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Bulletin

Contract Clauses

INTRODUCTION

Each time a mechanical contractor executes a contract to perform certain services, he pledges the assets of his company, and sometimes his personal assets, to faithfully and properly perform in accordance with the terms of the contract and will assume all the obligations, responsibilities and limitations contained in that agreement.

Therefore, it would seem prudent that he would examine all the requirements of that document to assure himself that they are proper and equitable, and that he is willing to accept all aspects of the agreement. Yet, it is all too frequent that a contractor, in his haste to sign a contract, will not read the document thoroughly, will minimize the importance of certain terms of the contract, will not explore the potential danger of certain phrases, or will simply feel willing to gamble that those "murder clauses" will never surface.

The purpose of this bulletin is to highlight many of the most dangerous clauses that are frequently found in contracts, so that the contractor or subcontractor may make a reasonable judgment regarding acceptance of those clauses, taking into consideration the possible disastrous effect it could have on his company and/or himself.

CONDITIONAL PAYMENT CLAUSES

There are two types of conditional payment clauses: "Pay When Paid" and "Pay If Paid."

The "Pay When Paid**"** clause is a typical clause that often is contained in a general contractor's agreement. The clause states that the general contractor will pay his subcontractors when he has been paid by the owner. This places the subcontractor in the position of being paid subject to the action or inaction of a third party over whom he has no control. If the owner does not pay the general contractor for any reason (lack of funds, dissatisfaction with performance of the general or some other subcontractor, or a dispute with the general), payment to the subcontractor may be delayed. Since the subcontractor has no legal relationship with the owner, he has no options for obtaining payment (other than a lien or sometimes bond suit).

Under the "Pay When Paid" clause, the courts have held that a general

contractor may not hold up payment to his subcontractors for an unreasonable length of time if the agreement merely states that he must pay the subcontractor when he receives payment from the owner. Therefore, this clause only shifts the timing of the payment because the general contractor will have to pay the subcontractor within a reasonable time, even if the owner ultimately does not pay the general contractor.

A potentially deal-breaking conditional payment clause is the "Pay If Paid" clause. This clause stipulates that payment from the owner to the contractor is a "**condition precedent**" to payment of the subcontractor. Therefore, the contractor is under no obligation to pay the subcontractor unless the owner pays the contractor. The subcontractor assumes the risk of non-payment by the owner. Some states, including California, have found these clauses invalid.

Furthermore, under the "Pay If Paid" clause, the subcontractor can even lose his lien rights under such conditions because technically the payment is not due the subcontractor until the owner pays the general contractor, which could be after the timing to file a lien. Check with local counsel regarding this issue.

There are ways of ameliorating such qualified payment clauses. For example:

1**. Insert in the contract a clause** stating that notwithstanding any other provisions of the contract, payments to the subcontractor shall not be unreasonably delayed for reasons unrelated to the subcontractor's performance.

2. **Secure a statement from the general contractor** granting the subcontractor power of attorney to act in his name to take any action against the owner that might be necessary to secure payment from the owner. This is less desirable since it requires extensive legal action and opens questions as to the owner's obligations under his contract to make payments to the general contractor.

WAIVER OF LIEN

Liens are usually the final means subcontractors have available to obtain payment for work performed, and care should be exercised in reviewing a contract to make certain that he has not directly or indirectly waived his rights to file a lien. Waiver of lien clauses can be artfully drawn so that a contractor waives those rights without being aware of it.

In some states, no lien clauses are unenforceable and in others, "no lien" projects may be legalized (usually those projects must be recorded in public documents.) On such projects, the contractors are prevented from filing liens. It is suggested that a letter be obtained from the general contractor, or any other party having a contract with the owner, stating that the work is not recorded as a "no lien" project.

Additionally, monthly partial waivers of lien forms are usually worded in such a manner that the contractor waives his lien rights up to the date of the waiver. This effectively includes retentions withheld as well as items of work performed but not yet paid. It is suggested that words relating "to the date of payment" be deleted and the words "to the extent of payment received pursuant to this waiver" be substituted.

