

Construction Subcontracts: An Exercise in Risk Management

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Introduction.

The purpose of this paper is to serve as a primer of sorts for subcontractors in the construction industry with particular focus on issues facing precast/prestressed concrete manufacturers. In this paper I attempt to touch on the key contract provisions as well as some current hot topics in the construction industry, such as escalation clauses for steel prices. This paper is based upon my experience in the construction industry including my familiarity with various state and federal rules, laws and cases. However, this paper is intended to provide practical suggestions. The usefulness of these suggestions may vary depending upon your state's laws. A construction lawyer should be consulted to provide specific advice regarding the peculiarities of the laws of the states in which you operate.



To begin, it is important that your project managers and sales staff have the proper perspective regarding contract negotiation. In American society, it is the risk takers that enjoy the spoils, not the risk avoiders. That is the lure of entrepreneurialship. However, entrepreneurs take measured or calculated risks. As an organization, you must determine what risks are palatable and what risks are not. Once you have assessed your risk tolerance you can then attempt to negotiate subcontracts in accordance therewith. Note that I said "attempt" - negotiating a contract is a process of give and take. Who the general contractor is (or Owner) and your willingness to stand your ground will determine the success or failure of your negotiations.

Ideally, a construction subcontract flows through the risk of the project only related to the subcontractor's work. In reality, many general contractors ("Contractor"), particularly the large multi-state Contractor's, flow more risk through to the first tier subcontractors than is appropriate given their scope of work. The key to successful contract negotiations is first identifying the places where the contractor shifts risk unfairly. Below are some of the key provisions that you should carefully study in each of your subcontracts.

Ten Critical Provisions in Every Construction Subcontract.

The list of provisions that follow are in no particular order. Each of these provisions are important, however you never know which contract provision is most crucial until you find yourself in a dispute. There are many other important construction subcontract provisions but below are ten which are frequently the subject of litigation.

- 1 Payment Provisions.** There are two basic payment provisions in virtually every subcontract and in most purchase orders. First is the progress payment whereby the Contractor generally makes payment based upon percentage of completion. Second is the final payment whereby the Contractor generally makes payment upon completion and acceptance of the work.

A **Progress Payments.** For Contractor's, progress payments are leverage. Leverage to keep the project current, leverage to correct deficiencies, leverage to perform extras, etc. In practice, payment disputes constitute a large percentage of all construction disputes. Contractors typically withhold payment for one of three reasons (1) they claim the subcontractor's performance is deficient in some manner; (2) they have no money (in which case the subcontractor is in a very tough position); and (3) the Contractor has not been paid by the Owner. Most states will enforce a "pay if paid" clause.¹ A "pay if paid" clause (often called a "pay when paid" clause or a conditional payment clause²) conditions a subcontractor's right to receive a progress payment upon the Contractor's receipt of the same payment from the Owner. The majority rule in the United States is that if a payment clause contains clear condition precedent language, such a conditional payment clause is enforceable.

Contract Negotiating Tips:

- (1) Attempt to negotiate simple 30 day payment terms.
 - (2) A second strategy is to set a time limit for receipt of payment from the Owner. For example, "As a condition precedent to making progress payments otherwise due Subcontractor, Contractor shall have reasonable time to receive payment from the Owner on account of Subcontractor's Work. Such "reasonable time" shall not exceed ___ days." Insert the number of days you feel is reasonable for your market.
 - (3) If the Contractor requires a pay if paid clause, review your state's law to determine if such clauses are enforceable. If the Contractor is demanding an enforceable conditional payment provision then seek to retain an express right to stop work. Additionally, it is advisable to seek the right to file and foreclose a lien claim or bond claim without regard to the conditional payment clause. To explain: as a condition to recover on virtually every bond and every lien claim, a Subcontractor must prove the right to be paid. If the Contractor has not been paid because the Owner has not paid the Contractor then the conditional payment clause may prohibit the Subcontractor from successfully recovering under the bond or foreclosing its lien. As a practical matter, if your state prohibits the waiver of a lien in advance of payment, then arguably, a conditional payment clause could not be used to defeat a lien claim because if it could that would be tantamount to waiving a lien in advance of payment.
 - (4) Another strategy is to rely upon standard industry forms for payment terms. For example, the AGC 650 document provides a "pay if paid" clause for the final payment only. If you incorporate a standard form term by reference (i.e. without inserting the provision in writing in to the subcontract you are negotiating) be certain to expressly exclude all other terms of the form document.
- B **Final Payment.** Often times, and in most every industry form (AIA, AGC, etc.), final payment, including retainage, is conditioned upon the occurrence of numerous items such as, receipt of final waivers, receipt of close out documents, receipt of written warranties, payment from the Owner, acceptance of the Work by the Owner/Architect and final or substantial completion of the entire project. In addition to the tips below, all of the comments for progress payments apply here as well.

