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A CFM'S GUIDE TO DRAFTING *Sensible & Useful Subcontracts*



Contractors plan for and price their work using sophisticated estimating and scheduling techniques and software and by including contingencies in their pricing.

But they do not always approach contract drafting with the same formalities, and the contract documents of even the most sophisticated GCs and subcontractors often include large gaps in risk allocation that cannot be addressed by pricing alone.

When subcontract drafting is approached systematically and early, the contracting process itself can be a powerful tool to help identify and manage potential problems and risk areas.

This article describes common bottom line contract terms and a methodical approach to subcontract drafting that results in terms that help, rather than hinder, management of a project.

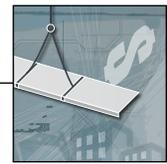
GCs and subcontractors alike can apply the principles identified in this article and dramatically decrease their risk exposure.

THE ISSUE: MARKET TRENDS REQUIRE IMPROVED SUBCONTRACTING FUNDAMENTALS

Owners continue to shift risks to the GCs and subcontractors, being guided by finance and management principles that encourage less owner risk in large capital projects.

This trend is not only evident in the increasing owner preference toward firm pricing, but owners are also asking contractors to bid more frequently on conceptual design, and then complete the design in connection with the construction work. This seemingly minor change can shift risks associated with design errors from the owners to the contractors.

The broader trend of shifting construction risks to contractors has overlapped other trends that increase contractor exposure. For example, GCs increasingly



rely on subcontractors (and, indirectly, sub-subcontractors) to perform greater aspects of project work. Technology that is incorporated into projects is becoming more complex and sometimes unproven. Building materials are increasingly regulated and changing, and may be sourced from multiple countries with different construction standards than in the U.S.

The recent economic downturn not only decreased the number of available, capable, and qualified professionals, but the departure of many individuals from the industry has taken a toll on long-standing, trusted relationships. The GC finds itself bridging ever-increasing gaps of contractual risks amongst a growing group of interested parties.

The way work is awarded doesn't help the subcontracting process. Owners typically begin their contracting process before the GC may even know of the project. The owner will assess its technical requirements, scheduling needs, financial projections, legal obligations and appetite for various aspects of construction risks.

GCs, in turn, often simultaneously receive draft commercial terms and project specifications, and are given little time to provide a technical proposal and take exception to the owner's proposed commercial terms.

While contractors use PMs, schedulers, and estimators to estimate and plan each item of work, a short bidding period and the desire to "get the work in the door" may cause contractors to not only forego serious negotiations of commercial terms, but also to discount the importance of carefully reviewing them.

All of these trends combine to increase contractor risk and are driving the need for improved subcontracting fundamentals.

THE SOLUTION: SOUND SUBCONTRACTING FUNDAMENTALS

It's important to approach this process similar to performing work on a project – one step at a time.

