What Is "In" the Contract: Flow-Down Issues

Introduction: What Is a "Contract"?

A "contract" is an exchange of promises. One party makes one set of promises, in exchange for promises made by the other party to the contract, whether it is called an "agreement," or a "purchase order," or a "memorandum of understanding," or anything else you like. An exchange of promises, such as a promise to provide work, materials and/or equipment in exchange for a promise of payment, is a "contract."

The contract promises don't necessarily have to be in writing. If the promises are in writing, they won't necessarily be contained in a single document. In fact, for construction subcontractors, the promises exchanged in a "contract" are not ordinarily contained in a single document, and are instead spread out among numerous "contract documents."

Promises from Other Documents: "Flow-Down"

Typical subcontract agreement forms incorporate written promises found in other documents by explicitly referring to those documents. Those other documents normally include the prime contract agreement, the plans and specifications, the general conditions, the special conditions and others that contain promises made by the prime contractor to the owner. The prime contractor wants those documents referenced in its written subcontracts in order to be certain that its subcontractors are obligated to provide everything that it is obligated to provide to the owner with respect to any subcontracted portions of the work. For example, if the prime contractor has agreed to give the owner the right to audit records of time and materials, then the contractor must ensure that its subcontractors are contractually required to provide it with all the same records that it is required to produce for the owner. Typical subcontract agreements, then, will not merely refer to the prime contract documents, but will also provide that the promises in those documents are passed down to subcontractors in what is generally referred to as a "flow-down" clause.

In one case illustrating what can happen without a flow-down clause, a contractor was unable to pass through to a subcontractor a change order it received from the project owner to delete a portion of the work.[1] The original contract required the contractor to remodel a shopping mall, including the removal and reinstallation of the storefront signage. The contractor hired a subcontractor to perform the signage work. After the subcontractor removed the signage and had received half the contract amount, the owner decided to buy new signage, and signed a change order deleting reinstallation of the old signs from the project. The prime contractor cancelled the remaining work under the subcontract, but the subcontractor sued for the contract balance and won the case.

[1] *Werner v. Ashcraft, Bloomquist, Inc.*, 10 S.W.3d 5745 (Mo. App. E.D. 2000).

The subcontract hadn't provided for change orders, so canceling the remaining work was a breach of contract.

The contractor's simplest solution would have been to include a flow-down clause in the written subcontract providing that the subcontractor would be bound to the contractor in the same manner, and to the same extent, as the contractor is bound to the owner under the prime contract documents, with respect to the subcontracted portion of the work. By referring to the prime contract documents, the written subcontract would have put the subcontractor on notice of the promises contained in those documents that related to its work, not only including the change order provisions, but also including standards of care and warranty obligations, limits on remedies, insurance requirements, and requirements for payment forms, waivers and releases. Further, by expressly providing that the subcontractor is bound in the same manner, and to the same extent, as the contractor is bound to the owner, the contractor can be reasonably certain that all of those promises become affirmative obligations of the subcontractor.[2]

The appropriateness of a flow-down approach will largely depend upon the appropriateness of burdening the seller with review of the contract documents. For large subcontracts, flow-down may be the simplest approach for both the buyer and the seller to ensure a mutually profitable bargain. For a small purchase order, on the other hand, it is probably more reasonable to put the burden on the buyer to determine its own requirements, than to burden the seller with sifting through the project manual to ensure its product will meet all the specifications and warranties required by the prime contract documents.

A flow-down clause doesn't just "incorporate" the prime contract documents by referring to them. A flow-down clause goes further, by providing that the individual promises in the referenced documents apply as between the contractor and the subcontractor to the same extent as they apply between the owner and the contractor. Otherwise, a court may find that prime contract documents are only incorporated into a subcontract for a limited purpose, as happened in a 2004 construction case.[3] The subcontract provided that the usual list of contract documents, including the A201-1997 *General Conditions of the Contract for Construction* published by the American Institute of Architects (AIA), were "hereby, made a part of this subcontract, as applicable to the work stated therein and pursuant to this subcontractor's intent to enter into this sub-contractual agreement, with reference to any and all of said work." The prime contractor argued that, since the A201-1997 required it to arbitrate its disputes with the owner, the subcontractor was also required to arbitrate its payment dispute with the prime contractor.