¹For example; North Carolina and South Carolina have passed statutes invalidating "pay if paid" clauses however they remain enforceable if properly drafted in many states. New York courts have held pay if paid clauses are void as against public policy.

²Note that some states (for example Louisiana) make a distinction between "pay when paid" verses "pay if paid" language. In such states, generally a "pay when paid" clause held not to be a suspensive condition and is construed to mean the contractor must pay the subcontractor in a reasonable length of time. While, a "pay if paid" clause is held to be a suspensive condition or condition precedent.

Contract Negotiating Tips:

- (1) Try to negotiate that final payment shall be due upon substantial completion. If required, define substantial completion as completion of your subcontract work excluding warranty items.
- (2) If you find a Contractor who will not budge on conditional final payment of retainage based upon the “pay if paid” condition, offer the Contractor a bond in lieu of retainage.
- (3) If the Contractor will not accept a bond in lieu of retainage then consider offering a letter of credit. Be careful with this suggestion, the terms upon which a Contractor can draw upon a letter of credit is critical.
- (4) “Acceptance by Owner/Architect” should at least be tempered to provide that Owner/Architect will not unreasonably withhold approval. As a practical tip, if you find yourself in a project with an overzealous Architect, review your state’s case law to determine if a cause of action is recognized for “over inspection”. In states were such is recognized, it can be a useful tool in speeding receipt of payment.

2 Warranty. Warranties can arise by agreement or by legal implication. In virtually every state, the Uniform Commercial Code (“UCC”) contains the implied warranty of “fitness for a particular purpose” and the implied warranty of “merchantability”. Even where outside of the scope of the UCC, many states have recognized implied warranties of fitness for new construction.³ Virtually, every construction subcontract contains a warranty provision. Warranties offer precasters an opportunity to stand behind their products, however, warranties also pose a significant risk. The risk comes in two primary forms (1) term; and (2) notice provisions. These risks can be minimized through clearly defining the term of the warranty, defining how notice is to be received, and through the use of disclaimers.

A Term of warranty Negotiating the term of a warranty requires striking a delicate balance between showing confidence in your product and minimizing risk. For many years, one year from the date of final completion was the standard warranty term. Now, we are beginning to see Owners requiring two year warranties, which are passed through in the subcontracts.

Contract Negotiating Tips:

- (1) Be certain to define when the term begins. The best case for a precaster is the date of substantial completion. However you must define that date; for example: “Substantial completion shall mean the last day Subcontractor’s erection crew is on the job” or “Substantial completion shall mean the day which Subcontractor completes all Work required by the Contract Documents except punchlist work.”
- (2) If the Contractor requires the warranty term to begin on the date of final completion define that date precisely as well. For example, if you are erecting a parking deck you may consider the following: “Final completion shall be the day on which Owner may use Subcontractor’s Work for its intended purpose.” Another suggestion is “Final Completion shall be the day on which Subcontractor has performed all Work required by the Contract Documents.” For this suggestion to be useful, precise daily job records must be maintained. What you want to avoid is defining Final Completion as the date the Owner “accepts” the work. This ties your warranty to the performance of others and will extend your warranty well beyond the intended term.

B Procedural/notice provisions and opportunity to cure. How are you to know when warranty work is required? This often overlooked issue becomes important when your customer claims it notified you of defective work during the term of the warranty. Further, it is important that the warranty only require you to perform remedial work which you are notified of during the warranty period. You do not want your warranty provision to look like an “occurrence basis” insurance policy. In other words, you do not want to be liable for defects that were first discovered by the

³UCC warranties only apply to the “sale of goods”. What constitutes “goods” is beyond the scope of this discussion, but many if not all of the “goods” sold by precasters are governed by the UCC. You should consult construction counsel to determine how best to limit warranty exposure in your state.

