 28.002 of 28.003 the Prompt Pay Act. McDonald's moved for summary judgment and to supplement the record with additional evidence that it incurred costs, more than what was owed to the contractor on all three projects, in hiring another contractor to redo the contractor's defective work on the first project. The trial court noted the good faith dispute exception under the Prompt Pay Act, which McDonald's relied on to justify its withholding of final payment on all three projects. The court found that the contractor did not contradict McDonald's claims of defective work with adequate evidence. Accordingly, the court granted McDonald's motion for summary judgment. Unfortunately, the court did not get to address in detail whether the offset provision in the contract supported McDonald's position regarding the Prompt Pay Act or whether the Act could trump such a provision; this is because the contractor simply failed to produce any evidence sufficient to support its arguments that its repairs

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70 The use of the word "includes" here of course generally means what follows is not an exclusive list. TEX. GOV'T CODE § 311.005 (13) (Code Construction Act) ("'Includes' and 'including' are terms of enlargement and not of limitation or exclusive enumeration, and use of the terms does not create a presumption that components not expressed are excluded."). But the fact that the only scenario mentioned is defective work regarding the "payment requested" adds to the argument that that is the kind of scenario envisioned by the good faith dispute exception, i.e., not work on other projects.

71 TEX. PROP. CODE § 28.003 (emphasis added).

72 *Id.* § 28.007 (emphasis added).

73 No. 7:19-CV-112, 2020 WL 7658077 (S.D. Tex. 2020).

74 *Id.* at *4.

were properly performed, or that McDonald's failed to exercise its "good faith business judgment" as under the parties' contract, or that McDonald's owed the amounts withheld.[75]

The above *Everlast* opinion *might* give support to parties withholding payments to a downstream party based on a contractual offset provision, under the Prompt Pay Act. But we are aware of no Texas case law specifically addressing this issue under the Act. It is also worth noting that withholding payment under Section 28.003 can sometimes be a gamble, since Section 28.003 does not exempt the withheld amount from accruing interest if the withholding party is ultimately found to be at fault for the breach at issue.[76] And of course an upstream party has to keep in mind the potential significant interest and attorney's fees and costs it might be liable for if it ultimately loses a Prompt Pay Act argument.[77] Perhaps most important, upstream parties could be faced with downstream parties attempting to exercise their right to suspend work under the Prompt Pay Act, in which case such parties are also entitled to demobilization and remobilization costs related thereto.[78]

While we found no Texas case law on point, the 2018 California Supreme Court opinion *United Riggers & Erectors, Inc. v. Coast Iron & Steel Co*[79] can provide further context and potentially persuasive authority. There, the supreme court narrowly interpreted the "good faith dispute" exception for California's private Prompt Pay Act, stating the good faith dispute exception could only apply to the specific payment at issue and not with regard to other projects:

> The dispute exception excuses payment only when a good faith dispute exists over a statutory or contractual precondition to that payment, such as the ***adequacy of the construction work for which the payment is consideration***. ***Controversies concerning unrelated work or additional payments above the amount both sides agree is owed will not excuse delay***; a direct contractor cannot withhold payment where the underlying obligation to pay those specific monies is undisputed.[80]

The *United Riggers* court also noted the legislative history of the California act favored the court's narrow interpretation of the good faith dispute exception:

> [T]he Legislature understood the ***importance of timely payment to contractors' cashflow*** (Sen. Rules Com., Off. of Sen. Floor Analyses, 3d reading analysis of Assem. Bill No. 329, *supra*, as amended Aug. 29, 1991, p. 2)—***a cashflow that would be impaired if any dispute between two contractors on one project could forestall payment on another, unrelated project***. All of which makes it plausible

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75 *Id.* at *10.

76 Patel v. Creation Constr., No. 05-11-00759-CV, 2013 WL 1277874, at *8 (Tex. App.—Dallas Feb. 27, 2013, no pet.).

77 TEX. PROP. CODE §§ 28.004, 28.005(b).

78 *Id.* § 28.009.

79 416 P.3d 792 (Cal. 2018).

80 *Id.* at 793 (emphasis added).

