

# Managing design professional risks arising out of the Prime/Subcontractor relationship

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# Agenda

Topics addressed in this presentation include:

- The Prime/Sub relationship
- Flow-down clauses
- Insurance coverage
- Termination provisions

# Learning Objectives

In this webinar we will discuss:

- Managing of the vicarious risk of Subconsultants and Subcontractors
- Understanding flow-down rights and obligations
- Contract do's and don'ts for Primes and Subs
- Managing site safety responsibilities

# Subcontract Relationships

On all but the smallest projects, the Prime Consultant is likely to have professional Subconsultants.

- Engineers who provide services such as building or geotechnical investigation may engage trade subcontractors to provide drilling, sampling and testing services.
- Engineers who provide turnkey equipment design and installation will have contracts with suppliers.

If a Sub that is providing a small but crucial part of the Prime's scope of work defaults, the default can have a domino effect on the work of other Subs, the Prime's work and the work of the Owner's other Consultants.

# Subcontract Relationships

Successful risk management includes allocating specific risks to the party that is best able to manage those risks.

Both the Prime and the Sub should carefully consider with whom they enter into a contract.

- When the Prime and Sub have not worked together before, they should exercise due diligence in deciding whether to work together.
  - Both parties should learn as much about each other as they can before signing the contract.

# Common Prime Contract Terms

*“The Architect shall be fully responsible for the acts, errors and omissions of its Subconsultants and Subcontractors.”*

Comment: Even when the Prime Contract does not explicitly include this provision, the Prime is responsible for its scope of work, whether the work is self-performed or performed by Subconsultants.

- Under the legal doctrine of *respondeat superior* (Latin for “let the master answer”), a party is responsible for (has vicarious liability for) the acts of its agents, where “agent” is a general term for someone who is working for someone else.

*“The Engineer shall not subcontract or assign any portion of this work without prior written approval from the Owner.”*

Comment: The Owner will generally have hired the Architect or Engineer based on its qualifications. Unless the proposal states that the services will be performed by someone else, the Owner can reasonably expect that the person or firm hired will perform the work.

- Even if the contract does not explicitly contain this provision, a court would likely hold that an assignment of the duties under a contract without the Owner’s agreement would be a breach of contract, particularly if the contract included representations with respect to the Consultant’s qualifications.
- Explicitly including this provision in the Subcontract can eliminate dispute over the issue.



# Common Prime Contract Terms

*“... Owner’s approval of a Subconsultant shall not in any way make Owner responsible for the Subconsultant’s acts.”*

- Even without this statement, a court would be unlikely to hold that approval of a Subconsultant makes the Owner liable for the Subconsultant’s work.
- Including this provision in the contract can eliminate disputes.

# When the Owner Requires a Specific Sub

The fact that the Owner has required that the Prime use a specific Subcontractor or Subconsultant generally does not alter the basic relationship between the Prime and the Sub, and does not make the Owner liable for the Sub's work.

- This is true even if the Owner will be paying the Sub directly.
- If the Prime has an objection to the Sub designated by the Owner or would prefer a different Sub, the Prime can certainly negotiate with the Owner.
  - However, once the Prime signs a contract with the Owner agreeing to use a certain Sub, it would be a breach of contract not to use that Sub.

**While the Prime is liable for the work of its own Subs, even if they were specified by Owner, it should not accept liability for the Owner's other Consultants.**

- Problematic contract wording: “The Consultant shall coordinate its services, the services of its Subconsultants, and the services of Owner’s other Consultants.”
- Wording like the above could make the Consultant liable for errors or delays caused by the Owner’s other Consultants. It should be changed to:
  - *“The Consultant shall coordinate its services and the services of its Subconsultants **with** the services of Owner’s other Consultants.”*

# The Owner's Other Consultants

It is not unreasonable for the Owner to want a single point of responsibility. However, this can create problems with liability.

Problematic contract wording:

*“Architect shall be responsible for ensuring that the work product of the Owner’s separate Consultants is fully integrated into the Architect’s drawings and specifications and ensuring a fully coordinated set of construction documents.”*

Change to:

*“Architect shall be responsible for **verifying** that the work product of the Owner’s separate Consultants is fully integrated into the Architect’s drawings and specifications and **producing** a fully coordinated set of construction documents. **Architect shall not be liable for delays caused by Owner’s separate Consultants and shall have no liability for any errors or omissions in Owner’s separate Consultants drawings and specifications.**”*

Incorporation by reference or flow-down (also referred to as "flow-through" and "pass-through") clauses is one of the most important issues with respect to subcontracts.

