UNDERSTANDING SUBCONTRACT TERMS AND FLOW-THROUGH CLAUSES

Texas Construction Law from Start to Finish
NBI, Inc.
October 29, 2024

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I. Introduction to Subcontract Terms and Flow-Through Clauses

In any meaningful prime contract negotiation, the owner and general contractor engage in a back-and-forth until both parties are comfortable with their respective risk; however, the risk-shifting does not end there. Prime contracts generally contain broad language requiring general contractors to flow-through identical (or at least substantially similar) risks and obligations to downstream contractors and suppliers via their respective subcontracts, purchase orders, and other vendor contracts. These provisions are commonly referred to as "flow-through" clauses.

One goal of these clauses is to bind subcontractors to the same obligations and duties that the general contractor owes to the owner, thereby creating consistency among the various project contracts without creating contractual privity between the owner and downstream contractors. Another objective is to appropriately shift the risks and responsibilities associated with particular scopes of work to the downstream parties actually performing the work. In flowing-through these obligations, upstream parties ensure that there are multiple pockets to look to in the event a dispute arises on the project.

An example of a flow-through clause can be found in Section 5.3 of the AIA A201-2017 General Conditions ("A201") of the Contract for Construction:

> By appropriate written agreement, the Contractor shall 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, including the responsibility for safety of the Subcontractor's Work that the Contractor, by these Contract Documents, assumes toward the Owner and Architect. Each subcontract agreement shall preserve and protect the rights of the Owner and Architect under the Contract Documents with respect to the Work to be performed by the Subcontractor so that subcontracting thereof will not prejudice such rights, and shall allow to the Subcontractor, unless specifically provided otherwise in the subcontract agreement, the benefit of all rights, remedies, and redress against the Contractor that the Contractor, by the Contract Documents, has against the Owner. Where appropriate, the Contractor shall require each Subcontractor to enter into similar agreements with Sub-subcontractors. The Contractor shall make available to each proposed Subcontractor, prior to the execution of the subcontract agreement, copies of the Contract Documents to which the Subcontractor will be bound, and, upon written request of the Subcontractor, identify to the Subcontractor terms and conditions of the proposed subcontract agreement that may be at variance with the Contract Documents. Subcontractors will similarly make copies of applicable portions of such documents available to their respective proposed Sub-subcontractors.

Article 2 of the AIA Form A401-2017 ("A401"), the Standard Form of Agreement Between Contractor and Subcontractor, likewise includes similar language intended incorporate the prime contract's flow-through provision(s):

> The Contractor and Subcontractor shall be mutually bound by the terms of this Agreement and, to the extent that the provisions of AIA Document A201–2017 apply to this Agreement pursuant to Section 1.3 and 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 that 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 that 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 that 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.

Many times, subcontracts not only contain flow-through clauses, but will also expressly make the prime contract, general conditions, plans and specifications, and other contract documents defined "Subcontract Documents," thereby binding subcontractors to all obligations set forth in the owner-contractor agreement. Below is an example of such a clause found in Section 1.1 of the A401:

> The Subcontract Documents consist of (1) this Agreement; (2) the Prime Contract, consisting of the Agreement between the Owner and Contractor and the other Contract Documents enumerated therein, including Conditions of the Contract (General, Supplementary and other Conditions), Drawings, Specifications, Addenda issued prior to the execution of the Agreement between the Owner and Contractor and Modifications issued subsequent to the execution of the Agreement between the Owner and Contractor, whether before or after the execution of this Agreement, and other Contract Documents, if any, listed in the Owner-Contractor Agreement; (3) other documents listed in Article 16 of this Agreement; and (4) Modifications to this Subcontract issued after execution of this Agreement. These form the Subcontract, and are as fully a part of the Subcontract as if attached to this Agreement or repeated herein.

Generally speaking, incorporation provisions like the above are broader than flow-through provisions, which typically confine themselves to a select issue. However, even with broad incorporation clauses, subcontracts will often times contain express language prioritizing the terms of the subcontract over the prime contract in the event of inconsistency between the two. Such language is important because inconsistency between controlling contractual language could lead to a misunderstanding between the parties as to their associated risks, as well as gaps in the scope of responsibility for particular portions of a project.

General contractors should strive for consistency in drafting subcontracts to mirror the particular prime contract obligations that need to be passed-through to subcontractors. However, general contractors should also be mindful when negotiating a prime contract that the terms they are ultimately required to flow-through to subcontractors could impact both the subcontractor bidding pool and pricing. Subcontractors should likewise make sure to carefully study these provisions, as the terms and conditions of a flow-through clause could have a substantial impact on a subcontractor's risk. And owners should clearly call-out in the prime agreement those terms that are critical for the general contractor to flow down and not rely solely on a broad flow-through and/or incorporation provision. Ultimately, clarity as to the allocation of risk is in the best interest of all parties to a project.