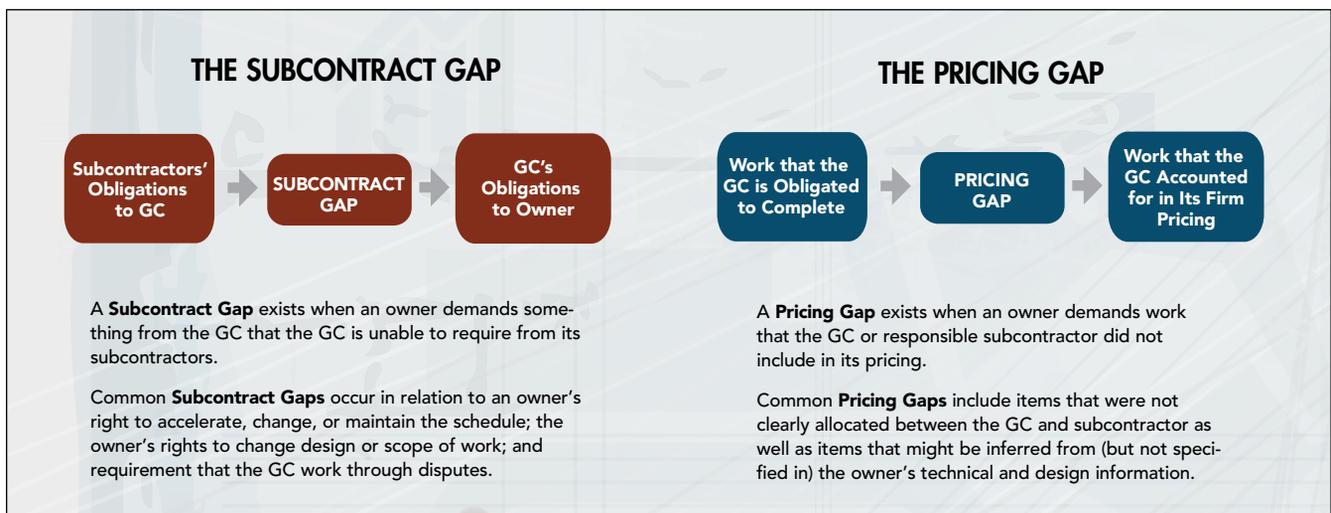
Step #1: Appoint a Contracting Team

Relying on purchase order forms for construction support or direct labor won't cut it. Subcontract forms that you've "always used" should only be considered as a starting point, not required forms.

In order to achieve sensible and useful subcontracts, you must first select a team that has the skills and time to conduct a thorough contract review. It's critical to have personnel familiar with construction contracting principles as well as the work to be performed.

For example, at a minimum, your contracting team should consist of someone with experience drafting or administering construction contracts (an attorney, if circumstances allow), an operations person that understands how the work will practically be performed in a "real world" environment, and a finance person who understands the financial risk and milestones that must be weathered to keep the project profitable.

A thorough effort by this team will ensure that the most common Subcontract and Pricing Gaps (see Exhibit below) are identified and addressed appropriately.



Step #2: Mind the Gaps

The contracting team should understand each provision of the prime and subcontract documents and confirm they make sense from an operational perspective.

The team must consider which aspects of a project are critical and understand how certain bottom line contract provisions will affect these critical aspects of the project. A detailed checklist is provided at the end of this article to help with this process.

All projects have certain aspects with narrow margins for error and a disproportionate impact on the project schedule. The GC needs contractual leverage to manage the project for the benefit of all parties involved, including dealing with unexpected circumstances or changes that may threaten these critical aspects of work.

Some critical aspects of a project may be obvious (such as getting a building pad ready so a foundation can be poured).

However, identifying the less obvious aspects and understanding how to manage them requires a degree of familiarity that comes from day-to-day involvement in project planning.

Step #3: Conduct a Page-By-Page Review to Ensure Obligations & Rights Flow Down Appropriately

The contracting team should engage in a process – literally, a page-by-page comparison of the work to be performed and the prime contract and subcontract terms – to ensure that the prime and subcontracts are consistent and allow for successful and profitable completion.

Because the GC is responsible to the owner, a subcontractor's responsibilities should be consistent with the GC's responsibilities to the owner. Thus, relying unquestioningly on old subcontract forms invites (and almost ensures) large Subcontract and Pricing Gaps.

For example, if the owner directs a change in the design or construction of some aspect of the project, the GC often needs to require additional action (or inaction) by its subcontractors – even if such actions are not spelled out in the original subcontract. Likewise, even when the owner directs changes, the prime contract may require notice of price changes be

accompanied by a fixed price change quotation. If the GC does not follow the contractual change process, or worse yet, if the subcontractor responsible for a changed scope of work is not required to assist in that process, then the owner may be relieved from paying for valid additional costs.

Subcontract provisions that refer to or incorporate certain aspects of the prime contract – often called flow-down provisions – enable a GC to plan and coordinate a construction project more effectively. However, despite the practical need for some consistency, overly inclusive flow-down provisions may be unfair and may not always make sense. The challenge for GCs and subcontractors is to identify which terms should flow down and how to draft clear provisions that make sense under the circumstances.

