# Combating Onerous Construction Project Contract Language

**WHAT HAPPENS TO** contractors and sureties when projects encounter onerous contract language? Here is a playbook on how to explain why such language harms both contractors and surety coverage and how to approach amending it.

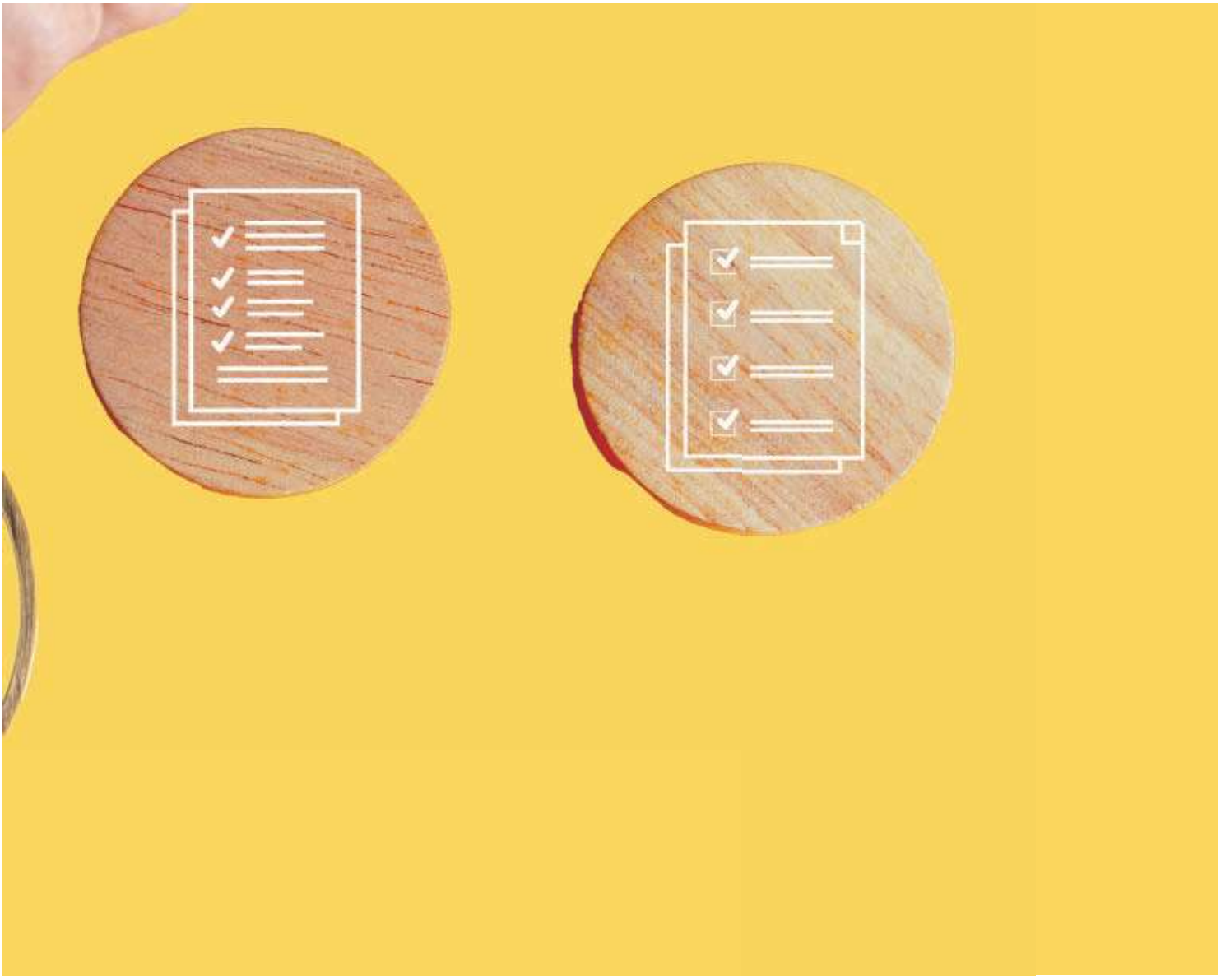
Many construction companies and owners use construction industry standard form contract documents similar to the Standard Form of Agreement between Owner and Contractor,[1] and the General Conditions of the Contract for Construction,[2] from the American Institute of Architects or one of the contracts from ConsensusDocs,[3] that integrates the general terms and conditions and the construction agreement terms into one document. In other cases, the parties may adapt the terms and conditions for their own proprietary contracts. The industry standard forms are generally more impartial, but some large general contractors (GCs) may require more stringent terms with subcontractors they have not previously worked with. In these situations, the GCs may seek to transfer a substantial portion of the risk to subcontractors.