II. Common Flow-Through Subcontract Terms

Every prime and subcontract is different, and, while it would be impossible to capture every theoretical flow-through scenario that could exist, the intent of this paper is to introduce some of the more common flow-through provisions seen on Texas construction projects. These include items

such as insurance obligations, indemnity, liquidated and consequential damages provisions, termination and assignment clauses, and dispute resolution provisions.[1]

A. Insurance

A project should be adequately insured from the top down with limits and requirements befitting the project. Prime contracts commonly impose certain insurance requirements and policy limits on the general contractor; however, it is important to note that the unmodified AIA construction contracts do not flow-through insurance requirements to subcontractors.[2] Therefore, it is incumbent on the owner risk team to not only carefully draft the insurance requirements and policy limits to meet the needs of the project, but to also ensure that necessary policy requirements and limits are passed through to appropriate downstream parties.

Contractual insurance provisions should carefully detail policy requirements, including required endorsements, forms, prohibitions on exclusions, and the like. Typical policy considerations are often comprised of multiple types of coverage, including Commercial General Liability, Builder's Risk, Automobile Liability, Workers' Compensation, Employer's Liability, Professional Liability, and Excess or Umbrella Liability. While it is common for the owner to require a general contractor to carry some or all of these types of coverage, whether and to what extent these requirements are flowed down to subcontractors often depends on a subcontractor's particular scope of work. It may be the case, in some instances, that a subcontractor needs to obtain the same coverages; other times, additional scope specific insurance requirements may need to be flowed down, such as crime insurance, cyber insurance, aircraft insurance, or prohibiting certain policy exclusions.

The takeaway is that properly insuring construction risks is by no means a "one size fits all" approach. Instead, contracting parties should always be mindful to carefully review and negotiate proper project-specific insurance requirements. Many times, prime contracts will also require that subcontractors name the owner and general contractor (and possibly the lender, JV partner, etc.) as "additional insureds" under certain policies, thereby allowing those parties to make claims under applicable policies for certain losses, including, in certain circumstances, the right to require the subcontractor's carrier to furnish a defense in a legal action by a third-party.[3]

B. Indemnity

Indemnity is similar, yet different, than insurance. In essence, indemnity agreements require one party—the "indemnitor"—to safeguard another party—the "indemnitee"—against certain liabilities and third-party claims.[4] Prime contracts routinely contain clauses requiring the general contractor to indemnify and hold harmless (and in some cases defend) the owner and owner-related parties from third-party claims for certain liabilities, including bodily injury and property damage.[5] Section 3.18.1 of the A201 provides an example of an indemnity clause:

> § 3.18.1 To the fullest extent permitted by law, the Contractor shall indemnify and hold harmless the Owner, Architect, Architect's consultants, and agents and

[1] This paper is intended to broadly address the impact that certain pass-through requirements might have on contracting parties, but is not intended to provide an in-depth analysis on any one topic. However, multiple sources are cited throughout to assist drafters and interested readers.

[2] *See* A102, A102, A104, A201, Exhibit A.

[3] For a more in-depth discussion on insurance requirements *see* "Contractual Insurance Requirements, Policy Forms and Endorsements" by Charles Comiskey for The Construction Law Foundation of Texas 37th Annual Construction Law Conference (2024).

[4] See *Dresser Indus. v. Page Pet., Inc.*, 853 S.W.2d 505, 508 (Tex. 1993).

[5] Joe F. Canterbury, Jr. and Brad Gaswirth, Texas Construction Law Manual § 8.3 (3d ed. Dec. 2023).

> employees of any of them from and against claims, damages, losses, and expenses, including but not limited to attorneys' fees, arising out of or resulting from performance of the Work, provided that such claim, damage, loss, or expense is attributable to bodily injury, sickness, disease or death, or to injury to or destruction of tangible property (other than the Work itself), but only to the extent caused by the negligent acts or omissions of the Contractor, a Subcontractor, anyone directly or indirectly employed by them, or anyone for whose acts they may be liable, regardless of whether or not such claim, damage, loss, or expense is caused in part by a party indemnified hereunder. Such obligation shall not be construed to negate, abridge, or reduce other rights or obligations of indemnity that would otherwise exist as to a party or person described in this Section 3.18.[6]

Indemnity clauses in construction contracts are often heavily negotiated, and parties often modify indemnity requirements to clarify, increase, or limit their scope. It is important to note, however, that many states have enacted anti-indemnity statutes that place limits on the scope of enforceable indemnity agreements. Texas' anti-indemnity statute, for example, is found in Texas Insurance Code Section 151.102, and voids certain intermediate and broad-form indemnity agreements (that is, those that purport to require the indemnitor to indemnify the indemnitee against its own negligence or fault).[7] Parties should always be mindful of the applicable state's anti-indemnity statute when drafting and negotiating contracts.