- The most common type of flow-down clause is a broadly worded clause in the subcontract. The intent of the clause is to ensure that the obligations of the Prime Contract for the portion of the work that the Sub will be doing pass down to the Sub.
- When the Sub further subcontracts certain portions of its work, it may include a similarly broadly worded clause to pass the obligations down to the Sub-subconsultant.

# Flow-Down Clause from AIA C401

## Broadly Worded

§ 1.3 To the extent that the provisions of the Prime Agreement apply to This Portion of the Project, the Architect shall assume toward the Consultant all obligations and responsibilities that the Owner assumes toward the Architect, and the Consultant shall assume toward the Architect all obligations and responsibilities that the Architect assumes toward the Owner. Insofar as applicable to this Agreement, the Architect shall have the benefit of all rights, remedies and redress against the Consultant that the Owner, under the Prime Agreement, has against the Architect, and the Consultant shall have the benefit of all rights, remedies and redress against the Architect that the Architect, under the Prime Agreement, has against the Owner. Where a provision of the Prime Agreement is inconsistent with a provision of this Agreement, this Agreement shall govern.

# Broadly Worded Flow-Down Clauses

## What is Often Used

“To the extent that the provisions of the Prime Agreement apply to this portion of the project, the Consultant shall assume toward the Architect all obligations and responsibilities that the Architect assumes toward the Owner. The Architect shall have the benefit of all rights, remedies and redress against the Consultant that the Owner, under the Prime Agreement, has against the Architect. Where a provision of the Prime Agreement is inconsistent with a provision of this Agreement, the Prime Contract shall govern.”

# Problems with Flow-Down Clauses

Often, the Prime will be using a standard subcontract with a standard flow-down clause.

- The Sub may be asked to sign the subcontract without being provided a copy of the Prime Contract.
- In some cases, the Sub may be asked to sign the subcontract before the Prime is even executed.

A Sub should not sign a subcontract without having been provided a copy of the Prime Contract.

- If Prime Contract is long and the Sub's scope of work will be relatively small, the Sub can ask that the relevant sections of the Prime Contract be marked.



# Flow-Down Provisions on Design-Build Contracts

## ConsensusDocs 420 – Standard Agreement between Design-Builder and Design Professional

*3.1 OBLIGATIONS DERIVATIVE ... To the extent that the terms of the agreement between the Owner and Design-Builder apply to the performance of the Design Professional's Services, then the Design-Builder assumes toward the Design Professional all the obligations, rights, duties, and remedies that the Owner assumes toward the Design-Builder. In an identical way, the Design Professional assumes toward the Design-Builder all the same obligations, rights, duties, and remedies that the Design-Builder assumes toward the Owner. In the event of an inconsistency among the documents, the specific terms of the ConsensusDocs 420 Standard Agreement as modified by the Parties shall govern.*

# What Actually Flows Down?

What actually flows down under a broadly worded flow-down clause is a matter of state law, but generally the substantive provisions applicable to the Subcontractor's scope of work will flow-down.

What additional provisions from the Prime Agreement will flow down depends up the state and the court. The following clauses are likely to flow down:

- The standard of care
- The indemnification and defense obligations
- Warranty obligations
- Confidentiality obligations

# What Actually Flows Down?

## What might not flow down:

- Dispute resolution provisions
- Waiver of lien rights

## What will generally require a specific agreement:

- Provisions that allow the subcontract to be assigned to the Owner if the Prime is terminated

# Qualification of the Flow-Down Obligation

The flow-down obligation can be qualified to explicitly define the Sub's Standard of Care and limit the Sub's indemnification obligations to what would be covered by professional liability insurance:

*Notwithstanding any clause in the Prime Contract or this agreement to the contrary, Subconsultant expressly disclaims all express or implied warranties with respect to the performance of its professional services, and it is agreed that the quality of such services shall be judged solely as to whether Subconsultant performed its services consistent with the professional skill and care ordinarily provided by firms practicing in the same or similar locality under the same or similar circumstances. It is further agreed that Subconsultant shall not provide indemnification of any indemnitee other than to the extent damages are caused by Subconsultant's willful misconduct or negligence, and shall not be required to defend any indemnitee against professional negligence.*

Sometimes the Prime Contract will require that any subcontract contain a flow-down clause, for example:

- *The Architect shall require its consultants to be bound by the terms of this agreement, and to assume toward the Owner all the contractual obligations and responsibilities that the Architect has assumed toward the Owner. This agreement shall control in the event of conflicts or discrepancies between such agreements with Consultants and this agreement. Any limitation or waiver of rights or remedies against, or the liability of, an Architect's Consultant shall be void, notwithstanding any terms to the contrary in such contract, unless expressly authorized in advance by the Owner.*

**When there is not a broad flow-down requirement in the Prime Contract, the Prime Contract may require that specific provisions flow down. These often include insurance requirements and confidentiality agreements, as well as more general requirements such as employment verification.**

- If the required provisions are not included in the subcontract, the Prime would be in breach of its contract.
- Even if the provisions were in the subcontract, if the Sub failed to comply with the provisions, the Prime would still be liable for the Sub's actions.

