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Better Manage the Four Types of Subcontractor Risk

Written by: Adrien Pickard, Construction Litigator, Shapiro Lifschitz & Schram

Subcontractor risk takes many forms. Managing the risks is one of the central challenges faced by every general contractor. Here are four types of risk posed by subcontractors and some ways to mitigate those risks.

1. CONTRACTUAL RISK

They say an ounce of prevention is worth a pound of cure. That couldn't be truer than when engaging subcontractors to perform work. Having in place a well-written, clear, and concise subcontract that details the obligations of all of the parties is the foundation of every successful subcontracting relationship. By contrast, a poorly written contract with vague terms and ambiguous responsibilities will make it difficult to enforce the subcontractor's obligations.

As such, subcontracts should use plain language that everyone can understand. They should include a specific, detailed, and thorough statement of the scope of work that identifies what the subcontractor must deliver and when. The subcontract should state how and when payments are to be made, how changes are to be addressed and how disputes will be resolved.

Subcontracts should, wherever possible, include adequate "flow down" provisions that ensure the subcontractor is delivering exactly what the owner requires from the contractor in the form, quantities, quality, and on the schedule demanded by the owner. For example, the subcontract should include a clause stating that the "subcontractor agrees to assume all obligations for the work (the subcontract scope) as set forth in the prime contract, the terms of which are incorporated by reference." This type of provision binds the subcontractor to the contractor in the same way the contractor is bound to the owner.

2. PERFORMANCE RISK

Once the obligations of the parties to the subcontract are negotiated and put in writing, the next big challenge is to ensure the subcontractor actually does what it has promised to do. Contractors should include in their subcontract requirements that the subcontractor provide regular updates on the progress of their work, thorough well-documented daily reports, and that it devote adequate resources to quality control to ensure that work is performed correctly and in accordance with the prime and subcontract specifications.

Contractors may also demand that the subcontractor secure a performance bond from a surety, which guarantees the subcontractor's performance in the event of default or insolvency. If the subcontractor fails to perform or abandons the work, the contractor may have relief against the surety, which will be required to step into the shoes of the subcontractor and complete the work (or pay to have someone else do so).

In addition to, or perhaps in lieu of, requiring that a subcontractor be bonded, contractors have the ability to take out a "subguard" insurance policy, which provides the contractor with certain protections in the event of a subcontractor default.

3. SCHEDULE RISK

The effects of the COVID-19 pandemic will continue to have significant impacts on construction projects for the foreseeable future. With global supply chains still in flux, on-time delivery of materials and availability of labor has become a major concern for contractors looking to complete work on schedule. Other global instabilities, like military conflicts in critical regions that supply needed materials, have made certain raw materials scarce or more difficult to obtain. Increased prices caused by inflation, increased shipping costs or skyrocketing raw material costs may also lead to cash flow issues that can impact the timely performance of the work.

Contractors should carefully review the force majeure clauses in their subcontracts to ensure that COVID-19 risks are properly allocated, including to specify what relief is available to the contractor and the subcontractor if shortages or material price increases are encountered. Contractors should consider including language that specifically recognizes COVID-19 as a force majeure event and provides reasonable but limited relief to subcontractors that incentivize pre-planning and appropriate cost projection but takes into account the ongoing uncertainty with price and delivery fluctuations. In most cases, the force majeure clause should mirror that found in the prime contract. Otherwise, the contractor risks creating a "gap" in the contracts where the contractor is saddled with too much COVID-19 risk by the owner without proper recourse from the subcontractor, or vice versa.

Contractors should also consider including a "No Damages for Delay" clause that limits the recovery of delay damages for causes other than those created by the contractor. The majority of states enforce these types of provisions, so long as they are unambiguous. Although each jurisdiction has its own rules on enforcement, these clauses are most commonly found unenforceable where the delay:

- Is caused by the contractor's bad faith;
- Is the result of the contractor's willful, malicious, reckless, or grossly negligent conduct; or
- Is unreasonably long and/or uncontemplated.