Contractor or Owner during the warranty period but you were not notified until several months or years after the warranty term expired.

Contract Negotiating Tips:

- (1) Require the Contractor to notify you in writing of any defect covered by the warranty within the term of the warranty.
- (2) Require that the word "notify" means Subcontractor's actual receipt of notice. Otherwise the "mailbox" rule might apply (i.e. if the Contractor drops notice in the mail during the term but you never receive it then Contractor has complied with the contractual notice provisions).
- (3) Specify the address notices must be sent to. This is particularly important if your company has multiple facilities.

C **Disclaimers.** The final big area of concern with warranties is the breadth of the warranty. Is the warranty so broad that you are warranting preceding work? In short, what are you warranting? By way of example I will use my home state, Georgia, who has adopted the UCC in a similar form to many other states. Under the UCC, warranties may be disclaimed.

- (1) O.C.G.A. § 11-2-314 provides that **unless otherwise disclaimed**, a warranty that the goods shall be merchantable is implied in the contract for their sale. Goods to be merchantable must be at least such as to pass without objection in the trade under the contract description, be fit for the ordinary purpose for which such goods are used, and run within the variations permitted by the agreement. Note that specially manufactured goods (such as many precast products) are not readily resalable, therefore, this warranty is not as applicable as the fitness warranty below.
- (2) O.C.G.A. § 11-2-315 provides that where the seller at the time of contracting has reason to know any particular purpose for which the goods are required, and that the buyers were relying on the seller's skill and judgment to select or furnish suitable goods, there is an implied warranty that the goods shall be fit for such purpose **unless otherwise specifically disclaimed**.
- (3) O.C.G.A. § 11-2-316 provides the method by which you can exclude or modify warranties. Basically, provisions waiving or modifying warranties must be clear and in accordance with general contract law. In order to exclude warranties, you must make plain that there is no implied warranty. For example, the Code states that language to exclude all implied warranties of fitness is sufficient if it states, for example, that "there are no warranties that extend beyond the description on the face hereof". This very innocuous statement is generally unobjectionable to Contractors but, in Georgia, it is an effective means to limit your warranty obligations to only those written in the subcontract or purchase order.

Contract Negotiating Tips:

- (1) Clearly define what you are warranting. I suggest something to the effect of "Subcontractor warrants its Work will be fit for its intended purpose and free from defects for a period of one year from the date of Substantial Completion." The key words being "its Work". This approach is effective only if the Subcontractor's Work is defined elsewhere in an acceptable manner (See Scope of Work below).
- (2) Disclaim all warranties not expressly stated in the subcontract.

3 **Scope of Work.** Scope of work is a vitally important section of any subcontract. A great deal of time and effort should go into scrutinizing the scope of work so that all questions and omissions can be discussed prior to commencement to the extent possible.

Contract Negotiation Tips:

- (1) One of the most dangerous scope of work provisions is that which generally states "To the extent any item or work is omitted from the drawings or specifications, the need for which can be reasonably inferred therefrom, are hereby included as Subcontractor's Work under this Subcontract." The word "reasonable" invites a dispute. If possible, it is advisable to agree that work will be performed pursuant to the contract documents. To the extent changes are necessary, the parties should follow the change order or work change directive procedures provided for in the contract documents.

- (2) Be careful incorporating documents by reference. When referring to plans, refer only to stamped plans by date, title and number of pages. Similarly, specifications should be referenced as specifically as possible.
- (3) Be certain that your scope of work does not include representing that preceding work has been installed/constructed pursuant to the Contract Documents. Confirming that preceding work is done in accordance with the Contract Documents is the Architect's job and such a provision could greatly broaden your warranty obligations. Of course, as a practical matter, you should always check preceding work as best you can to avoid any difficulties in construction.

4 Delays and Time Extensions. Virtually every project experiences some event that delays completion. Thus, provisions relating to delay damages and time extensions are extremely important.