> to infer the Legislature assumed former section 3260 to similarly require timely payment of all funds that were not themselves the subject of dispute, despite the absence of express language so declaring.[81]

This type of in depth analysis of the intent of the Act was unfortunately not presented to the court in the *Everlast* case. But in certain instances, one could see a Texas court potentially being persuaded by the legislative intent argument, and other dicta, from the *United Riggers* opinion.

B. Prompt Pay Act for Public Projects (Texas Government Code Chapter 2251)

Texas public projects are also governed by a Prompt Pay Act, found in Texas Government Code Chapter 2251 and similar in many respects to the Prompt Pay Act for privately owned projects (Property Code Chapter 28). Governmental entities are required to make payments promptly to contractors,[82] generally referred to as "vendors" in Chapter 2251.[83] Texas law requires that a governmental entity make payment before the thirty first day after the later of:

(1) the date the governmental entity receives the goods under the contract;
(2) the date the performance of the service under the contract is completed; or
(3) the date the governmental entity receives an invoice for the goods or service.[84]

A vendor paid by the governmental entity must pay its subcontractor not later than the tenth day after the date the vendor receives payment.[85] A subcontractor paid by the vendor must pay its material suppliers and laborers not later than the tenth day after the date the subcontractor receives payment.[86] Like the private Prompt Pay Act, statutory interest will accrue on overdue payments under Chapter 2251[87] and there is a similar right to attorney's fees[88] and a right to suspend work for overdue payments.[89]

Similar to the private Prompt Pay Act's exception for a good faith dispute, Chapter 2251 has an exception for a "bona fide" dispute. If the governmental entity contends there is a bona fide dispute for payment, notification must be sent to the contractor and must include a list of specific reasons for the failure to pay. If the reasons include failure to comply with the contract, the contractor must be provided with an opportunity to remedy the alleged non-compliance or be

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81 *Id.* at 799 (emphasis added).

82 TEX. GOV'T CODE § 2251.021 (2024).

83 *Id.* § 2251.001(10) ("'Vendor' means a person who supplies goods or a service to a governmental entity or another person directed by the entity. The term does not include a state agency, except for Texas Correctional Industries. The term includes an officer or employee of a state agency when acting in a private capacity to supply goods or a service.").

84 *Id.* § 2251.021(a).

85 *Id.* § 2251.022(a).

86 *Id.* § 2251.023(a).

87 *Id.* § 2251.025.

88 *Id.* § 2251.043.

89 *Id.* §§ 2251.051, 2251.052.

permitted to make a reasonable offer of compensation if remediation is not appropriate.[90] For subcontractors, the provisions are nearly identical.[91] Interestingly, perhaps even more restrictive than the private Prompt Pay Act, the "bona fide dispute" exception for Chapter 2251 arguably emphasizes that such exception can only apply as to the quality of the work furnished on the project at issue (Project B in our scenario), providing:

> Sec. 2251.002. EXCEPTIONS. (a) Except as provided by Subchapter D, Subchapter B does not apply to a payment made by a governmental entity, vendor, or subcontractor if:
>
> (1) there is a ***bona fide dispute*** between the political subdivision and a vendor, contractor, subcontractor, or supplier ***about the goods delivered or the service performed that causes the payment to be late***;
>
> (2) there is a bona fide dispute between a vendor and a subcontractor or between a subcontractor and its supplier ***about the goods delivered or the service performed that causes the payment to be late***;
>
> (3) the terms of a federal contract, grant, regulation, or statute prevent the governmental entity from making a timely payment with federal funds; or
>
> (4) the invoice is not mailed to the person to whom it is addressed in strict accordance with any instruction on the purchase order relating to the payment.[92]

Additionally, as to governmental entities, Chapter 2251 seems to clearly tie a right to withhold for a bona fide dispute solely to a particular invoice / invoices on the project at issue; that is, in our example, only Project B invoices are analyzed, regardless of what happened on Project A. Subchapter C provides in part:

> Sec. 2251.042. DISPUTED PAYMENT. (a) A governmental entity shall notify a vendor of an error or ***disputed amount in an invoice*** submitted for payment by the vendor not later than the 21st day after the date the entity receives the invoice, and ***shall[93] include in such notice a detailed statement of the amount of the invoice which is disputed***.
>
> (b) If a dispute is resolved in favor of the vendor, the vendor is entitled to receive interest on the unpaid balance of the invoice submitted by the vendor beginning on the date under Section 2251.021 that the payment for the invoice is overdue.
>
> (c) If a dispute is resolved in favor of the governmental entity, the vendor shall submit a corrected invoice that must be paid in accordance with Section 2251.021. The unpaid balance accrues interest as provided by this chapter if the corrected invoice is not paid by the appropriate date.