Step #4: Test the Process to Achieve the Desired Outcome

Experience teaches that doing things the right way takes time. And in order for any process to achieve a desired outcome, it must not only objectively and predictably lead to that outcome, but process must also be followed.

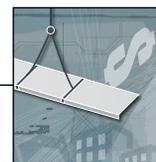
This article lays out an objective process for arriving at sensible and useful subcontracts. It is your responsibility to confirm the process is being followed.

Set aside time for a formal meeting where the contracting team walks you through the checklist and explains its answers to the questions identified in that checklist. Test the team with questions about the schedule, possible changes, and project cash flow. Contracts should not be signed unless they withstand this testing process.

CONCLUSION

You would not cut corners in the work your company performs, so why would you cut corners in the contract documents that allow you to perform the work in an organized, predictable, and profitable manner?

With some extra planning and hard work, you can apply the processes described in this article to arrive at sensible and useful subcontract documents and eliminate risky Subcontracting and Pricing Gaps that could threaten your company's financial viability. ■



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SUBCONTRACT PROVISIONS

Know Before You Sign

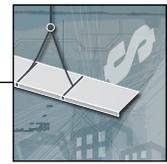
Here are some common “bottom line” contract provisions, what they mean, and the questions your contracting team should be able to answer.

| Common BOTTOM LINE Terms | Common APPORTIONMENT of Risk | Common SUBCONTRACT and PRICING GAPS | STOP and ASK YOURSELF |
|---|--|--|--|
| Venue and Dispute Provisions | Construction contracts typically define a process to resolve disputes (while work continues) through negotiation, mediation, and submittal of a claim to a neutral decision-maker. | Subcontractors that have a disproportionate impact on scheduling (e.g., because of the nature of their work, order of work, physical parameters of the site) can affect all parties to the project if a dispute arises and the GC is unable to bring all parties to the table in the same forum and process. | <p>Are the venue provisions logical and cost effective? (That is, they do not enable one party to delay or prolong disputes and, if the parties must litigate, set a logical location for proceeding.)</p> <p>Can disputes that involve several parties be resolved in a single forum?</p> <p>Does the subcontract require work to continue through disputes?</p> |
| Payment Provisions | Payment typically is conditioned upon the GC reaching certain milestones or based on percent complete. Often, payment requires some degree of owner acceptance. | When the subcontract sets payment at different intervals than the prime contract, or if the subcontractor is invoicing on a purchase order or T&M basis, the GC may end up financing more of the project than anticipated if delays occur or work needs to be reordered to support the project schedule. | <p>What deliverable documents in the prime contract are tied to the payment provision? Are those documents adequately addressed in the subcontract?</p> <p>Can payment provisions be written fairly to align the timing and amounts of payments to the subcontractor with the GC's payments from the owner?</p> <p>Are there circumstances where the subcontractor or sub-subcontractor costs greatly exceed estimates without the higher-tier contractor being able to recover those costs with change orders? If so, what is the plan to manage that?</p> <p>When a pricing gap occurs, what is the plan to monitor and manage potential pricing gaps?</p> |
| Warranty Provisions | Owners typically require GCs to provide a warranty for work that the GC will perform through subcontractors. | If the subcontractor's warranty obligations are not consistent with the GC's, the GC may have to pay for remedial work that was part of a subcontractor's scope. An example of this situation can occur when the owner's warranty rights commence at different intervals than the subcontract provides, or if the owner is not required to give notices commensurate with the requirements of the subcontract. | <p>Are the warranty periods consistent?</p> <p>Is there any circumstance where the subcontractor would be relieved of warranty obligations even if the owner correctly invoked its warranty rights?</p> <p>If so, under what circumstances and how can such gaps be managed or mitigated?</p> |
| Pay Request/ Invoicing Provisions | Owners may specify claim and lien waivers, invoice formatting, or certain information or reporting to be provided with invoices. Some owners may require that invoices be submitted using the owner's portals or software. Failure to properly invoice may delay payment. | If the subcontractor or suppliers invoice at time intervals and in a format that complicates the GC's ability to timely invoice the owner, then the GC may have to finance any delays, or worse, the owner may receive work for which the GC cannot invoice. | <p>Do the subcontracts clearly spell out the owner's requirements so that there are no unnecessary delays in payments from the owner?</p> <p>Do the subcontracts take into account the time that will be necessary for the GC to assemble and present invoices to the owner?</p> |
| Change Order and Price Change Provisions | Owners typically require formal notice within a short time period of the GC's discovery of any condition that implicates a request for additional compensation. | If the subcontractor can demand additional compensation without giving the GC sufficient time and notice to raise the issue with the owner, then the GC may unintentionally relieve the owner of having to pay for valid, additional costs. | <p>For lump-sum subcontracts covering a defined scope of work, does the subcontract clearly define the subcontractor's scope of work and mechanism to submit change orders?</p> <p>Have the notice requirements in the prime contract and subcontracts been compared, and will the GC have sufficient time and information to obtain valid price adjustments?</p> <p>For subcontractors that invoice on a T&M basis, is there a plan in place to manage and track costs?</p> |
| Indemnification | An indemnity is a promise to pay for someone else's losses. GCs are often required to indemnify owners for all types of risks and losses arising from the work, including personal injury or property damage, subcontractor and supplier claims, and other forms of losses. ¹ | Indemnity clauses are just as often too broad as they are too narrow (i.e., a GC or subcontractor can unwittingly take on obligations to pay for losses even if the indemnifying party has minimal responsibility for loss). | Are the indemnity provisions narrowly drafted to cover things like personal injury or property damages related solely to the fault of the indemnifying party? Or are they broad, covering losses such as delays and contract damages that may be the fault of multiple or other parties? |