Naturally, owners and general contractors will also want indemnity from subcontractors and other downstream parties. In general, consistency amongst indemnity obligations is advisable, and indemnity provisions in prime and subcontracts should try to align to the extent possible, ensuring risk against third-party claims is adequately apportioned. Section 4.7 of the A401 requires subcontractors' indemnity obligations to mirror the requirements set forth in Section 3.18 of the A201. This standard AIA indemnity clause, referred to as "limited indemnity" or "comparative fault" indemnity, obligates a contractor to indemnify the owner to the extent of the contractor's (or its subcontractors') comparative fault in connection with the claim, loss, or liability.[8]

C. Liquidated and Consequential Damages

What are the owner's damages if the project is not completed on time? How are those damages quantified? How are those damages assessed? Many times, the answers to these questions depend on two related contractual issues—(i) liquidated damages, and (ii) consequential damages waivers.

Time is most often of the utmost importance on a construction project. From the owner's perspective, every day that a project is delivered late is lost income, in addition to other expenses an owner may incur such as interim loan and finance costs. Given that these amounts can, in some circumstances, be hard to quantify with certainty, owners and contractors may elect to stipulate to a contractual liquidated damages clause setting forth the amount of damages the non-breaching party is entitled to in the event of a delay. Often times, these clauses calculate liquidated damages on a daily

[6] Article 3.18 of the AIA A201-2017 General Conditions to the Contract for Construction.
[7] Tex. Ins. Code § 151.102.
[8] For a more in-depth discussion on indemnity see the following: "The Art of Negotiating Construction & Design Contracts" by Harrison Trammell, Kristen Sherwin, Daniel Gurwitz, and Cara Kennemer for the Construction Law Foundation of Texas' 36th Annual Construction Law Conference (2023); and "Oddities of the Texas Anti-Indemnity Statute," co-authored by D. Blake Wilson, for the Construction Law Foundation of Texas' 33rd Annual Construction Law Conference (2020).

basis, typically beginning on a date certain set forth in the contract, such as critical milestone dates or contractual substantial completion.

Contractual liquidated damages clauses are enforceable under Texas law if: (i) "the harm caused by the breach is incapable or difficult of estimation"; and (ii) "the amount of liquidated damages called for is a reasonable forecast of just compensation."[9] In determining the above, courts look to the circumstances that existed at the time the contract was made, and the party seeking liquidated damages bears the burden of showing that the liquidated damages provision, as drafted, accounts for these considerations.[10] However, note that even in the event that a liquidated damages provision is found to be unenforceable, it is still possible for a non-breaching party to instead pursue a claim for actual damages (which in some cases may be more than the liquidated damages amount).

Generally speaking, owners may prefer liquidated damages because they can incentivize contractors to complete the project on time. Likewise, contractors and subcontractors may also, in some circumstances, prefer such clauses because it allows them to quantify their risks in the event of any given set of project delays.[11] Below is an example of a contractual liquidated damages clause:

> The Construction Manager [Contractor] acknowledges and agrees that, if the Construction Manager [Contractor] fails to achieve Substantial Completion of the entire Work [*and to meet the completion requirements of the Critical Milestones, if any*] within the Contract Time as established by the Contract Documents, the Owner will sustain extensive damages and serious loss as a result of such failure. The exact amount of such damages will be difficult to ascertain.
>
> Therefore, the Owner and Construction Manager [Contractor] agree that, if the Construction Manager [Contractor] shall neglect, fail or refuse to achieve Substantial Completion of the Work by the date required by the Contract Documents for Substantial Completion of the Work [*or to meet the completion requirements of the Critical Milestones, if any*], subject to adjustments in the Contract Time as provided in the Contract Documents, then the Construction Manager [Contractor] (and its Surety, if any, in the case of default) agree to pay to the Owner as liquidated damages and not as a penalty or forfeiture, the sum of sums for each day of delay as follows:
>
> > [*Set out liquidated damages or cross-reference to an Exhibit which sets out the liquidated damages. For an [AIA] A133 Agreement, the Contract Time requirements, particularly any critical interim completion deadlines that have monetary consequences for the owner ("Critical Milestones"), may not have been finalized. If the parties are not able to establish the liquidated damages schedule at the time the A133 agreement is executed, insert "To be established in the Guaranteed Maximum Price Amendment or other Modification of the Agreement."]*
>
> Such liquidated damages are hereby agreed to be a reasonable pre-estimate of damages the Owner will incur as a result of the delayed completion of the Work or relevant portion thereof.

[9] *Atrium Med. Ctr., LP v. Houston Red C LLC,* 595 S.W.3d 188, 192 (Tex. 2022).
[10] *Id.*
[11] For a more in-depth discussion on the enforceability of liquidated damages provisions, *see* "I'm Late, I'm Late, for a Very Important Date" by John Slates for the Construction Law Foundation of Texas 36th Annual Construction Law Conference (2023).