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90 *Id.* § 2251.051(d).

91 *Id.* § 2251.052.

92 *Id.* § 2251.002 (emphasis added).

93 The use of the word "shall" here of course arguably indicates a mandatory requirement which, if not fulfilled, makes the government's notice invalid. TEX. GOV'T CODE § 311.016(2) (Code Construction Act) ("'Shall' imposes a duty.").

(d) The ***governmental entity may withhold from payments required no more than 110 percent of the disputed amount***.[94]

Though we have found no Texas case law addressing whether offsetting on Project B to pay for Project A would violate either private or public Prompt Pay Act, the above statutory provisions at least provide arguments for downstream parties, similar to the other arguments discussed above for private Prompt Pay Act projects, to proceed with a Prompt Pay Act claim despite the existence of a cross-project offset provision. Upstream parties must at least consider these issues when contemplating withholding of payment, as detailed further below.

VI. Practice Tips

If it was not already clear from the above, Texas law on cross-project offsets lacks clarity in many areas, while at the same time posing potential risky consequences for those who attempt such offsets. With the above in mind, below are suggested practice tips for parties attempting such offsets.

1. Make sure you have a contract that expressly allows for such cross-project offsets. While Texas and other states appear to lack certainty on this issue, it is of course better to try to avoid the ambiguity all together. As noted, industry standard forms – such as AIA and EJCDC – have clauses that potentially create ambiguity on this issue. Conversely, though not expressly stated in the opinion, it appears the owner's express contractual cross-offset provision in *Everlast* bolstered the owner's argument and allowed the court to perhaps more easily uphold summary judgment.

    a. For starters, sample contract language might be found in reference to the offset language at issue in *Everlast*, which again provided: "Notwithstanding any terms contained in this Contract or any Supplement to the contrary, in addition to all remedies available at law or in equity, [Owner] may, at its option, withhold or deduct the amount of money due from [Contractor] under this Contract from the monies [Owner] may be obligated to pay to [Contractor] under any other Contract or Supplement between [Owner] and [Contractor]."[95]

    b. More elaborate language could be used as follows, though any language will of course need to be tailored to the parties and project at issue: "If Contractor has any other agreement with Owner or its affiliates, assigns, or successors involving a different project, Owner or its affiliates, assigns, or successors may withhold and apply any and all monies due or allegedly due to Contractor under this Contract or any such other agreement to pay or settle claims for any damages arising out of Contractor's default under this Contract or any other such agreement, or to hold the same interest free as security to satisfy any

94 TEX. GOV'T CODE § 2251.042 (2024) (emphasis added).

95 2020 WL 7658077, at *4 (S.D. Tex. 2020).

anticipated default by Contractor in the performance of this Contract or any other such agreement."

2. While having an express contractual cross-project offset provision is certainly a good start, the party trying to enforce such a provision must still be prepared for the potential issues raised above.

    a. Owner. The Owner withholding from the Contractor on Project B must keep in mind that such Contractor might assert a counterclaim against Owner under the Prompt Pay Act, Trust Fund Act, or, for private projects, even proceed to file a lien against the project property.

        i. Perhaps even worse, Owner in this scenario must keep in mind that the Contractor's downstream subcontractors and sub-subcontractor may assert a Trust Fund Act, similar to what occurred in *Dealers Electrical Supply Co. v. Scoggins Construction Company*, as discussed above. Such downstream parties might not be able to assert a Prompt Pay Act cause of action against Owner under Texas law, due to a lack of privity.[96]

        ii. But perhaps worst of all, Owner in this scenario must keep in mind that withholding money from Contractor on Project B may still open Owner, and its project property, up to a slew of project lien claims. This is even more important for projects started January 2022 or later, in light of 2021 legislation that (speaking very generally) made it somewhat easier for lien claimants to perfect their liens.[97]

        iii. What is Owner to do with this information? Unless the project has a statutory payment bond covering the entire project (Texas Property Code Chapter 53, Subchapter I) – which may mitigate some of the subcontractor / sub-contractor claims above, certainly the lien claims – Owner needs to reassess its financial strategy in withholding payment on Project B. There are limitless scenarios that may arise, but the primary point the Owner needs to keep in mind is that, rather than using the Project B offset funds entirely to mitigate the impacts of Project A, Owner may need to set aside, and ultimately use, some / all of those funds to pay lien claims and other claims by the subcontractor / sub-subcontractors of any tier. Owner generally should have a right to pay