The biggest challenge with all contracts is that many parties don't read them carefully enough, and they don't ask questions about terms or provisions that are confusing or ambiguous. Smaller subcontractors may review the contract and ask the GC to explain the terms and conditions, but those explanations may be incorrect.

Many times, when signing a contract, subcontractors don't fully appreciate what they could be held liable for. Many disagreements over terms and conditions could be resolved before the project begins if all parties read the documents carefully and agree on what the terms mean, and who will bear the risk if certain problems arise. Because of the importance of the language used in these contracts, it is strongly suggested that the subcontractor discuss the

ISTOCK.COM/CHAMPPIXS

BY OMAR J. HARB AND AUSTIN CHANDLER



contract with an attorney. If the subcontractor doesn't have in-house counsel, the firm should hire a local construction attorney to review these contracts and highlight terms that may not be as friendly to the subcontractor. While there is a cost to hiring legal counsel before the project begins, that expense could save the subcontractor significantly more costs resulting from problems that may arise during the course of construction.

Here are six common contract terms that are often misunderstood, or which may cause issues for subcontractors if any issues arise during the project.

**1) Right to Setoff**

This is one of the hottest topics in the surety industry, and it may affect whether the subcontractor will be able to get a bond and on what terms. The right to setoff arises when a contractor or subcontractor is working on multiple jobs for the same owner or GC. If a problem occurs on one job, that owner or GC can withhold funds from the downstream contractor/subcontractor on a smoothly functioning job and deduct (or set off) contract balances to cover costs on the problematic project. This eliminates many options the subcontractor might have to mitigate the damages or cure the situation. This also could cause cash flow problems for the subcontractor, especially if they are a smaller business. Problems on one project can thus lead to potential defaults on other projects—even if those other projects had been progressing without issue.

This clause is so standardized, it's difficult to negotiate. When considering a contract that includes this clause, subcontractors must make an educated decision. If they don't have another job with the same contractor or owner, agreeing to the setoff clause should not be a problem. However, it may affect their choice of whether to take another job with that GC/owner in the future. If they do, the subcontractor must be aware of the risk and anticipate potential problems.

It's also possible that the project may be in a jurisdiction where there is an equitable or common law right of setoff. The subcontractor should check with its attorney to see what the law is in that jurisdiction.

On the other hand, the jurisdiction may have a "trust fund" statute that provides that the general contractor holds contract balances in trust for subcontractors and suppliers working on that project. Such a statute may prohibit the general contractor from withholding funds on one project

to cover amounts owed by the subcontractor on another project—even if there is a "set off" right in the subcontract.

For example, a federal court in *Atlantic City Associates LLC v. Carter & Burgess Consultants, Inc.* (See 2008 U.S. Dist. LEXIS 25144 (D.N.J. Mar. 27, 2008)) held that—despite a set-off provision in the subcontract—the general contractor was not entitled to set off amounts owed by the subcontractor on one project against amounts owed to the subcontractor on a separate project. The court based its reasoning on New Jersey's Trust Fund Act, which prohibits the contractor from diverting funds for purposes unrelated to that project.

Once again, the subcontractor should consult a construction attorney regarding the existence of any trust fund statute in its jurisdiction and how that statute affects a setoff provision in the subcontract.

**2) Waiver of Consequential Damages**

Consequential damages can expose a subcontractor (and its performance bond surety) to significant damages. Because of this, many sureties won't provide a bond if the subcontract allows consequential damages (or does not contain a waiver of such damages). The good news is that even in the more onerous contracts with larger GCs, there is typically a waiver of consequential damages. In any event, subcontractors need to understand what this clause means.

In such a waiver clause, the GC and subcontractor mutually agree to forgo any consequential damages that occur. Consequential damages are uncertain and indirect, and it's difficult to define what the sheer scale of those damages could be. For example, there may be delays on an apartment construction project that can be attributed to the subcontractor. The building owner may therefore claim entitlement to lost rent for each unit in the building while it was not available for occupancy. This type of lost income could add up to hundreds of thousands of dollars the subcontractor did not anticipate. Other potential consequential damages are increased financing costs or the loss of other business opportunities.

A mutual waiver of such damages can also benefit the upstream parties (owner or GC), as a subcontractor could similarly allege various damages resulting from a delay caused by others, such as lost profits from other projects that the subcontractor could have been available to complete, if not for delays on the current project.

While owners will often agree to a mutual waiver of consequential damages, many still wish to protect themselves from the consequences of a delayed project. Accordingly, contracts often call for liquidated damages, which clearly define the amounts the subcontractor would be responsible for should the project take longer than scheduled. For example, a liquidated damages clause could specify that the GC or subcontractor would be responsible for $500 (or some other specified sum) per day for each day's delay.

GCs and subcontractors should be sure their contracts include waivers of consequential damages and closely examine the contract to determine what liquidated damages, if any, are included.