> Such liquidated damages shall be in lieu of consequential damages resulting from Construction Manager's [Contractor's] wrongful delay in performance, including without limitation, damages for any loss of use or capital, but shall not be in lieu of any actual, direct costs incurred by Owner in supplementing, accelerating, completing, or correcting the Work resulting from Construction Manager's [Contractor's] breach of its obligations arising under the Contract, including all design and consulting costs also arising therefrom. The Owner may deduct liquidated damages described in this Subsection from any unpaid amounts then or thereafter due the Construction Manager [Contractor] under this Agreement. Any liquidated damages not so deducted from any unpaid amounts due to the Construction Manager [Contractor] shall be payable to the Owner at the demand of Owner, together with interest from the date of the demand at rate equal to the lawful rate of interest payable by the Construction Manager [Contractor.][12]

From a general contractor's perspective, if a prime contract contains a liquidated damages provision, those damages should be incorporated and passed through to subcontractors and other lower-tier parties to the extent project delays are attributable to those parties. Subcontract liquidated damages clauses do not, in all cases, need to be as robustly drafted as those in the prime contract, and can instead rely on and incorporate the prime contract's liquidated damages provision. Below is an example of such a clause:

> Liquidated Damages. Subcontractor is liable for any liquidated damages to the same extent and under the same terms as are applicable to Contractor under the Prime Contract.

Sometimes, though, it may not be feasible for a subcontractor to agree to the same daily rate set forth in the prime contract. Other times, rather than passing through the prime contract's liquidated damages provision, the contractor and subcontractor will instead negotiate their own clause providing for liquidated damages at a different rate. Bear in mind, though, that in the latter instance, the general contractor and subcontractor would then be placed in the same positions as the owner and general contractor in proving the enforceability (or lack thereof) of a contractual liquidated damages clause.

On a different, but related, note, contracting parties should also consider any applicable waiver of consequential damages when considering the issue of delay damages. Texas common law recognizes two types of damages: (i) direct damages; and (ii) consequential damages.[13] Direct damages, on the one hand, are those that are the necessary and usual result of a defendant's wrongful act—that is, they flow naturally and necessarily from the wrong.[14] On the other hand, consequential damages result naturally, but not necessarily, from the defendant's wrongful act, and which are foreseeable by the parties at the time the contract was entered.[15] In other words, to be recoverable, consequential damages must be both foreseeable and directly traceable the defendant's wrongful act.[16]

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[12] "Negotiating Tricky Clauses in Prime Contracts – The Sequel," by Robert C. Bass, Jr. and John W. Slates, for the Construction Law Foundation of Texas 32nd Annual Construction Law Conference (2019).
[13] *See DFW Int'l Airport Bd. v. Vizant Techs., LLC,* 576 S.W.3d 362, 373 (Tex. 2019).
[14] *Arthur Anderson & Co. v. Perry Equipment Corp.*, 945 S.W.2d 812, 816 (Tex. 1997).
[15] *Id.*
[16] *Id.*

Prime contracts will often contain waivers of consequential damages by one or both parties. Section 15.1.7 of the A201 General Conditions contains an example of a mutual waiver of consequential damages by the owner and contractor:

> The Contractor and Owner waive Claims against each other for consequential damages arising out of or relating to this Contract. This mutual waiver includes:
>
> .1 damages incurred by the Owner for rental expenses, for losses of use, income, profit, financing, business and reputation, and for loss of management or employee productivity or of the services of such persons; and
> .2 damages incurred by the Contractor for principal office expenses including the compensation of personnel stationed there, for losses of financing, business and reputation, and for loss of profit, except anticipated profit arising directly from the Work.

Section 6.4 of the A401 likewise contains a mutual waiver of consequential damages between the general contractor and subcontractor:

> The Contractor and Subcontractor waive claims against each other for consequential damages arising out of or relating to this Subcontract, including without limitation, any consequential damages due to either party's termination in accordance with Article 7. Nothing contained herein shall be deemed to preclude an award of liquidated damages, when applicable, in accordance with the requirements of this Agreement.

Parties should carefully consider and spell out the types of damages covered by liquidated damages clauses and consequential damages waivers. For example, the parties may contemplate liquidated damages to cover only certain types of damages arising from delays (*e.g.,* loss of use damages), but not every damage generally arising from any delay. To the extent the parties have agreed to establish liquidated damages for certain types of damages, those damages would not be waived by a corresponding waiver of consequential damages.[17] The parties may also want to clarify what is covered by the term "consequential damages," as even experienced construction lawyers (and courts) sometimes get confused in trying to distinguish between actual and consequential damages. Likewise, both owners and contractors may want to consider not including consequential damages waivers in design and consulting contracts, as professional liability (or "E&O") policies will usually cover these damages.

In summary, owners, general contractors, and subcontractors need to closely review their contracts for liquidated damages clauses, waivers of consequential damages, and any language addressing extensions of contract time in order for the parties to adequately assess their exposure in the event of project delays.[18]

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[17] Bass and Slates, Negotiating Tricky Clauses in Prime Contracts.

