

CONSTRUCTION CONTRACTS – TRAPS FOR THE UNWARY PART ONE

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In a perfect world, the construction contract that you enter into should be prepared with the goal of protecting **your** interests, not those of the owner or general contractor. In real life, however, you are usually given a pre-printed AIA or AGC form, or even one that has been prepared by the owner/contractor, and you are left with the impression that no modifications to the contract will be permitted.

Regardless of whether you have the leverage to negotiate more favorable contract provisions, it is very important that you review and understand all of the contract's terms and conditions. Failing to do so may lead to adverse consequences such as:

- Not being fully aware of your duties and responsibilities;
- Failing to protect or exercise your rights and remedies;
- Failing to preserve and assert your claims and defenses; and
- Not being able to realize the full benefit of the contract.

This article is part one of a two-part series that identifies a few of the potential traps that an inattentive subcontractor may find in a contract. The goal of these articles is to make you aware of some of the pitfalls that you may face, with the hope that you implement a procedure to evaluate each construction contract prior to signing and to handle disputes should they arise during performance of the work.

1. Pay-When-Paid v. Pay-If-Paid

Almost all construction subcontracts have provisions that outline the procedure for the disbursement of progress payments, retention and final payment. These provisions generally require payment from the owner before the contractor will release funds to the subcontractor. They typically fall into one of two categories: (a) "pay-when-paid" clauses; or (b) "paid-if-paid" clauses. Although they sound similar, these clauses can have a significantly different impact on the subcontractor.

"Pay-when-paid" clauses affect the timing of payments to a subcontractor. The contractor must make payment to the subcontractor within a reasonable time regardless of whether the owner makes payment to the contractor.

"Paid-if-paid" clauses, on the other hand, create a condition that must be met before the contractor is obligated to make payment to the subcontractor. The contractor is excused from making payment to the subcontractor if the owner does not pay the contractor.

The risk that the subcontractor undertakes is significantly different depending upon which clause is in the subcontract. Under a “pay-when-paid” clause, the contractor bears the risk of nonpayment by the owner. In contrast, it is the subcontractor, not the contractor, who bears the risk of the owner’s non-payment under a “pay-if-paid” clause. This “risk” exists regardless of whether the owner’s nonpayment is the result of the owner’s insolvency or bankruptcy, the owner skipping town, the owner’s refusal to pay for “unauthorized” extra work, or even the owner’s dispute with the contractor over unrelated issues or projects.

2. Attorneys’ Fees

The construction subcontract may also contain a provision permitting the recovery of attorney’s fees if the parties have to litigate or arbitrate their dispute. There are generally two types of attorneys’ fees clauses: (a) “prevailing party,” and (b) “non-reciprocal.” The “prevailing party” clause allows the party who wins the dispute to recover its attorneys’ fees from the losing party. A “non-reciprocal” clause, however, only allows one of the parties, typically the contractor, to recover its attorneys’ fees – even if the other party wins the dispute.

3. Incorporation and “Flow-Down”

The last topic covered in part one of this series relates to “incorporation” and “flow-down” contract provisions. Construction subcontracts often contain language that bind the subcontractor to other documents or other obligations that are not specifically outlined in the subcontract. Here are two examples:

The provisions of the General Contract are incorporated as if fully rewritten herein. The “General Contract” means the contract between the General Contractor and the Owner, together with all the provisions, general conditions, plans, drawings, specifications and addenda. Subcontractor agrees to comply with and not violate any term, covenant or condition of the General Contract.

Subcontractor hereby assumes all duties and obligations to General Contractor which General Contractor has assumed toward the Owner in the General Contract. All rights that the Owner may enforce against the General Contractor may be enforced by the General Contractor against the Subcontractor.

The first example is known as an “Incorporation Clause.” It means that other documents are incorporated into the provisions of the subcontract. The second provision is known as a “Flow-Through Clause.” It essentially passes on to the subcontractor some or all of the obligations that the contractor has to the owner, but it does not necessarily give the

subcontractor the same rights against the contractor that the contractor may have against the owner.

These provisions could have an unintended impact upon a subcontractor. For example, if the subcontractor is successful at negotiating an arbitration or liquidated damages clause out of the subcontract, those efforts may be rendered meaningless if the prime contract requires arbitration or permits the assessment of liquidated damages.

Part two of this series will examine contract provisions that require you to continue work despite a dispute, that require you to provide notice of certain events, and that place limitations on your ability to recover additional compensation.

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