[2] However, the subcontractor must then be concerned that the "flow-down" clause no longer simply passes through obligations owed to the owner, but also provides the contractor with defenses against its own mistakes or misconduct. See below.

[3] *MPACT Construction Group, LLC v. Superior Concrete Constructors, Inc.*, 802 N.E. 2d 901 (Ind. 2004).

The court, however, reviewed flow-down language in construction contracts from several other cases around the country, as well as the requirement in the A201-1997 itself, at ¶ 5.3.1, which required the prime contractor to "require each Subcontractor, to the extent of the Work to be performed by the Subcontractor, to be bound to the Contractor by terms of the Contract Documents, and to assume toward the Contractor all the obligations and responsibilities which the Contractor, by these Documents, assumes toward the Owner and Architect." The Court found that the subcontract language that the prime contractor actually used, which made the other contract documents "a part of this subcontract *as applicable to the work* stated therein," failed to meet the requirements of ¶ 5.3.1. of the A201-1997, and failed to pass-through the arbitration requirements to the subcontractor, who the court permitted to proceed with a lien foreclosure action separate from the prime contractor's dispute with the owner, which the court sent to arbitration. Instead of requiring the subcontractor to "assume … all the obligations and responsibilities … [of the] Contractor," the actual subcontract had only required the subcontractor to assume responsibilities "applicable to the work," which the subcontractor successfully argued did not include the responsibility to arbitrate disputes.

"Flow-down" or Add-on?

More expansive flow-down clauses, on the other hand, will not only pass through to the subcontractor all of the obligations that are owed to the owner, but will also be interpreted to provide the prime contractor with defenses for its own misconduct, not involving the owner. For example, no-damage-for-delay terms in the prime contract will not only exculpate the owner for owner-caused delays, but will also exculpate the prime contractor for its own failures in managing the project when those same terms are "flowed-down" to a subcontractor, as illustrated by a case[4] brought against a general contractor who caused a *two year* project delay. The general contractor argued that the subcontractor was only entitled to an extension of time based on no-damage-for-delay terms in the prime contract documents which, it argued, were applicable to the subcontractor because of the flow-down provisions in the written subcontract: "Contractor shall have the same rights and privileges as against the Sub-contractor herein as the Owner in the General Contract has against the Contractor. … The Sub-contractor agrees to be bound to the contractor by the terms of the contract documents and assume toward the contractor all of the obligations and responsibilities that the contractor by aforesaid document assumes toward the Owner." The court ruled that "Because the general contract accords the project owner protection from an action brought by the general contractor for delay damages, it necessarily follows that the subcontract accords the same protection to the general contractor *vis a vis* the subcontractor," and dismissed the subcontractor's claims.

[4] *L & B Construction v. Ragan Enterprises,* 482 S.E.2d 279 (Ga. 1997).

The case illustrates dangers inherent in flow-down clauses for subcontractors. Unlike a general contractor, a project owner will not ordinarily bear responsibility for sequencing and scheduling the work of subcontractors, or for providing sufficient work and storage areas, or for providing temporary facilities. Thus, a no-damage-for-delay clause in a prime contract, which prevents recovery against the owner for delays, will subject the prime contractor to a completely different, and ordinarily much smaller, group of risks than the same clause in a construction subcontract, which would prevent recovery against the prime contractor. Or, as another example, consider hold harmless and insurance terms. A general contractor who is directly involved in supervision of the project site and coordination of subcontractors is much more likely to have actual liability for an accident than a project owner who does not have active operations at the project site. A subcontractor might not object to contract terms that pass through an obligation to name an owner as an "additional insured" on its general liability policy, at least where the owner will not have active operations at the project site. Nonetheless, the same subcontractor probably should object to an additional obligation to also name the general contractor as an "additional insured," because the potential for liability is much, much higher.