[18] *See* "Maybe I will, Maybe I Won't: Solving the Liquidated Damages Puzzle," by Bethany F. Beck, for The Construction Law Foundation of Texas 32nd Annual Construction Law Conference (2019) and "Impact of the Failure to Mitigate on the Enforceability of Liquidated Damages Provisions," by Brian K. Carroll and Shaina M. H. Swanson, 17 Constr. L.J. 53 (2021).

D. No Damages for Delay Clauses

No damages for delay clauses are commonly seen in owner-contractor prime agreements. As the name suggests, these clauses usually provide that in the event of a delay to a construction project, outside of an enumerated set of "excusable delays," the contractor's sole remedy for any delay is an extension of time to the construction schedule. Such clauses are generally enforceable in Texas.[19]

General contractors typically will not want to put themselves in the position of waiving delay claims against the owner, while at the same time retaining exposure from downstream contractors for the same claims. Thus, general contractors will often seek to not only include a subcontractor-specific no damage for delay clause—providing that the subcontractor is not entitled to compensation for delays caused by the subcontractor itself—but also a flow-through clause providing that the subcontractor is not entitled to damages for owner-caused delays to the same extent as the general contractor under the prime contract. Below is an example of such a clause:

> In the event that Subcontractor's performance of its Work is delayed, accelerated, or interfered with for any reason or period of time by acts or omission of the Owner, Architect, Contractor, or other subcontractors or third-parties not employed by Subcontractor, then Subcontractor shall not be entitled to any increase in the Subcontract Sum or to damages as a consequence of such delay, acceleration, or interference, except to the extent that the Prime Contract entitles Contractor to compensation for such delay, and then only to the extent of actual amounts that Contractor may, on behalf of Subcontractor, actually receive from Owner.
>
> Under no circumstance, however, shall Subcontractor be entitled to additional time or compensation if the delay is the result of acts or omissions of the Subcontractor, its sub-subcontractors, or anyone for whom Subcontractor is responsible. Subcontractor shall be liable for any damages for delay sustained by Contractor and caused directly or indirectly by Subcontractor, including, but not limited to, liquidated or actual damages for which Contractor is liable to Owner. Any such damages shall be deducted from payments due Subcontractor, and, if such damages exceed the amount of payments due, Subcontractor shall pay Contractor such excess damages upon demand.

From a general contractor's perspective, it is important to ensure that the subcontract's no-damages-for-delay provisions align with the prime contract's; otherwise, a contractor may expose itself to liability for a subcontractor's delay claims that are non-compensable under the prime contract. Along those same lines, the general contractor should also make sure that the subcontract allows for the deduction of any damages for subcontractor-caused delays directly from payments due to the subcontractor, less a general contractor find itself with the inability to actually recover such damages (or the cost of doing so becomes prohibitively expensive).

In a similar vein, to the extent a subcontract's no-damage-for-delay clause provides for recovery of money for "excusable delays" as defined in the prime contract, a general contractor should make sure to limit its obligation to pay any funds to amounts actually received from the owner for such delays. From a subcontractor's perspective, as with other risks of owner non-payment, the

[19] *See, e.g., Zachary Constr. Corp. v. Port of Houston Auth.*, 449 S.W.3d 98 (Tex. 2014).

subcontractor is likely going to have to be willing to stomach the risk of delay to the project for which the owner refuses (rightly or wrongly) to compensate the general contractor.

E. Termination/Assignment

Prime contracts generally allow both parties the ability to terminate the contract "for cause" under certain enumerated circumstances, and will also usually allow an owner (but typically not the contractor) to terminate the prime contract "for convenience"—*i.e.* for any reason. The unmodified A201 contains the following termination for convenience language:

> § 14.4.1 The Owner may, at any time, terminate the Contract for the Owner's convenience and without cause.
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> § 14.4.2 Upon receipt of notice from the Owner of such termination for the Owner's convenience, the Contractor shall
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> .1 cease operations as directed by the Owner in the notice;
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> .2 take actions necessary, or that the Owner may direct, for the protection and preservation of the Work; and
>
> .3 except for Work directed to be performed prior to the effective date of termination stated in the notice, terminate all existing subcontracts and purchase orders and enter into no further subcontracts and purchase orders.
>
> § 14.4.3 In case of such termination for the Owner's convenience, the Owner shall pay the Contractor for Work properly executed; costs incurred by reason of the termination, including costs attributable to termination of Subcontracts; and the termination fee, if any, set forth in the Agreement.

The right to terminate for convenience is usually flowed down, allowing the general contractor to terminate its subcontracts for convenience upon the owner's termination of the prime contract on the same basis. For example, Section 7.2.2 of the A401 largely mirrors the termination for convenience language above, providing the general contractor the right to terminate the subcontractor for convenience upon the owner's doing of the same; however, it is important to note that the A401 entitles the subcontractor to "reasonable overhead and profit on the Work not executed"—a distinction from the prime contract as to what each party is entitled to recover in the event of a termination for convenience. The key for the general contractor, then, is to ensure that its prime and subcontracts are consistent—that is, if the prime contract does not allow for recovery of overhead and profit on unexecuted work, such language should be removed from the subcontract and vice-versa. Otherwise, upon an owner's termination for convenience, a general contractor might be faced with a significant amount of unforeseen and unaccounted for costs to terminate its own subcontracts.