# Negotiating the Terms in a Prime Contract that will be Passed Down

When the Prime is negotiating the terms of its contract with the Owner, it needs to be aware of the terms that it will either want to pass down to its Sub or will be required to pass down.

- A Prime who agrees to unreasonable terms in the Prime Contract may have trouble negotiating contracts with its Subs
  - For example, professional liability policies do not cover defense of indemnified parties. A Prime who agrees to an indemnification clause including defense may find that its Subs will not agree to the defense requirement. This could leave the Prime responsible for the defense of a claim arising from a Sub's negligence.

# A Caution to Subconsultants

Under the legal principle of *contra referendum* (Latin for "against the drafter"), if there is ambiguity in a contract, the ambiguity will be interpreted against the party that drafted it.

- If there is no ambiguity in the contract, the contract will be interpreted according to its plain meaning.
- If a Sub signs a contract saying that it has reviewed the Prime Contract and agrees to be bound by the terms of the Prime Contract as applicable to its portion of the work, it will be held to these terms.



## Should a Subconsultant / Subcontractor be required to carry insurance?

- The short answer is “yes”:
  - Often it will be required by the Prime Contract.
  - Whether or not it is required by the Prime Contract, if there is a claim because of the Sub's work, the Prime will be vicariously liable.
  - If the Sub does not have insurance, the Prime's insurance (or the Prime itself) may end up covering the claim against the Prime that arises out of the Sub's work.

## What if a Sub does not have insurance?

- The Sub may be the only one that is able to provide the required service locally.
- The Sub may be a small (one-person) firm that provides a unique service at a rate that does justify their procuring insurance.

It becomes a business decision for the Prime:

- Are the services that the Sub will be providing likely to generate considerable risk?
- Do the advantages of using this particular Sub justify the risk that the Prime's insurance will have to cover any claims arising from the Sub's services?

## What if a Sub does not have the insurance required in the Prime Contract flow-down agreement?

- The Sub may not have the limits required.
- Subcontractors such as drilling companies that do not provide professional services often will not have professional liability insurance.

The Prime can request that the requirement in the Prime Contract be qualified:

- *The Consultant shall require that its Subconsultants carry the insurance required by this agreement, **unless otherwise approved by the Owner, where such approval shall not be unreasonably denied.***

## **Should a Prime agree to a limit of liability in a subcontract when there is no limit of liability in the Prime Contract or the limit of liability in the Prime Contract is much higher?**

- The short answer is “it depends”:
  - A Sub who has a contract for \$20k might be unwilling to agree to unlimited liability for its services, particularly when there are a lot of other Subs and it would have very little control over the costs that could accumulate.
  - A design-professional's contract with a design-builder can be particularly problematic as often the Prime Contract will carry very substantial delay penalties.

## **Should a Prime agree to a limitation of liability in a subcontract when there is no limitation of liability in the Prime Contract or the limitation of liability in the Prime Contract is much higher than what the Sub is asking for?**

As with a decision as to whether to subcontract with an entity that does not carry insurance, this is essentially a “business decision.”

- In most cases, the limits of the Sub's liability is going to be the available proceeds of its insurance policy.

# When Things Go Wrong

## Termination Provisions

The subcontract should address the termination rights of both the Prime and the Sub.

- The Prime is ultimately responsible for the scope of work in its contract with the Owner. If a Sub becomes overextended or loses a key individual, it may be unable to comply with the schedule it has agreed to. The subcontract should address this issue and give the Prime the right to bring in another firm if the Sub is not performing in accordance with the required schedule (or is not performing at all).
  - The contract should also address the use of the Sub's work product if the Sub is terminated, particularly if the Sub's work product includes proprietary specifications or design features.

# When Things Go Wrong

If the subcontract doesn't address the Prime's termination rights, the Prime can end up with a claim for terminating the Sub.

- Generally, a court will require that if a party is in breach of its contract, it must be given notice and a reasonable amount of time to cure. The required notice and cure period will be "read into" the contract by the court.
- To avoid having the Prime's right to terminate end up as a dispute, both the notice provisions and the cure period should be stated in the subcontract.
  - If the Sub does need to be terminated because it is not performing in accordance with its contractual requirements, the termination procedures must be strictly followed.

# When Things Go Wrong

## If the Sub Isn't Getting Paid

Subcontracts are often written with "pay-if-paid" clauses that make the Prime's obligation to pay the Sub contingent on the Prime's receipt of payment from the Owner.