Precedence

Another case[5] illustrates how subcontractors can blunt the expansive effect of broad "flow-down" clauses that afford the prime contractor with defenses and protections against its own mistakes or misconduct, not involving the owner. The case was brought by a mechanical subcontractor who claimed that sequence and schedule changes had disrupted, and then constructively accelerated, its work. The general contractor responded that the prime contract included no-damage-for-delay terms limiting the remedy for delays to an extension of time, and that the written, mechanical subcontract included a flow-down clause which incorporated, along with everything else, the no-damage-for-delay terms found in the prime contract. However, in addition to a flow-down clause, the subcontract also contained other, "inconsistent" terms that did entitle the mechanical subcontractor to "compensation" for delays and disruptions in certain circumstances. To resolve the inconsistency, the court relied on another, common subcontract clause governing the precedence of the contract documents. The clause provided that "in the event a provision of the agreement between Beers and the project owner is inconsistent with the [subcontract], the [subcontract] controls." The court consequently decided to permit the subcontractor's delay and disruption claims to proceed to trial, notwithstanding the no-damage-for-delay clause in the prime contract and the flow-down clause in the subcontract.

Clauses providing for the precedence of one contract document over another, in the event of conflicts between them, are common in construction contracts, and

[5] *Atlantic Coast Mechanical v. R.W. Allen Beers Construction*, Court of Appeals of Georgia No. A03A0893, Nov. 24, 2003.

understandably so, considering that construction contracts incorporate promises found in many different "contract documents" that are drafted from different perspectives for different purposes. Precedence clauses permit the parties to any particular subcontract to negotiate their own terms, and then use the other contract documents as a fall-back, for the purpose of filling in gaps not specifically covered in the negotiated portion of the agreement. All the parties need is a precedence clause that gives the negotiated portion of the agreement priority over promises contained in any of the other contract documents that were not specifically negotiated between the subcontracting parties.

However, precedence terms can take a much more dangerous form than the typical clause providing that, in the event of a conflict or inconsistency, one document will be deemed to have precedence over another document. Instead, a precedence clause may provide that the terms placing the greatest burden or risk on the subcontractor shall control, no matter which contract document includes any particular term. The implications of such a clause may not always be obvious until after the worst has occurred, although such terms are typically used in connection with insurance requirements where the implications can be more easily considered before work begins. In any context, however, a 'greater risk' type of precedence clause amounts to an abdication by the prime contractor of its responsibility to manage the work of its subcontractors. In the context of insurance, for example, such clauses force each subcontractor to review both the owner's and the prime contractor's insurance requirements to decide what the prime contractor really wants, while exculpating the prime contractor from responsibility to review its own insurance requirements and decide, on its own, what it wants. Such a procedure is grossly inefficient because it tasks numerous subcontractors to "re-invent the wheel," rather than tasking the project leader to perform the job once. Further, such tactics betray inattention on the part of a prime contractor who is too lazy to review and understand its own, written insurance requirements, despite its responsibility to lead and manage the project.

Inappropriate Flow-Down

Subcontractor concerns about "flow-down" clauses are not limited to cases where the prime contractor seeks a free ride on exculpatory terms benefiting the owner. Even a straight pass-through of obligations owed to the owner can be reasonably objectionable. As noted previously, it may be more reasonable, depending on the size of the subcontract or purchase order, for the prime contractor to determine its own requirements, than for the prime contractor to require the subcontractor or supplier to review the entire project manual. Another example is design-build delivery. A design-builder agrees not only to construct the project, but also to design the project. A design-builder's subcontractors, on the other hand, will ordinarily be hired to perform discrete construction tasks only, and not to hire architects or engineers to create a separate design, or to fly-speck and alter the design prepared by the design-builder. A subcontractor who bids only the cost of *constructing* a design-builder's design should object to a blanket flow-down of all of the design-builder's responsibilities to the owner

absent an exception for the design responsibilities owed to the owner by the design-builder.