**3) "Pay If Paid" or "Pay When Paid"**

Many subcontracts include "pay if paid" clauses. These can be very burdensome for smaller subcontractors, who may have a difficult time funding construction efforts without prompt payment from the GC. The provision essentially means: "If I don't get paid, you don't get paid." With this clause, the receipt of payment from the project owner is a condition precedent to the GC's obligation to pay the subcontractor. Essentially, the clause shifts the risk of owner non-payment from the GC to the subcontractor.

If the GC doesn't receive payment, the subcontractors have no remedy because their claims are triggered only after the GC receives payment. The subcontractors wouldn't get paid even if they fully performed under the contract. Note that courts have distinguished between true "pay if paid" provisions and "pay when paid" clauses, which only affect the timing of payments to the subcontractor. To constitute a "pay if paid" clause, which could potentially act as a complete defense to a payment obligation, the clause must typically contain explicit "condition precedent" language. See e.g., *Berkel & Co. Contractors v. Christman Co.*, 533 N.W.2d 838 (1995).

One method of limiting the potentially draconian impact of such a clause on a subcontractor would be to include a requirement that the GC can only withhold payment if the reason for non-payment from the project owner to the GC was directly related to the subcontractor's scope of work. With that additional language, if the subcontractor is not the cause of non-payment from the owner to the GC, then the subcontractor should not be punished for problems caused by the GC or other subcontractors on the same job.

Recognizing how unfair a "pay if paid" provision can be to subcontractors, some states (through case law or statutes) prohibit such clauses, as being against public policy. For example, such clauses are prohibited in California, pursuant to *Wm R. Clarke Corp. v. Safeco Insurance Co.* (See 15 Cal. 4th 882, 896-97 (1997)), holding that "a general contractor's liability to a subcontractor for work performed may not be made contingent on the owner's payment to the general contractor." South Carolina has banned such provisions by statute. S.C. Code § 29-6-230 provides that "payment by the owner to the contractor or the payment by the subcontractor to another subcontractor or supplier is not… a condition precedent for payment to the construction subcontractor. Any agreement to the contrary is not enforceable."

Another way courts have lessened the harsh effects of an express "pay if paid" provision is through the "prevention doctrine." That doctrine states generally that, "when the enforceability of a contract depends on a condition precedent, one cannot avoid his liability by making the performance of the condition precedent impossible, or by preventing it." See *Whitaker v. Advantage RN*, 2012-Ohio-5959, *P30 (12th Dist. Ohio Ct. App.).

Courts have relied on the prevention doctrine to stop a GC from withholding funds from a subcontractor. In *Connelly Construction Corp. v. Travelers Casualty & Surety Company of America* (See 2018 U.S. Dist. LEXIS 123009 (E.D. Pa., July 23, 2018)), a GC withheld $200,000 in retainage from its masonry subcontractor (based on a pay if paid clause) because the owner had not paid retainage to the GC. The court noted that the owner had withheld retainage from the GC based on "serious concerns regarding both late completion and unacceptable performance of the project work" (unrelated to the subcontractor's work), and that the GC "appears to be at least partly responsible for the project delay." The court found that the "prevention doctrine" was applicable, even if the GC's actions in causing the owner to withhold retainage were "mere inadvertence" rather than deliberate. Accordingly, the court found that the GC "may not rely on the pay-if-paid clause if it is to blame for the non-satisfaction of the condition precedent."

Contractors and subcontractors should consult with local attorneys to determine whether pay if paid clauses are enforceable in their state and whether the prevention doctrine might nevertheless stop a GC from enforcing it in certain situations.

As noted previously, "pay when paid" clauses do not act as a defense to payment but only set forth timing requirements. With this clause, the subcontractor has a claim for payment as soon as the GC receives payment, or within a certain number of days thereafter.

Ideally for the subcontractor, the contract should include a time limit on how long the subcontractor has to wait for payment. For instance, is it 30, 60, or 90 days? Also, it should not depend on whether the GC receives payment. Such a provision would greatly aid small subcontractors, who otherwise may struggle with cash flow if the project owner is slow in paying the GC.

**4) Days to Cure**

When something goes wrong with a project, for example, plumbing or electrical work is not up to code, the work is not done in accordance with the plans and specifications, or the subcontractor is behind schedule, the contract typically specifies that the subcontractor has a certain amount of time to remedy the situation. The contract would require the GC to:

- give the subcontractor written notice of what is deficient,
- ask the subcontractor to remedy the problem, and
- provide a reasonable time frame within which the subcontractor can begin to fix the problem.

In most cases, if the subcontractor can't remedy within the allotted time, but is making a good faith and meaningful effort that is satisfactory to the GC, the contract is not likely to be terminated, and the GC will allow the subcontractor to keep working.

These provisions serve an important function, as they can help to avoid later disputes and can get a flailing project back on schedule. It forces the GC to articulate the problems at a point when they can be dealt with, rather than waiting until the end of the project, when rectifying the issue may be more costly and time consuming. These provisions can avoid later legal expenses by addressing issues without the need for litigation.