1. To learn more about this clause, read “Indemnification: One Leg of Contract Risk Management” by Jeffrey S. Ammon in the May/June 2013 issue.

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Sensible & Useful Subcontracts



| Common BOTTOM LINE Terms | Common APPORTIONMENT of Risk | Common SUBCONTRACT and PRICING GAPS | STOP and ASK YOURSELF |
|---|--|---|--|
| Project Schedule and Owner-Directed Changes | Owners typically demand that all work be performed in strict conformance with the project specifications and schedule, and may even retain the right to direct changes while maintaining the schedule. Deviation from the schedule can result in assessment of liquidated damages or dismissal from the project and assessment of completion costs and other expenses. | If the subcontractor is not required to perform work in a manner that supports the schedule, and any changes to the pace of order of work that may be dictated by owner changes or unforeseen circumstances, then the GC will either be at risk for damages and costs that are not recoverable from the subcontractor or may have to expend additional funds to maintain the schedule. | <p>Do subcontract milestones, document submittal requirements, and completion dates align with and support each item of the project schedule?</p> <p>Are there owner obligations that must be performed before the subcontractor can begin performance? Do the prime contract and subcontracts account for the potential delay that these owner obligations may cause?</p> <p>Can the GC enforce changes in the schedule, design, or scope of work in a manner that supports the schedule (e.g., require the subcontractor to "ramp up") but allows a fair opportunity for additional compensation when appropriate?</p> <p>Does the subcontract permit the GC to step in or take over subcontractor work to support the project schedule?</p> <p>Does the subcontract contain fair but adequate termination provisions?</p> |
| Liquidated Damages | Liquidated damages are predetermined amounts that the owner can assess if the GC fails to deliver on performance or schedule criteria. Liquidated damages are often capped, but are also often cumulative (or in addition) to other remedies available in the prime contract. | If the subcontractor is not responsible for liquidated damages that relate to its scope of work, then liquidated damages triggered by subcontractor activity may not be recoverable by the GC. | <p>What is the likelihood that the subcontractor's performance can trigger liquidated damages?</p> <p>Is the subcontractor responsible for liquidated damages to the extent its actions trigger an assessment of liquidated damages by owner? If not, how can the project team otherwise manage that risk?</p> |
| Default, Remedial Work, and Termination Provisions | An owner typically will insist on the ability to terminate the GC "for cause," after a defined cure period, or "for convenience," which typically specifies what the owner will pay for work already performed. | <p>If the subcontract does not specify how an owner termination is to be treated, or if the subcontractor has greater rights to "cure" a default than the GC, then a termination can cause the GC to have a liability to the subcontractor that the GC cannot recover from the owner.</p> <p>Likewise, if the subcontractor has less rights to "cure" defects than the GC, then the subcontractor may be assessed back-charges that could have been avoided if the subcontract and general contract had consistent notice and cure periods.</p> | <p>What costs are recoverable under a termination for convenience provision in the prime contract? Is the subcontractor entitled to the full contract price or some amount beyond the termination for convenience payments for which the GC is entitled?</p> <p>Are cure periods and cure efforts consistent amongst the prime and subcontracts?</p> <p>Can the GC step in to complete work and support the project schedule?</p> |