The point is illustrated by the case of a lump-sum electrical subcontractor who was hired by a design-builder on an elementary school construction project.[6] According to the court's written opinion, the written subcontract required the subcontractor to "perform its work in accordance with the Agreement between [the design-builder] and [the owner]," and further provided that the design-builder would "furnish to the Subcontractor … additional information and Plans … to further describe the Work to be performed by the Subcontractor and the Subcontractor shall conform to and abide by same insofar as they are consistent with the purpose and intent of the [bid] Plans …." The Subcontractor assumed all of the obligations of the design-builder to the owner for the design of the project on a fast-track basis, as construction proceeded. Based on the contract language, the appeals court not only dismissed claims by the subcontractor for "extra" work that it claimed were the result of design changes after bid, but it also reinstated claims by the design-builder against the subcontractor for abandoning the project. After all, the design changes were already part of the subcontractor's scope of work, before they had even been finalized.

Industry Standard Protections for Subcontractors

Although flow-down clauses have reasonable applications, it is false to argue that flow-down clauses merely pass along the written obligations owed to the owner by the prime contractor, because they also impose new, identically worded obligations between the prime contractor and the subcontractor without accounting for the completely different nature of many of the risks and liabilities involved. It is also false to argue that it is always appropriate to pass along ***all*** of the obligations owed by the prime contractor to the owner, as exemplified by design-build projects where subcontractors should not assume the risk of design changes although those responsibilities are, naturally, assumed by the design-builder.

Moreover, subcontractors want to be certain that they are not shortchanged of the rights that the prime contractor has against the owner to make claims for extra time or compensation, or to require quick turn-around of submittals, or to limit exposure for consequential damages, among other rights the prime contractor may have under the contract documents. Lack of mutuality may even leave the subcontractor without recourse to make claims for extra work actually performed at the request of the prime contractor!

Industry trade organizations that publish model subcontract forms all recognize and accommodate important subcontractor concerns, by including terms in their subcontract forms providing (1) that the subcontractor accepts not only the obligations, but is also

[6] *Sunhouse Construction v. Amwest Surety*, 841 So.2d 496 (Fla.App.Dist.3 2003).

entitled to the rights, provided in the contract documents, (2) that the subcontractor is entitled to copies of the contract documents, and (3) that the terms in the subcontract form, which are actually negotiated between the parties, take precedence over any inconsistent terms in the other contract documents. None uses a "greater burden" type of precedence clause.

AIA's A401-1997 *Standard Form of Agreement Between Contractor and Subcontractor,* for example, refers to a number of contract documents, including the prime contract "and the other Contract Documents enumerated therein," modifications of that agreement "whether before or after the execution of this Agreement," other documents listed in a blank space provided in the form, and "the edition of AIA Document A201, General Conditions of the Contract for Construction, current as of the date of this Agreement." *See* ¶¶ 1.1, 16.1. The form provides that "The Subcontractor shall be furnished copies" of all of the contract documents "upon request," subject only to payment for "the reasonable cost of reproduction." ¶ 1.4. The flow-down and precedence terms are both contained in ¶ 2.1. Those terms pass to the subcontractor not only the obligations, but also the rights, of the prime contract documents, and provide that, in the event of inconsistency, the terms of the A401-1997 as completed by the parties will govern:

> … to the extent that … provisions of the Prime Contract apply to the Work of the Subcontractor, the Contractor shall assume toward the Subcontractor all obligations and responsibilities that the Owner, under such documents, assumes toward the Contractor, and the Subcontractor shall assume toward the Contractor all obligations and responsibilities which the Contractor, under such documents, assumes toward the Owner and the Architect. The Contractor shall have the benefit of all rights, remedies and redress against the Subcontractor which the Owner, under such documents, has against the Contractor, and the Subcontractor shall have the benefit of all rights remedies and redress against the Contractor which the Contractor, under such documents, has against the Owner, insofar as applicable to this Subcontract. Where a provision of such documents is inconsistent with a provision of this Agreement, this Agreement shall govern.