Relatedly, if the owner terminates for cause, it is important that the prime contract allow for the contingent assignment of subcontracts to the owner. Section 5.4.1 of the A201 states as follows:

> § 5.4.1 Each subcontract agreement for a portion of the Work is assigned by the Contractor to the Owner, provided that
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> .1 assignment is effective only after termination of the Contract by the Owner for cause pursuant to Section 14.2 and only for those subcontract

agreements that the Owner accepts by notifying the Subcontractor and Contractor; and

.2 assignment is subject to the prior rights of the surety, if any, obligated under bond relating to the Contract.

When the Owner accepts the assignment of a subcontract agreement, the Owner assumes the Contractor's rights and obligations under the subcontract.

§ 5.4.2 Upon such assignment, if the Work has been suspended for more than 30 days, the Subcontractor's compensation shall be equitably adjusted for increases in cost resulting from the suspension.

§ 5.4.3 Upon assignment to the Owner under this Section 5.4, the Owner may further assign the subcontract to a successor contractor or other entity. If the Owner assigns the subcontract to a successor contractor or other entity, the Owner shall nevertheless remain legally responsible for all of the successor contractor's obligations under the subcontract.

Owners should modify Section 5.4.1 to limit the owner's assumption of the contractor's rights and obligations under the subcontractor to the work performed after the owner's acceptance of the assignment. This can be accomplished by the following:

§ 5.4.1 . . . When the Owner accepts the assignment of a subcontract agreement, the Owner assumes the Contractor's rights and obligations under the subcontract <u>with regard to the Work to be performed after the acceptance of the assignment by the Owner.</u>

Additionally, the owner should add the following Section 5.3.1 requiring the owner's approval over the form of subcontract agreement to be used:

§ 5.3.1 The form of the subcontract agreements shall be reasonably satisfactorily to both the Contractor and Owner. Without limiting the foregoing or any other requirements of the Contract Documents, each subcontract agreement shall provide for the contingent assignment to the Owner as required by the Contract Documents.[20]

Lastly, general contractors must flow-through the contingent assignment obligation into its subcontracts. Article 7.4 of the A401 is generally sufficient to effectuate an assignment to the owner in the event the contractor is terminated for cause:

§ 7.4.1 In the event the Owner terminates the Prime Contract for cause, this Subcontract is assigned to the Owner pursuant to Section 5.4 of AIA Document A201–2017 provided the Owner accepts the assignment by notifying the Contractor and Subcontractor.

§ 7.4.2 Without the Contractor's written consent, the Subcontractor shall not assign the Work of this Subcontract, subcontract the whole of this Subcontract, or subcontract portions of this Subcontract.

[20] *See* "Contracts Panel (Owner, General Contractor, Subcontractor)" by Andrea Hight, Joseph Mira, and Kelly Carr for the Construction Law Foundation of Texas 34th Annual Construction Law Conference (2021).

F. Dispute Resolution

Construction litigation is often highly technical, document intensive, and expert driven. As a result, some take the view that arbitration before experienced construction lawyers (whether a single arbitrator or a panel) is a more favorable method of dispute resolution. Subscribers to this view argue that arbitration allows parties to select a uniquely qualified arbitrator with extensive knowledge and experience in the construction law realm, and that arbitration is often quicker than traditional litigation in state or federal court. Conversely, some parties prefer traditional litigation in state or federal court for procedural reasons, including the preservation of the parties' appellate rights.

Either way, parties need to be certain to identify and specify their preferred dispute resolution method. The AIA documents default to arbitration with the American Arbitration Association ("AAA") in accordance with the Construction Industry Arbitration Rules, so if the parties prefer traditional litigation, they should expressly state so in the prime contract.[21] As a side note, if parties prefer arbitration, they may also consider specifying that arbitration will conducted outside the AAA via a private arbitration proceeding, as that could potentially result in a significant cost saving to the parties.

Standard AIA language also requires mediation as a condition precedent to initiating arbitration. Industry players generally have mixed opinions on this. One line of thought is that mediation so early in the dispute is often futile and a waste of money. At the pre-litigation stage, discovery has not been exchanged, facts and damages have not been fleshed out, and the parties are usually coming off the heels of unsuccessful pre-litigation discussions. In contrast, some believe that early mediation gets adjusters involved sooner, and forces parties to better understand, and be more realistic about, their positions much sooner in the dispute resolution process.