General contractors usually require subcontractors to present their waivers of lien along with their payment requests prior to receiving payments. If a

subcontractor is reluctant to waive his lien rights before he receives payment, it is suggested that the waiver of lien be modified to read that it is a "conditional" release and is not effective until the subcontractor receives the payment due. After receipt of such payment, the subcontractor might be asked to substitute an unconditional release for past amounts received.

CANCELLATION CLAUSES

In the event of a project cancellation, many agreements only provide for payment to the subcontractor for work in place as of the date of cancellation. This does not take into consideration legitimate costs incurred or committed by the subcontractor covering work not yet incorporated in the construction. It is suggested that the contract agreement be modified to also include payment for all costs incurred up to the date of cancellation, including payment for material on hand or en route but not in place, and other charges for which the subcontractor is liable as well as any costs arising out of the termination itself (e.g., restocking charges) plus profit on all of these costs.

WORK TO THE SATISFACTION OF THE CONTRACTOR

Frequently, statements are included in the general contractor's contract to the effect that the subcontractor's work is to be "to the satisfaction of the general contractor." This unilaterally gives the general contractor the privilege of determining the compliance by the subcontractor of his contractual responsibilities and could be capriciously used. It is suggested that the entire clause be stricken as compliance with the contract documents should be the sole criterion, and not be subject to the general contractor's "satisfaction."

WAIVER OF CLAIMS BY FINAL PAYMENT

Occasionally, a contract may contain a clause stating that any pending or asserted claim is waived upon acceptance of final payment. Be careful of these clauses since merely by accepting an undisputed final payment, subcontractors could be giving up their claim rights. However, even if this clause is present, some states have declared it void and unenforceable as against public policy. Check with counsel in your state. Moreover, always preserve by written agreement with the general contractor any claims that remain outstanding at the time of final payment.

NO WAIVER OF BOND RIGHTS

Some states have declared waiver of a subcontractor's right to sue against a prime contractor's surety bond **void and unenforceable as against public policy**. It is important that you know the laws of your state in order to preserve a claim. Check with counsel in your state.

CODE COMPLIANCE

Often, contracts include provisions requiring that the subcontractor's work is to be "in compliance with governing codes." Since governing codes often involve design capacities (ventilating requirements, heating, etc.) the contractor should be certain that he does not assume these responsibilities, which should rest with the architect/ engineer through his specification requirements, but should limit such code compliance to installation methods required by public authorities.

ASSUMPTION OF GENERAL CONTRACTOR'S OBLIGATIONS TO OWNER

The subcontractor is usually required to assume to the general contractor all the obligations that the general contractor is bound through his contract with the owner. This is not an unfair requirement, but it is important that the subcontractor insist upon examining that document to assure himself that there are no objectionable features in the general contractor's agreement and that the subcontractor can accept all of the applicable requirements. Refusal by the general contractor to allow the subcontractor to check his agreement with the owner should be cause for concern.

RETENTION REDUCTION

Often the bidding documents and specifications describe the formula for reducing the retention as work progresses. When reviewing the general contractor's contract to the subcontractor, it is often noted, however, that the retention provisions are not as favorable as those mentioned in the specifications or other upstream documents. It is suggested that the subcontractor compare the two and require the general contractor to comply with the upstream documents.

"PRIMARY" INSURANCE

Contract agreements frequently require the subcontractor to provide "primary insurance" to the general contractor. This could be a dangerous clause as it may obligate the subcontractor, possibly at additional expense, to furnish more coverage to the general contractor than a general liability insurance policy normally provides. The subcontractor should check with his insurance agent when such a clause appears to see whether he has coverage, and if not, what the requirements involve.

COMPLIANCE GENERAL WITH CONTRACTOR'S CONSTRUCTION SCHEDULE

If a subcontractor is required by the general contractor's contract to comply with the general's construction schedule, it is suggested that that schedule be checked by the subcontractor before the contract is signed to make certain it can be met. Otherwise, the subcontractor is obligated to take whatever means are needed to meet the schedule (i.e., additional manpower, overtime, etc.) or face a penalty for breach of contract if he fails to meet the schedule. An alternative solution would be to insert the words "as approved by the subcontractor" where reference is made to the general contractor's schedule.