A Delays frequently arise as the result of design changes by the owner, errors in the plans and specifications, decisions by code officials or governmental entities, and simple inability on the part of the Contractor to complete the work on schedule. The damages suffered by a subcontractor as a result of delays can be enormous, particularly for a precaster whose plant production can be effected.

B Most subcontracts provide a right to a time extension in the event of a delay only to the extent that delay was not caused by Subcontractor and then only to the extent an extension is received from the Owner. This is generally fair, however, where the delay is caused by the Contractor, a time extension should be granted regardless if the same is granted from the Owner.

Contract Negotiation Tips:

- (1) Require that Subcontractor is entitled to an extension of time if delay is caused by Contractor or anyone for whom Contractor is responsible.
- (2) To the extent delay is caused by Owner or Owner's representative, require that Contractor seek an equitable extension of time pursuant to the Prime Contract. If Contractor fails to seek such extension, or fails to comply with the Prime Contract relating to extensions of time, then Subcontractor shall have the right to an extension of time without regard to whether Contractor receives a similar extension from the Owner.

5 No Damages for Delay Clauses. "No damage for delay" clauses are often used by Contractor's to avoid liability for delays caused by anyone. These clauses typically provide that in the event of a delay which the Subcontractor did not cause, the Subcontractor's sole remedy shall be an extension of time and Subcontractor shall have no right to any additional compensation except to the extent the Contractor recovers the same from the Owner. This clause makes the Subcontractor assume the risk of Owner breach, Contractor breach and other Subcontractor's breach and is fundamentally unfair.

Contract Negotiation Tips:

- (1) At a minimum, eliminate no damages for delay where the delay is occasioned by the act, omission, or breach of Contractor. If the Contractor fails to perform, it must pay for damages caused thereby.
- (2) Further, if possible, eliminate no damages for delay where the delay is caused by other subcontractors. Here, such delays are out of your control and the Contractor has recourse against the party at fault to recover any damages you suffer.
- (3) As a practical matter, there have developed ways in your State in which subcontractors have been able to beat a "no damages for delay" clause such as characterizing the damages as resulting from "acceleration", "inefficiency", "interference", "disruption", "lack of good faith and fair dealing" or some similar term. If you find yourself fighting a "no damages for delay" clause look to the case law of the state of New York for guidance. New York has fairly well developed case law providing that a Contractor cannot actively interfere with performance then hide behind a no damages for delay clause to avoid liability.

6 Indemnification. It seems the modern Contractor requires subcontractors to indemnify them, and everybody else who they have a relationship with, from everything under the sun. Standard industry forms, like the AIA A201 General Conditions form, contain a simple indemnity that is closer to fair but most savvy Contractor's have moved away from using an industry form in favor of their own onerous subcontract (BEWARE - even a subcontract that looks like an industry form has often times been substantially modified). Indemnity provisions should cover personal injury and property damage

claims resulting from the construction work, but only to the extent caused by the subcontractor. However, most indemnity obligations span well beyond personal injury and property damage caused by the subcontractor unfairly shifting the risk of the project to the subcontractor.

Contract Negotiation Tips:

- (1) Amend the indemnity provision to provide that “Subcontractor hereby agrees to indemnify and hold harmless, Contractor, Owner and Architect, from and against any claim, damage, expense, fee, fine, penalty, damage or any other cost arising out of or is related to Subcontractor’s Work and caused by Subcontractor, Subcontractors employees, agents, or others for whom Subcontractor is responsible. To the extent any cause, claim, damage, expense, fee, fine, penalty, damage or any other cost arises or caused in part by Contractor, Owner, Architect or others, and in part by Subcontractor, liability therefore shall rest solely on the party causing the same in proportion to its degree of fault or negligence”
- (2) As a practical tip, many states, such as Georgia and Florida, do not allow a party to indemnify another party from their own sole negligence. In Georgia, if an indemnity provision indemnifies a party from their sole negligence then the entire provision may be void. Check the relevant state law to determine if the law in your jurisdiction is similar. If it is, and you are faced with such a void indemnity, you may consider accepting the indemnity with the hope that a court will declare the provision void if contested. In order to take this approach, you must be certain you know and understand the law of the relevant jurisdiction.
- (3) Limit the indemnity to damages for personal injury or property damage arising out of or related to Subcontractor’s Work. Some provisions are expansive and cover items well beyond personal injury and property damage.