| Design Delegation Provisions | The prime contract may require the GC to either: 1) familiarize itself with design and confirm its accuracy or 2) bid on conceptual design, leaving the detail design to the GC. This has a tendency to shift risk of design errors to the GC. The GC may have responsibility to ensure that the final construction functions as a completely compatible system. | <p>For any scope of work that is subcontracted, the GC may rely on that subcontractor to discover and identify design errors or ambiguities. If the subcontractor does not have the same obligations to recognize and report design errors, then the GC may not be able to recover any costs or design changes or any estimating shortfalls until after it is too late.</p> <p>For projects that involve multiple systems or processes that function together, performance and outputs of individual components may affect the overall output or capacity of the project.</p> | <p>If the subcontractor will be responsible for any design or completion of design, is the subcontractor performing the design and construction work for a fixed price?</p> <p>Has the subcontractor familiarized itself with design prior to bid submission? If not, what steps have been taken to assess the risk of design errors or ambiguities prior to bid submission?</p> <p>Does the subcontract require the subcontractor to perform a thorough preconstruction walk prior to commencing the work to ensure that the design is appropriate?</p> <p>Is the subcontractor required to notify the GC of any design errors or detrimental conditions?</p> <p>Does the subcontract require the subcontractor to ensure that its work, when added to the work of others, will result in a completely compatible system?</p> |
| Consequential Damage Limitation | Owners typically require that the GC waive in advance any potential claims for consequential (i.e., indirect) damages, such as lost profits, lost opportunities, or other damages that may result from a breach. Even if the owner asks the GC to waive consequential damages, the owner may not be willing to make a similar waiver. | <p>If an owner breach causes consequential damages that the GC has waived, the subcontractor might still be able to recover its consequential damages from the GC if did not similarly waive such damages.</p> <p>Likewise, if a subcontractor breach causes consequential damages, the GC may owe consequential damages to the owner, but not be able to recover such damages if the subcontract contains a broad and mutual waiver of consequential damages.</p> | <p>If the GC is required to waive consequential damages, is the subcontractor also required to waive consequential damages?</p> <p>If the owner retains the right to assert consequential damages, can the GC recover such damages against a subcontractor whose breach caused the damages?</p> |
| Passage of Title | In many projects, title passes to the owner upon acceptance of work by the owner. | There is a potential gap of time where construction may be complete and the subcontractor has moved on, but the owner has not yet accepted the work. The GC will typically retain this risk exposure but can manage it by seeking prompt acceptance of work or negotiating with the owner. | <p>When does title pass from subcontractor to GC?</p> <p>Is there a potential gap in time, and therefore obligations, between the time the GC accepts the work from the subcontractor and when the owner accepts the work from the GC?</p> <p>What provisions are in place to protect the GC against potential damage, replacement, corrections, repairs, etc., that are needed after title passes from the subcontractor to the GC but before the owner accepts the work?</p> |