Regardless of the method selected by the owner and general contractor, though, it is important that such requirements are consistent among the subcontracts and design contracts on the project. Many times, subcontracts will contain express provisions binding the general and subcontractor to the same dispute resolution as specified between the owner and general contractor under the prime contract. Below is a typical example of such a clause:

> Subcontractor agrees that any dispute between Contractor and Subcontractor arising out of or relating to the Work or the Subcontract shall be resolved in accordance with the dispute resolution procedures in the Owner/Contractor Contract. If Owner and Contractor agree to enter into litigation, arbitration and/or mediation with respect to any matter arising out of or relating to the Work or the Subcontract, then Subcontractor shall and does consent to, at its own cost and expense, enter into and be bound by such proceedings and shall immediately discontinue the pursuit, through the courts or otherwise, of any claims, disputes, or other matters associated with the Work or the Subcontract relating in whole or in part to the litigated, arbitrated, or mediated dispute.

Additionally, dispute resolution provisions should contain express language allowing the owner and contractor to join all parties in any proceeding (whether litigation or arbitration) where such parties are needed to fully adjudicate the claims. If a prime contract calls for arbitration but a subcontract calls for litigation, the owner and contractor might find that themselves litigating the

[21] *See* Article 15 of the A201-2017 General Conditions to the Contract for Construction.

claims in two separate dispute resolution proceedings because of the inconsistency. The end result will certainly cost the parties more money and it could result in inconsistent findings as to liability.[22]

Relatedly, another important and often-seen subcontract term is a notice of claims requirement, though the exact conditions of these provisions vary widely. Texas courts, depending on the language of these provisions, may construe them as contractual conditions precedent, thereby barring non-compliant subcontractors from bringing claims. On this topic, though, it is important to note Texas Civil Practice and Remedies Code Section 16.071, which purports to void any contractual notice of claims provision that is a condition precedent to suing for damages and that requires notification of a claim within less than 90 days from occurrence. However, the debate over a particular notice of claims provision's validity, enforceability, and compliance therewith, is typically a costly endeavor, so it is prudent for parties to take note of such contractual provisions and heed their requirements to the extent possible.

III. Additional Subcontract Clauses to Consider

Beyond the above, below are a few additional subcontract clauses that merit a brief discussion. Although perhaps not so much common "flow down" clauses as those discussed above, they are nonetheless important issues for both general contractors and subcontractors to consider in contract negotiations.

A. Contingent Payment Clauses

Many general contractors look to shift some or all of the risk of the owner's non-payment to downstream parties to the extent possible. One common way to do that in Texas is through the use of contingent payment provisions. In a nutshell, contingent payment clauses provide that a contractor's obligation to pay a subcontractor for work performed or material supplied arises only *if* the general contractor receives payment from the owner. This is commonly referred to as a "pay-if-paid" clause, which, if enforceable, effectively releases the general contractor from its payment obligations to subcontractors in the event of non-payment by the owner. Conversely, a "pay-when-paid" clause, the other type of payment provision, relates only to the timing of a general contractor's payment, but does not otherwise release a general contractor from its ultimate payment obligation.

"Pay-if-paid" clauses are enforceable in Texas, provided that the contract language is sufficiently clear that a subcontractor is assuming the risk of the owner's payment failures to the general contractor.[23] However, any ambiguity in drafting will result in Texas courts construing such clauses merely as "pay-when-paid" clauses. And even if a contract contains a valid "pay-if-paid" clause, it is still subject to the statutory scheme set forth in Texas Business and Commerce Code Chapter 56, which restricts the enforcement of "pay-if-paid" clauses in certain circumstances (and parties may not waive the statute by contractor or other means).[24]

Below are examples of "pay-if-paid" and "pay-when-paid" clauses:

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[22] *See* "The Art of Negotiating Construction & Design Contracts" by Harrison Trammell, et. al.

[23] *See, e.g., Gulf Const. Co., Inc. v. Self*, 676 S.W.2d 624, 630 (Tex. App.—Corpus Christi 1984, writ ref'd n.r.e.); *Sheldon L. Pollack Corp. v. Falcon Indus., Inc.*, 794 S.W.2d 380, 384 (Tex. App.—Corpus Christi 1990, writ denied); *C&C Rd. Constr., Inc. v. SAAB Site Contractors, L.P.*, 574 S.W.3d 576, 589 (Tex. App.—El Paso 2019, no pet.).

[24] *See* Tex. Bus. & Comm. Code §§ 56.001-.057.

Pay-if-Paid

> To the fullest extent permitted by law, Subcontractor acknowledges that Contractor's obligation to remit any payment to Subcontractor hereunder is directly contingent upon the receipt by Contractor of payment from Owner, that payment by Owner to Contractor for Subcontractor's Work shall be a condition precedent to payment by Contractor to Subcontractor and not a covenant. It is understood and agreed that Subcontractor is only entitled to payment for that portion of the Work that Contractor was expressly paid for by Owner, and Subcontractor expressly assumes the risk of nonpayment by Owner. This provision establishes a condition precedent and shall not be construed merely as a time of payment clause.