The standard industry contracts generally give the GC or the subcontractor seven days to cure. If there is no attempt to cure, or the attempt isn't satisfactory, the subcontractor will often be entitled to a second warning with three more days to remedy the problem. After that, the GC may have the right to terminate the contract and seek other relief against the subcontractor or its surety.

However, subcontractors need to be aware that, in some contracts, the time can be as short as 24 hours, with no

clear direction as to what the subcontractor has to do to cure the problem. The clause may state that, if the subcontractor hasn't corrected the problem within 24 hours, the GC can step in, terminate the contract, and take over all of the subcontractor's equipment. Any additional costs to complete the job on time could then be passed on to the subcontractor. Subcontractors should therefore carefully review the time limits in the subcontract and consider whether they provide the subcontractor with a realistic opportunity to correct any problems that may arise.

Most GCs have a very positive outlook on their projects and the time needed for completion. However, it's almost inevitable that something will happen to cause delays in construction at some point. The subcontractor should ensure that the contract has risk mitigation tools in place so that there is a reasonable amount of time to respond and remedy any problems that arise.

**5) Release of Retention**

Most construction contracts have a retention or holdback of 5% or 10%, depending on the percentage of completion. Although subcontractors may work on large-scale (and long-term) projects, their portion may only take a few months. However, the GC would hold any retainage owed to the subcontractors until the entire project is complete, even though the subcontractors have successfully completed their part.

Depending on the size of the project, subcontractors could be waiting for one to two years to collect retainage. For a small subcontractor, that 5% or 10% holdback could be the amount of their profit on the job, and they are not earning interest on the retention amount. Subcontractors may seek to negotiate for better terms so that they can be paid after completion of their portion of work. Even if the GC is unwilling to pay down retention prior to full job completion, it may agree to reduce the retention (from 10% to 5%, for example) prior to completion.

**6) Hazard of GC Using Supplemental Forces**

Another common clause to look out for is the ability of the GC to supplement forces of the subcontractor while using the subcontract balance to fund the supplementation. This limits the subcontractor's ability to mitigate damages while quickly eroding the subcontractor's profit on the job and losing control of the outcome of the work.

The subcontractor should seek to have this clause stricken from the subcontract, if possible. However, if this is not possible, the subcontractor should seek to negotiate very clear objective terms on what triggers the GC's ability to supplement. If the terms are subjective, it is difficult to prevent a GC from supplementing forces for their own purposes and using the subcontractor's contract balances, which are not otherwise captured in the subcontract language. At the very least, subcontractors should ensure that there is a written notice requirement and a cure period before the GC can supplement the subcontractor's work.

**Key Takeaways**

What is the best way for GCs and subcontractors to protect themselves and mitigate the risks of working on construction projects? Here are three simple rules. They should:

- **Read the contract** and make note of anything they don't understand.
- **Discuss it with a local construction attorney** and their surety professional.
- **Know what they're signing** because this will prevent a significant portion of the disputes that come up, and they will be more prepared to mitigate risks.

By always following these rules, GCs and subcontractors may be able to amend onerous contract language, resulting in more equitable contracts. Even if they are unable to revise the contractual language, subcontractors can ensure that their bid or quote takes into account the risks associated with such provisions. ●

*Omar J. Harb is Assistant Vice President of Claims at Old Republic Surety Company (www.orsurety.com), based in Michigan. Harb has over 30 years of experience as a surety, fidelity, and construction law litigator and claims handler. He has written and spoken about numerous topics in the surety and fidelity field over the years, and he has played an active role in the Fidelity and Surety Law Committee (FSLC) subsection of the American Bar Association. He is currently an Editor-in-Chief of the FSLC Newsletter and a Vice-Chair of that committee. He can be contacted at oharb@orsurety.com or 248.938.6791.*

*Austin Chandler, AFSB, is a Senior Contract Underwriter with Old Republic Surety Company, (www.orsurety.com), based in Atlanta, GA. He received his Bachelor of Business Administration in Finance from Kennesaw State University in Georgia. A member of the Old Republic Surety team since 2022, Chandler is also a graduate of the Old Republic Surety Associate Underwriting training program. Chandler can be reached achandler@orsurety.com or 770.916.1238.*

**End Notes**

1. See https://aiacontracts.com/documents?series=a-series
2. See https://aiacontracts.com/documents/a201-2017
3. See https://www.consensusdocs.org/contract-catalog/

## Find Out More

Check out the Killer Construction Contract Clauses set of NASBP Virtual Seminars for more information on onerous language: https://learn.nasbp.org/p/killer, https://learn.nasbp.org/p/killerredux. Access all NASBP Virtual Seminars here: https://learn.nasbp.org/.