Contractors can also encourage on-time performance by including incentive bonuses if work is completed early or on-time. They may also consider including in the subcontract a delay liquidated damage provision that couples a guarantee by the subcontractor to complete the work by a set date with a liquidated damage amount (usually calculated daily) if the work is not completed on time. Contractors should be mindful that liquidated damage clauses will only be enforced where the damage is not considered to be a penalty for non-performance. Therefore, these clauses should be drafted to reflect the fact that damages in the event of a breach are not readily ascertainable, that the liquidated damage amount is not disproportional to the contractor's reasonably expected damage arising from the breach and that the liquidated damage is not a penalty.

4. FINANCIAL RISK

Contractors need to balance their obligations to pay their subcontractors with the need to secure adequate funds to continue to finance ongoing construction efforts. One way to maintain this balance is by negotiating payment terms that ensure the contractor receives payment from the owner before the subcontractor is paid. To achieve this, contractors may include specific and express language in their subcontracts stating that the contractor's receipt of payment from the owner is a "condition precedent" to the subcontractor's entitlement to payment. These are often referred to as pay-if-paid clauses, which many courts have held creates a condition precedent to payment. These clauses are distinct from pay-when-paid clauses, which courts have held merely set a reasonable time for payment. Several states bar the inclusion of pay-if-paid

clauses. These states include California, New York, Wisconsin, and, more recently, Virginia. In April 2022, Virginia's Governor Youngkin signed into law Senate Bill 550, which makes pay-if-paid and pay-when-paid clauses unenforceable under most circumstances. Those states that do allow such provisions require clear and specific language providing that the subcontractor bears the risk of non-payment by the owner.

Before paying a subcontractor, contractors should also insist on receiving lien and claim waivers that release the contractor from any claims by that subcontractor. These waivers should be written broadly and should include a provision that the payment by the contractor "constitutes full and complete payment for all work performed, and all costs or expenses incurred relative to the work or improvements at the property as of the date of this waiver, except for the payment of retainage." They should also include language that the subcontractor "waives, quitclaims and releases any claim for damages due to delay, hindrance, interference, acceleration, inefficiencies, or extra work, or any other claim of any kind it may have against the contractor, the owner, or any other person or entity with a legal or equitable interest in the property, as of the due date of this waiver and release." Be mindful that certain states, including Arizona, California, Florida, Georgia, Massachusetts, Michigan, Mississippi, Missouri, Nevada, Texas, Utah, and Wyoming regulate the form and content of lien waivers. For example, North Carolina recently passed legislation invalidating certain overly broad lien and claim waivers.

Lastly, contractors should consider including broad indemnity clauses that require the subcontractor to "hold harmless" the contractor from claims and liability "arising out of" the subcontractor's work. Contractors should negotiate for the inclusion of clauses that address first-party liability (e.g., claims by the contractor arising against the subcontractor for its defective work) as well as third-party liability (e.g., providing protection to the contractor against claims brought by others as a result of the subcontractor's work). Well-written clauses will include language that the subcontractor will "indemnify, defend, and hold harmless the contractor from and against any and all injuries, claims, damages, liabilities, losses, fines, penalties, demands, causes of action, suits, costs or expenses, including, but not limited to, attorneys' and professional fees and court costs, arising out of, relating to or resulting from (1) the performance of the work by, or any act or omission of, the subcontractor or anyone directly or indirectly employed by them or anyone for whose acts they may be liable; (2) any breach of the terms of the subcontract; and/or (3) the negligence or tort liability of the subcontractor or anyone directly or indirectly employed by them or anyone for whose acts they may be liable, under any theory."

Engaging with subcontractors is a necessary risk. Employing these strategies can help mitigate that risk.

About the Author

Adrien Pickard is a construction litigator in the Washington, D.C., law firm Shapiro Lifschitz & Schram. He may be reached at pickard@slslaw.com.

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