Pay-when-Paid

> Payment will be made within seven (7) days after payments are received by Contractor from Owner. In the event Contractor is not paid by Owner for work properly performed by Subcontractor, Contractor shall pay Subcontractor within forty-five (45) days of when such payment would otherwise be due, upon three days written request of Subcontractor.

In addition to contingent payment provisions, all parties should consider requirements for payment, such as necessary back-up and other documents required to be submitted. Although many times such requirements are flowed down from the owner, to the extent they are not, perhaps both the general and subcontractor should consider how cumbersome of contractual payment requirements they wish to impose, and whether one or both parties can feasibly comply with those requirements.

B. Price Escalation Clauses

Price escalation clauses have been an especially hotly-debated topic since the Covid-19 pandemic. Prior to that time, these clauses were not particularly prevalent, and many parties gave little or no thought to price escalation in what was generally viewed as an otherwise fairly stable economic market. However, with the shortage of labor and material during the pandemic leading to a widespread price fluctuation (for example, at one time lumber rose to nearly eight times its pre-pandemic price), there has been a renewed focus on these clauses.

An owner typically desires cost certainly, and is generally looking for as firm a contract price as feasible. Contractors and subcontractors, conversely, are usually unwilling to bear the risk of market escalations beyond their control. What can the parties do? One option is to include a price escalation contingency clause in the prime contract that identifies materials of concern (take the lumber example above), and sets a separate contingency for those items, with no contractor's fee or general conditions included. In that scenario, any unused contingency funds could be accounted for through a deductive change order at the end of the project. Other options could be that the general contractor requires its subcontractors to procure materials from suppliers willing to lock-in long term pricing. From the owner's perspective, this sets some outer cost control limit, and from the contractor's and subcontractor's perspective, they have some assurance that they will not be left holding the bag in the event of an unforeseen change in the market.

The takeaway is that the general contractor should consider and attempt to account for potential price escalation in the negotiation of its prime contract, and then flow that same price escalation protection down to its subcontractors. That way all parties have assurance that the risk of price escalation will be shared, in some measure, by all relevant project participants.

C. Continuation of Work Pending Default or Dispute

Depending on a particular subcontractor's bargaining power, it may or may not have the right to terminate or suspend a subcontract based on the general contractor's default. However, almost all subcontracts will contain notice of claims procedures allowing a subcontractor to place a general contractor on notice of default or notice of a dispute in work. Often times, the subcontract will spell out the exact requirements for a subcontractor to perfect such a claim, which should be strictly followed.

It is important to note, however, that most general contractors will not want a dispute with a subcontractor to cause delays to the subcontractor's work, or to the work of other subcontractors. Thus, almost all subcontracts will require a subcontractor to continue performing its work during the pendency of the dispute, less the general contractor be entitled to place the subcontractor in default and terminate the subcontract. Below is an example of such a clause:

> In the event of a controversy, dispute, or claim, Subcontractor shall continue to perform the Work in accordance with the Contractor's written direction. Failure to proceed shall constitute a material breach of the Subcontract, regardless of the ultimate outcome of the dispute. Subcontractor agrees that no controversy between the parties shall be a reason to delay or suspend the Work, unless otherwise directed by Contractor.

D. Warranties

It is common for a general contractor to provide some form of warranty of workmanship to the owner, often for a period of one year from the date of substantial completion of a project. Because the general contractor is often warranting the work performed on the entire project, it will, in turn, often want a warranty from its subcontractors for their specific scopes of work. Many times, the subcontractor's warranty will be for the same period as the general contractor's warranty to the owner, and will extend not just to the general contractor, but also to the owner, thereby allowing the owner to make a warranty claim directly against the subcontractor as well.

One point of contention with subcontractor warranties, however, can be the date of commencement. Often, a subcontractor's scope of work will be completed before substantial completion of the entire project is achieved. For example, a concrete foundation subcontractor may complete its entire scope of work months or years before the project comes anywhere near substantial completion. Should the foundation sub's one-year warranty begin to run from the date the subcontractor's own scope of work is substantially complete, or from when the entire project achieves substantial completion and the general contractor's one-year warranty period begins to run? The answer is often times left to the parties to negotiate.

As with all of the clauses discussed in this paper, the takeaway should be that ensuring continuity and conformity amongst the various contract documents is critical. Thus, the

subcontractor's warranty scope and term should be clearly defined, less a general contractor be left with the obligation to perform warranty work at the behest of the owner with no right of recourse against the downstream subcontractor.

CONCLUSION

This paper focuses on only a few of the many risks that owners, general contractors, and subcontractors must assess and attempt to mitigate the best they can on a construction project. Hopefully, though, readers take away the impression that each project is unique, and, therefore, the contours and risks associated with any given project should be carefully analyzed. Ultimately, clarity as to the allocation of risk should be the goal that all project parties strive for in negotiating prime and subcontracts.