LABOR AND MATERIAL PROVISIONS

Occasionally, a contractual requirement is encountered to furnish labor and material to prevent strikes. This is a reasonable inclusion where the subcontractor has knowledge and authority to comply with trade jurisdiction requirements of the trade union with which he has an agreement and also provide material as specified and required, as long as that specified material does not violate any trade union restrictions.

The subcontractor should not, however, be in breach of contract if a dispute arises between unions relative to jurisdiction or other inter-union matters or if the material he provides, according to contract requirements, results in a union dispute. It is suggested that where such a clause appears in a contract, a qualification be inserted that it be limited

to conditions within the subcontractor's control.

Occasionally, a contract requires the subcontractor to furnish the maximum number of apprentices his union agreement allows. The subcontractor is cautioned to review the local trade collective bargaining agreement and qualify any requirement that could require an inordinate number of apprentices.

COMPENSATION FOR UNREASONABLE DELAYS

While contracts usually provide for an extension of time for delays outside the subcontractor's control, some do not allow for additional compensation. It is suggested that, where such a clause appears, the question of reasonableness be considered.

Short term delays can usually be accepted, but where delays are extensive, and not the fault of the subcontractor, he should be compensated for additional costs caused by such delays. These causes could be as basic as construction stoppages due to lack of funding, governmental intervention, changes in design, change orders involving other trades, work stoppages, etc., and it is obviously unjust to expect the subcontractor to assume all the additional expenses, such as increased labor rates and material costs, resulting from same.

Additionally, for delays caused by the owner or prime contractor or their agents during construction, check your state's laws as a clause that only extends days but not dollars might be void and unenforceable.

EXAMINATION OF WORK OF OTHER TRADES

A contract clause that requires a subcontractor to examine all other trades' work and to be responsible that his work fits, as is sometimes found, should be noted as it imposes great potential exposure upon him. This is usually the duty of the designing engineer, and the subcontractor might wish to delete this requirement.

INCLUSION OF ALL WORK WITHIN SUBCONTRACTOR UNION'S JURISDICTION

Frequently, one will find inconspicuously hidden in the contract or remotely located on one of the general sheets of the plans a notation calling for the subcontractor to include in its contract scope all work within his trade union's jurisdiction. Therefore, even though work is not included in the applicable portion of the specifications, if it comes within the jurisdiction of the union employed by the subcontractor, he becomes responsible for same. The subcontractor is cautioned to be alert for this "murder clause" and either knowingly accept this obligation or take exception to it.

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this “murder clause” and either knowingly accept this obligation or take exception to it.

PLACEMENT OF PAYMENTS INTO SEPARATE TRUST FUND

Occasionally, a clause is contained in a contract requiring a subcontractor to place all payments made by the general contractor into a separate trust fund rather than into the subcontractor’s regular account. This technically limits the use that the subcontractor can make of these payments, and he should be aware of this limitation.

BUILDERS’ RISK DEDUCTIBLE

Contracts frequently stipulate that the general contractor or owner will provide a builders’ risk insurance policy having a sizable amount as a deductible. The subcontractor should be aware of this limitation and protect himself accordingly. It is also recommended that the subcontractor review the bidding documents to make certain that the general contractor’s contract is not at variance with the bidding documents.

INDEMNIFICATION CLAUSES

Inclusion of unreasonable and excessively broad indemnification clauses might not be insurable and therefore might not be covered in contractual liability policies. These clauses should be reviewed by the subcontractor’s insurance carrier to assure that he is covered or what the impact might be. Moreover, a subcontractor should insert language limiting his indemnity obligation for damages/injuries to the extent they arise from the subcontractor’s fault or negligence.

SUMMARY

The above are examples of some of the pitfalls that are found in many contracts used by general contractors. The subcontractor would be well advised to carefully scrutinize the contracts offered him to make very certain that, in addition to those mentioned above, there are not terms contained which could place him in a dangerous position. Acceptance, modification or rejection of these is a decision that a subcontractor must make, but it should be pointed out that there are extreme exposures present and the subcontractor would be prudent to give serious thought, or to seek professional advice, before he agrees to accept them.

The information in this bulletin should not be construed as legal advice. Contact your local counsel for specific legal advice regarding the information contained in this bulletin.