The AGC 650 (1998) *Standard Form of Agreement Between Contractor and Subcontractor (Where the Contractor Assumes the Risk of Owner Payment),* published by the Associated General Contractors of America, is similar. It refers to the prime contract, special conditions, general conditions, specifications, drawings, addenda, change orders, amendments and any pending alternatives. *See* ¶ 2.3. It provides that the prime contractor "shall" make copies of the documents available to the subcontractor "prior to the execution of the Subcontract Agreement," and that "Nothing shall prohibit the Subcontractor from obtaining copies of the Subcontract Documents from the Contractor at any time after the Subcontract Agreement is executed." *See* ¶ 2.3. It states that "In the event of a conflict between this Agreement and the other

Subcontract Documents, this Agreement shall govern," ¶ 2.4, and, at ¶ 3.1, contains a mutual form of flow-down clause:

> … To the extent the terms of the prime contract between the Owner and Contractor apply to the work of the Subcontractor, then the Contractor hereby assumes toward the Subcontractor all the obligations, rights, duties and redress that the Owner under the prime contract assumes toward the Contractor. In an identical way, the Subcontractor assumes toward the Contractor all the same obligations, rights, duties and redress that the Contractor assumes toward the Owner and Architect under the prime contract. …

The DBIA 535 (1998) *Standard Form of Agreement Between Design-Builder and Subcontractor (Where Subcontractor Does Not Provide Design Services),* published by the Design-Build Institute of America, also makes reference to the prime contract, the plans and specifications, written supplementary conditions "if any," and provides a blank to list other documents. It provides that the contract documents "shall take precedence in the order in which they are listed in Section 1.3," which begins with modifications, change orders, and the subcontract agreement. Finally, the form includes a limited, but mutual, flow-down provision, at ¶ 1.1.1, which avoids imposing any responsibility for design on the subcontractor:

> Design-Builder has contracted with Owner to provide the services necessary for the design and construction of the Project as set forth in the Design-Build Agreement. Subcontractor, through itself, and Sub-Subcontractors, agrees to provide all construction and other aspects of the Work[7] consistent with the Contract Documents. Design-Builder and Subcontractor agree that to the extent applicable to the performance of the Work hereunder, Subcontractor shall have the same rights, responsibilities and obligations as to Design-Builder as Design-Builder by the Design-Build Agreement has against and to Owner, except as may be modified herein.

Note that the agreement states that the Design-Builder has agreed to provide "design and construction," while stating that the Subcontractor agrees to provide "construction" only.

ASA's Addendum to Subcontract (2004) begins, in its introductory paragraph, with a precedence clause giving the terms of the addendum priority over any other inconsistent terms. It further provides, in ¶ 1, that "The Scope of Work shall include only the work set forth in the ATTACHED Subcontractor's proposal or description of work, which proposal or description is expressly incorporated and made a part of the

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[7] The form defines "Work" to include items incidental to construction, such as supervision, inspection, testing, start-up, temporary utilities, temporary facilities "and all other items and services reasonably inferable from this Agreement and the other Contract Documents necessary to complete the portion of the Project described in Exhibit _____."

Subcontract Documents between the Contractor and the Subcontractor." In case those terms should be insufficient to ensure that there is no flow-down of design risks, the Addendum also has warranty terms disclaiming any warranty for the design (¶ 4), and another provision (¶ 6) that "Contractor, Owner and Architect are entitled to rely on the accuracy and completeness of design services or certifications provided by Subcontractor only to the extent that design responsibility for a particular part of the Work is specifically delegated to Subcontractor by agreement in writing …."

The addendum also ensures that the subcontractor is entitled to copies of all of the relevant contract documents, and that, regardless of the subcontract form that is used, the flow-down clause will be appropriately mutual:

> **2. Contract Documents.** Subcontractor shall have the benefit with respect to the Contractor of all the same rights, remedies and redress that the Contractor has with respect to the Owner. No terms and conditions or other document that Contractor includes by reference in the Subcontract shall be binding on the Subcontractor unless a copy of any such terms and conditions or document has been furnished to the Subcontractor prior to execution of the Subcontract, and unless expressly accepted in a writing signed by the Subcontractor.