- State law varies with respect to how these clauses are interpreted.
- Courts in some states have held that it is unfair to pass the risk of non-payment to the Sub and therefore will treat a "pay-if-paid" clause as a "pay-when-paid" clause.

Under a **"pay-if-paid"** clause, receipt of payment from the Owner is a condition precedent to the Prime's obligation to pay the Sub. If the Prime never gets paid, it has no contractual obligation to pay the Sub.

In contrast, under a **"pay-when-paid"** clause, if the Prime is never paid, it must still pay the Sub within a "reasonable amount of time."



# When Things Go Wrong

## If the Sub Isn't Getting Paid

Some Subconsultants clarify that they are not agreeing to give up their rights to payment by adding language such as the following to the payment provisions of the subcontract:

- *“In no event shall the Subconsultant be paid the undisputed amounts of any invoice more than 90 days from the date of invoice.”*

Alternatively, they can use wording adapted from the provisions in ConsensusDocs 750, standard agreement between Constructor and Subcontractor:

- *If Prime Consultant does not receive payment for Subconsultant's work from the Owner through no fault of the Subconsultant, the Prime Consultant will make payment to the Subconsultant for work satisfactorily performed within a reasonable time.*

# When Things Go Wrong

## If the Sub Isn't Getting Paid

### **Subs should require the right to suspend their services if they have not been paid.**

- A right to suspend is typically more valuable than a right to terminate. Usually the Sub would like to resume working on the project once it has been paid.
- Typical wording of a suspension clause:  
*If Architect fails to make payment within sixty (60) days of receipt of Subconsultant's invoice, such failure shall be considered cause for suspension. Subconsultant shall provide Architect with a written notice to cure and if Architect fails to make payment of the sums properly due to Subconsultant within ten (10) days, Subconsultant may suspend performance under this Agreement until payment is tendered. Subconsultant shall not responsible for any damages or delays due to such suspension.*

# Jobsite Safety Responsibilities

- An employee of an independent contractor cannot generally recover damages from the one who hired the contractor for work-related injuries. There are exceptions to this rule, however.
  - One such exception is when the hirer retained control of the work or otherwise caused or contributed to the injuries.
- Example: Individual was injured while performing electrical work at a University project. His employer was a Sub-subcontractor on the project.
- The injured worker sued the Prime Contractor, asserting that the Prime was responsible for the conditions that led to the accident.
- In finding against the Subcontractor's employee, the court explained that, "in order for a worker to recover on a retained control theory, the hirer must engage in some active participation."
  - The court further explained that, "An affirmative contribution may take the form of directing the Contractor about the manner of performance of the work, directing that the work be done by a particular made, or actively participating in how the job is done."

# Prime Contractor Found Not Responsible for Injuries Sustained by a Subcontractor's Employee

- A General Contractor (GC) was performing a build-out for a tenant (not the property owner) and retained the services of a Subcontractor for certain work. An employee of the Subcontractor was injured by falling from a ladder and subsequently sued the owner to recover its damages. The owner then sued the GC for both common law indemnification and contractual indemnification because the Owner had been found vicariously liable under the state's statutory law.
- Although the GC was not found to be either directly liable or vicariously liable for the injuries of the Subcontractor's employee, the property owners argued they were entitled to common law indemnification. They asserted the GC contractually assumed sole responsibility and control of the entire project and had the contractual authority to (1) direct, supervise and control the means and methods of plaintiff's work; and (2) institute safety precautions to protect the workers.

*McCarthy v. Turner Construction*, 953 N.E. 2d 794 (NY 2011)

# McCarthy Case Explained

- The appellate court held that in the absence of proof of any negligence or actual supervision of a Subcontractor, the mere authority the GC has to supervise the work and implement safety procedures is not a sufficient basis to require common law indemnification of the property owner.
- Although the GC interacted with both the Subcontractor and Sub-subcontractor whose employee was injured, the court found that the GC had no supervisory authority over the Sub-subcontractor's work, and it provided no tools or ladders to Subcontractors that worked at the site.
  - The court, held that because the GC "did not actually supervise and/or direct the injured plaintiff's work, [GC] is not required to indemnify the property owners under the common law."

**As is generally true in most contract negotiations, the party with the greater leverage has the ultimate decision on the terms.**

- In most contracts, this is the "upstream" party – the party that is paying for the services. However, Subs who are in high demand or have a very good reputation may have significant leverage.
- Regardless of who is dictating the terms, unless they are fair and reasonable, what starts as a minor problem can escalate into a major liability for both sides.
  - In the end, a Prime may find that a Sub who will accept uninsurable defense requirements, unreasonable indemnification requirements and unrealistically high limits of liabilities is more of a risk than a Sub who insists on negotiating reasonable terms.

# Questions?

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