7 Procedural Provisions. Many subcontracts contain various types of notice and claims provisions. The most important of these procedural provisions are those requiring the Subcontractor to give the Contractor notice of some event.

A Procedural provisions are generally found in multiple places in the subcontract. For example, typically there are notice requirements for delay claims, unforeseen site conditions, or a claim based on a change in the scope of the work.

B Do not hesitate to make written claims even if precautionary. It is quite often that Subcontractors, after a job is complete or near complete, discover that delays cost them substantial sums of money. As a practical matter, the best practice is to cover yourself through good project management. However, it is also a good idea to lengthen the time in which you are to give notice. Further it is important that the duty to notify is triggered by the Subcontractor’s actual knowledge, not when it “should have known” or “could have known”.

Contract Negotiation Tips:

- (1) A Contractor will be tied to the prime contract. Therefore, review the prime contract and seek to get at least one-half the amount of time the Contractor has to make similar claims to the Owner. This gives the Contractor a fair amount of time to investigate and make a claim to the Owner.
- (2) Make certain that all notice provisions are triggered by Subcontractor’s actual knowledge. For example: “Subcontractor shall notify Contractor of any events out of Subcontractor’s control which delay its work within fourteen (14) days of Subcontractor first discovering such cause of delay.” (This language is much different than the typical language whereby notice is triggered by the event causing delay).

8 Termination. The termination clause of a subcontract can be critical. The key issue for subcontractors in termination clauses is payment for work performed and costs of demobilization.

A Most termination clauses give the Contractor the flexibility to terminate the subcontract immediately and for its convenience, limiting the damages payable to the subcontractor in those circumstances. Generally, a Contractor can terminate “for cause” where the Subcontractor fails in some respect to perform its Work in accordance with the subcontract. Where termination is “for cause” amounts due Subcontractor are offset by the cost of hiring a follow-on subcontractor to complete the work. In these circumstances, it is important that the Subcontractor have written notice of default and a meaningful opportunity to cure.

- B The second right of termination found in subcontracts is the termination “for convenience”, whereby a Contractor can terminate a subcontractor for any reason or for no reason at all. Generally, where a subcontractor is terminated for convenience, the subcontractor has the right to get paid for work installed. When negotiating these provisions, subcontractors should seek the right to payment for work installed and stored. Further, materials in the process of manufacture, restocking fees, costs of idling the plant (if any) and disposal costs must be recoverable.

Contract Negotiating Tips:

- (1) Where termination is “for cause”, make certain Contractor has an obligation to provide written notice of the default stating with specificity the nature of the default. Further, negotiate a meaningful opportunity to cure. I suggest the following: “In the event Subcontractor is in default under the Subcontract, Subcontractor shall, within 48 hours of receiving written notice thereof, commence such work, including increasing shifts and working overtime, at no cost to the Contractor or Owner, as is necessary to cure such default and Subcontractor shall diligently continue such work until the default is cured.”
- (2) Where termination is “for convenience” Subcontractors should attempt to expand the damages recoverable. Ideally, Subcontractors would want to recover lost profits, however, it is highly unlikely a Contractor will agree to such a provision. It is advisable that Subcontractors retain the right to be paid for work installed and stored. Further, for materials in the process of manufacture, restocking fees, costs of idling the plant (if any), disposal costs, and any other costs associated with stopping a project.

- 9 **Changes in the Work.** Changes in work arise in two basic ways: (1) design changes and (2) unforeseen conditions. The key is to define a “change” as any work outside the defined Scope of Work of the Subcontract. Changes should relate to work that was not contemplated by the Subcontractor. Subcontractors should beware of mark up limitations and other limitations on amounts to be paid for change order work.

Contract Negotiating Tips:

- (1) Subcontractor’s obligation to perform additional work resulting from changes should be triggered by a written directive to perform such work.
- (2) Subcontractor should receive an equitable increase in the Subcontract amount/price plus ___% for overhead and ___% for profit.
- (3) If Contractor and Subcontractor cannot agree on price adjustment, it is acceptable to move forward with the work and agree on price later as long as there is no provision making the Contractor, Owner or Architect the final arbiter of price. Litigation or arbitration should be available, if necessary, to resolve the matter.