Negotiating Tips for Subcontractors and Suppliers

Whenever a buyer proposes to use a subcontract form or purchase order that incorporates other documents by reference, the seller should consider whether the expected profit justifies the cost to review all of the referenced documents. The task of reviewing and understanding all of the owner's contract requirements properly applies to the project leaders and major subcontractors, but further delegations of that responsibility to ever lower tiers of subcontractors and suppliers are inefficient, inappropriate, and suggestive of a crisis of competent project leadership. In most cases, when a buyer places an order, then it is up to that buyer to ensure that it has ordered the right products or services, without what amounts to a disclaimer that "if I ordered the wrong thing, it is the seller's fault."

If, however, the contract amount is large enough to justify the application of the specialty contractor's expertise to the interpretation of the owner's requirements, the subcontractor must immediately insist on having copies of every single document which is referenced in the proposed subcontract agreement or purchase order. The subcontractor is also entitled to copies of any document referenced in those documents, and so on. When a general contractor says that a certain document can only be reviewed, but no copies made, the subcontractor should say "no thank you" and refuse the agreement. The entire purpose of a written subcontractor is to ensure a clear understanding, and clear expectations, between the parties. Anyone who would refuse one of the parties to a contract a copy of that contract seeks to frustrate that purpose, by ensuring that the subcontractor is never clear in either its understanding or

expectations for the duration of the project. “You can’t have a copy” means “I don’t intend to treat you fairly, or even honestly.” A “contractor” does what the contract says, hence the name. A “contractor” who isn’t allowed to have a copy of the contract isn’t really a “contractor,” but is instead little more than a puppet on a string. Independent contractors can’t use their independent judgment unless they can review their contracts independently.

Flow-down terms should specify that they only apply to the extent the terms of the prime contract apply to the work of the subcontractor. After all, a subcontractor only agrees to perform a portion of the project, not the entire project. A steel erector who agreed to be bound by all of the terms of the prime contract, would be responsible for a finished project and not just the erection of the structural steel. Furthermore, flow-down terms should specify that the subcontractor has all the *rights* against the contractor that the contractor has against the owner under the prime contract documents, and should not merely refer to the *obligations and duties* existing under the prime contract documents. One-sided flow-down provisions give the subcontractor all the downside of the prime agreement without any of the upside. As noted above, all industry standard documents, without exception, flow-down rights and remedies, as well as obligations and duties. Subcontractors can’t agree to be liable for damages to the contractor that the owner has waived, and can’t agree to be powerless to seek payment for items of work that the contractor is permitted to claim from the owner. Subcontractors are in the business to make profits, not to perform work for free or at a loss.

Finally, the terms of the subcontract form, which are actually negotiated between the parties, must take precedence over any inconsistent terms in the other contract documents. Why spend time negotiating a subcontract agreement if its terms might not even apply? Again, the entire point of having a written contract is to ensure a clear understanding and clear expectations. A precedence clause that fails to give priority to the one contract document that both parties negotiate creates the opposite situation, and encourages the parties to find ways to spring surprises on each other as the project progresses.

Conclusion

A contract is an exchange of promises, written down to ensure that all parties to the agreement have properly understood each other and agreed to the same thing. Devices which work contrary to the purpose of ensuring a clear understanding must therefore be inherently suspect and suggestive of unfair and sharp dealing practices. Terms inconsistent with the subcontractor’s right to have a copy of complete agreement, including all the written promises to which the subcontractor is bound, put the subcontractor in an extraordinarily vulnerable position. A construction subcontractor is a creditor, who provides work and materials on credit for a promise of future payment. Inability to review the contract terms for lack of a copy of some or all of those terms is unacceptable. Similarly, any terms which leave doubt as to which terms have

precedence over other, inconsistent terms, are also contrary to the fundamental purpose of a written contract to ensure a clear understanding. Finally, terms which "flow-down" the obligations of other contract documents must also "flow-down" the rights and remedies of those documents as well, or else create even more surprises for lack of clarity, as it may not always be clear how to distinguish an "obligation" from a "right" in the first place. Subcontractors should insist that references to contract documents outside of their written agreement be fair, even-handed, and be supplemented with actual copies of the referenced documents.