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Understanding Flow-Down Clauses in Subcontracts

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One of the most overlooked contract provisions in a subcontract is the so-called flow-down or flow-through clause. These clauses are found in most subcontracts. The purpose of the flow-down clause is to bind the subcontractor to the terms and conditions of the prime contract – the contract between the general contractor and the owner. The prime contractor wants the terms and conditions of the prime contract referenced and incorporated in its written subcontracts to ensure sure that its subcontractors are obligated to provide everything that the prime is required to provide to the owner. Thus, if the prime contract permits the owner to audit the contractor's books and records to verify costs, the flow-down clause ensures that the contractor is also permitted to audit the subcontractor's records. A typical flow-down clause reads as follows:

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 which 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.

The language seems harmless at first glance, but it can have significant, and even disastrous, consequences if not understood. A flow-down clause does not just incorporate the prime contract. It provides that the individual terms and conditions in the documents which are referenced in the prime contract apply as between the contractor and the subcontractor to the same extent as they apply between the owner and the contractor. These clauses can impose substantial legal obligations upon a subcontractor because they can bind the subcontractor to duties and obligations that are not spelled out in the subcontract, and are instead buried in other contract documents that the subcontractor might not have seen. It is therefore critical for subcontractors to obtain a complete copy of the prime contract, including the main agreement and the general, supplementary, and any special conditions. From the general contractor's perspective, the flow-down clause is an effective way to implement the objectives of the owner and make sure the subcontractor is bound to the same extent that the general contractor is bound to the owner. However, general contractors that afford a subcontractor greater rights than they have under the prime contract are taking on risk.

Failing to read and understand the prime contract when there is a flow-down clause can come back to haunt subcontractors. A flow-down clause binds the subcontractor to the prime contract requirements involving almost everything including change orders, timing of notices, payment requirements,



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indemnification, dispute resolution, damages for delay, requirements to provide release/waiver forms, warranty obligations and insurance requirements, just to name a few.

The effect of a flow-down clause is demonstrated by the following example: A subcontractor had a claim for additional costs on a project. The subcontract did not contain a time limit by which written notice of the claim had to be provided to the general contractor. Although there had been verbal discussions about the claim, the subcontractor did not submit the claim in writing to the general contractor until near the end of the project. The general contractor cited to the prime contract, which required written notice of claims to be provided within 21 days of the date that the claim arose. The general contractor contended that the subcontractor's claim was waived because it was not submitted in writing within 21 days. The general contractor pointed to the flow-down clause and argued that the 21-day notice of claims requirement was binding on the subcontractor. The court agreed and dismissed the subcontractor's claim as untimely and waived.

In another case, a subcontractor filed suit against the general contractor seeking progress payments and payment for additional work. The subcontract did not specify any particular method of dispute resolution, so the subcontractor filed suit in court in the county where its office was located. Under the general contractor's contract with the owner, however, all disputes had to be arbitrated by a panel of three arbitrators in a county on the other side of the state. The general contractor sought dismissal of the lawsuit on the basis of the arbitration clause in the prime contract arguing that the subcontractor's claim had to be arbitrated. The court agreed and dismissed the lawsuit. This required the subcontractor to pursue its claim through arbitration with three expensive arbitrators in a city 300 miles away from its office. The subcontractor eventually settled the case for a low amount because the cost to pursue the claim was so high.

In another case, a court ruled that a no-damages-for-delay clause in the contract between the owner and the contractor was binding upon a subcontractor by virtue of the flow-down clause. As a result, the subcontractor could not recover from the general contractor, which had caused a two-year project delay and enormous additional costs to the subcontractor.

A subcontractor must protect itself from these risks by obtaining a copy of the prime contract and reviewing it carefully. If there are provisions in the prime contract that a subcontractor does not want to be bound by, the subcontract must be revised to identify clauses in the prime contract that do not flow-down.

Some subcontracts that bind the subcontractor to the obligations that the general contractor assumes toward the owner do not give the subcontractor the benefit of any *rights and remedies* that the general contractor has under the prime contract. Subcontractors should request the following language be included in the flow-down or flow-through clause:

Subcontractor shall have the benefit with respect to its customer of all the same rights, remedies and redress that the customer has pursuant to its contract with its own customer.



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This sentence gives the subcontractor all the benefits that the general contractor has under the prime contract. For example, the prime contract might specify that retainage is to be reduced to five percent when the project is fifty percent complete. With the above language giving the subcontractor the benefit of all rights, remedies and redress that the general contractor has against the owner, the subcontractor can demand reduction of its retainage at fifty percent completion as well.

One way a subcontractor can attempt to protect itself is by including a precedence provision in the subcontract. A precedence clause provides for one contract document to control over another in the event of conflicts or inconsistencies between them. A precedence clause might provide that the subcontract governs over any other inconsistent or conflicting terms in any other contract document. A general contractor would likely prefer a precedence clause that states that in the event of a conflict or inconsistency, the provision imposing the greatest burden or risk on the subcontractor shall control. If the parties have specifically negotiated certain provisions, the agreement should state that the specifically negotiated portions control.

In summary, when your customer proposes to use a contract or purchase order that references or incorporates other documents, obtaining and reviewing the incorporated documents is a must. Failing to read and understand a document incorporated by reference will not be a defense to enforcement of the provision.