- 10 **Incorporation by reference.** Virtually all Subcontracts contain a clause incorporating the Prime contract, general conditions, supplemental conditions and design documents as part of the Subcontract (referred collectively as the “Contract Documents”).

A The Prime Contract will inevitably conflict with the Subcontract. There are two possible contracting strategies here: 1) clearly provide that the Subcontract, as amended, controls and supersedes, or 2) use the conflicting provisions to your advantage.

B The second approach is a difficult approach and is ill-advised without the assistance of construction counsel. Notwithstanding the foregoing, and by way of example, a conflict in the Prime contract and Subcontract can be advantageous where there are two different payment clauses. For example, the Contractor has a lump sum contract with the Owner but there is a “pay if paid” clause in the Subcontract. If the Subcontract incorporates the Prime Contract by reference without a conflict resolution provision, then which payment term controls? Several states have addressed this issue the most well reasoned of which is Florida where it was held that the conflicting payment provisions create an ambiguity and the Contractor must pay the Subcontractor within a reasonable amount of time (see also Kansas case law). This second approach is useful only in an extremely limited number of instances.

Contract Negotiation Tips:

- (1) Provide a clear statement that in the event of conflicts the Subcontract, as amended, controls and supersede over all other Contract Documents.
- (2) Alternatively, and if there is no conflicts resolution provision, agree to the incorporation of the Contract Documents with the idea that the Subcontractor will be in position to take

advantage of the numerous ambiguities in the documents. This approach may only be taken after a thorough review of all Contract Documents. Consulting construction counsel is strongly advised.

- (3) Under either approach, know the Contract Documents. Many Subcontractors stick their heads in the sand with regard to the Prime Contract. This self imposed ignorance can come back to haunt the Subcontractor in the event of a contract dispute. Further, you must know what is being incorporated in the subcontract.

Contracting Issues Specific to the Precast/Prestressed Concrete Industry.

- 1 Material price escalations.** Recently, the entire country has seen substantial increases in the price of steel. Further, many parts of the country have seen substantial increases in the price of concrete. How do we deal with unforeseen material price increases?
 - A From a contracting standing point, a price escalation clause is the simplest answer. Below as a fairly simple provision that will help avoid the problem of material price increases (other more sophisticated escalation clauses have been promulgated by industry organizations such as the American Institute of Architects and the Associated of General Contractors of America).
 - B "In the event of significant delay or price increase of material, equipment, or energy occurring during the performance of this contract through no fault of the Subcontractor, the contract sum, time of completion, or contract requirements shall be equitably adjusted by change order. A change in price of an item of material, equipment, or energy will be considered significant when the price of an item increases _____ percent between the date of this Contract and the date of manufacture."
- 2 Erection.** For those precasters who are more than suppliers, erection presents to most substantial area of risk in the entire project, although representing a very small portion of the cost of the project. This inverse cost to risk relationship dictates that some care and thought be given to how this risk might be limited.

Contract Negotiation Tips:

 - (1) Separate the subcontract with the Contractor into two Subcontracts. One being basically as supplier contract or purchase order representing the bulk of the cost related to the precast scope of work. The second contract being a contract for erection. Be certain that these contracts are truly independent and that performance under one is not a condition of payment under the other. The overall risk to the precaster remains the same but the risk of non-payment is potentially greatly reduced.
 - (2) Subcontract the erection portion of the project using a very tightly drafted erection subcontract shifting all risks of erection to the erector. Be certain that the precaster does not retain any inspection or approval obligations over the shoring or OSHA compliance.
- 3 Design responsibility.** For structural precast manufacturers, it may be advisable to hire outside design professionals for any particularly difficult projects so that the risk and design deficiencies are shifted to outside design professionals thereby minimizing risk.

Conclusion

Negotiating a construction subcontract can be a frustrating endeavor, but it is an important one. Many construction disputes are lost before they get to court because a Subcontractor signed an onerous subcontract without thought. Subcontractors often adopt a "everybody else is doing it mentality" about agreeing to unfair subcontract terms. The bottom line is that negotiating subcontracts is an exercise in risk management. Determine your risk tolerance as an organization and negotiate your subcontracts accordingly.