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96 *E.g.*, National Environmental Service Co., Inc. v. Homeplace Homes, Inc., 961 S.W.2d 632, 636 (Tex. App.-San Antonio 1998, no pet.) ("Read as a whole, chapter 28 does not require an owner to pay a subcontractor the principle sum or any interest.").

97 Tex. H.B. 2237, 87th Leg., R.S. (2021). For more on the impacts of this legislation see Brian R. Gaudet and Mason P. Hester, *Misconceptions, Potential Traps, and Practice Tips for the 2021 Changes to the Texas Lien Laws*, 18 State Bar of Tex. Constr. Law J. 1, 22-35 (Summer 2022).

such claimants directly under the lien statute[98]; it will ultimately be a case-by-case and day-by-day assessment by Owner regarding the wisest way to use such funds, keeping the above statutes and other risks in mind. While public owners will not share these concerns about lien claims, the potential Prompt Pay Act and Trust Fund Act causes of action may still come into play, including from Contractor.

b. The Prime Contractor. Contractor withholding from Subcontractor on Project B, because of defaults by that same Subcontractor on Project A, generally should have the same concerns as the Owner regarding a possible Trust Fund Act, or Prompt Pay Act claim by the Subcontractor. Similarly, lower tier sub-subcontractors arguably might still have a Trust Fund Act claim against Contractor, though maybe not a Prompt Pay Act claim as noted above.

   i. Lien claims by Subcontractor and lower tier sub-subcontractors will actually still be a concern for Contractor. As noted, Contractor may have a contractual duty to indemnify Owner from such claims and Owner may have a contractual right to withholding payment from Contractor in light of such claims. And regardless of this fact, Contractor's ultimate statutory duty to generally defend and indemnify Owner from any suit on a lien must also be a concern for Contractor.[99]

   ii. Of course if there is a payment bond on the project, whether under Chapter 53 (privately owned project) or the McGregor or Miller Acts (state-owned or federally owned project, respectively), any valid claims by subcontractors and sub-subcontractors against such payment bond will of course ultimately come back to Contractor as the payment bond principal, via Contractor's general agreement of indemnity with the payment bond surety.

   iii. Given the above, a Contractor in this scenario must keep the above risks in mind and weigh them against the benefits of offsetting on Project B. Like Owner discussed above, Contractor must remain cognizant of the fact that funds it thought it could withhold to offset for the impact of Project A may ultimately have to be used to pay the claims of Subcontractor and sub-subcontractor, depending on the facts of each case. Further, it will become even more imperative for Contractor to ensure it is obtaining and tracking lien releases from all lower tier sub-subcontractors, so Contractor can better assess its universe of risk for a particular offset strategy and to mitigate such risk generally.

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98 *E.g.* TEX. PROP. CODE §§ 53.056, 53.081.

99 TEX. PROP. CODE § 53.153.

c. A Subcontractor (in direct privity with Contractor) might not have the same bond or indemnity concerns as Contractor above, or the same concerns regarding claims against the project property as the Owner above. Nevertheless, the sub-subcontractor from whom the Subcontractor is withholding on Project B, might arguably still assert a Trust Fund Act or Prompt Pay Act claim against the Subcontractor. Further, such sub-subcontractor may proceed with a (no longer mandatory) "second month" pre-lien notice of non-payment to Contractor,[100] who might then decide to halt further payments to the Subcontractor until the claim is resolved. Like Owner and Contractor above, the Subcontractor – and any downstream party attempting to rely on a cross-project offset provision – must weigh these risks against the rewards of relying on such provision, on a case by case basis.

Contractual cross-project offset provisions remain a very useful and powerful weapon in the right circumstances. But, as shown above, that weapon can sometimes backfire. Parties attempting to use such a weapon must be aware of the potential risks and strategies detailed above and proceed accordingly.

[100] TEX. PROP. CODE § 53.056(a-4).