

Chapter XV

SUBCONTRACTORS, RIGHTS AND REMEDIES

By: Kevin S. Hendrick
Clark Hill PLC

The purpose of this chapter is to alert both contractors and subcontractors to some of the unique aspects of the contractor/subcontractor relationship. The rights and remedies of subcontractors and general contractors in the subcontractor relationship are principally based upon the terms and conditions of the subcontract agreement. Throughout this Contractor's Guide to Michigan Construction Law, much of the information in the other chapters applies equally to the subcontractor/general contractor relationship. Rather than repeat all of the applicable contract information, this chapter will outline only the key rights and remedies of this particular relationship.

I. CONTRACT RIGHTS AND TERMS

A. General:

Regardless of the issue, dispute or event in the contractor/subcontractor relationship, the rights and remedies of the subcontractor will almost always depend on the contract terms. Moreover, although the subcontract agreement is typically very short, a key provision in the subcontract agreement, the "flow-down" clause will have the legal effect of binding the subcontractor to the general contractor, to honor all the terms and conditions of the owner-general contractor agreement. The effect of the flow-down clause can be to bind the subcontractor to contract terms it never saw. Many key contract terms are explained at length in Chapter I of this Guide, written by Joseph DeLave. An explanation of the impact of Pay-When-Paid, Liquidated Damages, No-Damage For-Delay, Incorporation by Reference and Flow-Down clauses is set forth in Chapter I. These clauses will be applied in the same manner, whether found in a general contract or subcontract, and accordingly, the reader is referred to Chapter I.

B. Indemnification:

Although Chapter I contains a full explanation of contract indemnity provisions, the particular application of a common indemnity provision to subcontractors merits an added word.

In Michigan, an agreement to indemnify (or hold someone harmless) for their own negligence is enforceable. As long as the intent of the parties to require indemnification is clearly set out, the contract will be enforced. Michigan does have, in the construction setting, an anti-indemnity statute, which forbids one party from being indemnified for its "sole negligence." However, this statute provides only the slightest restriction on a broad indemnity requirement in a subcontract. For example, in a typical subcontract, the subcontractor will be required to indemnify the general contractor "for all losses, claims, injuries or damages which arise out of or relate to the work." If there is an injury or loss that was principally caused by the general contractor, the subcontractor will still be required to provide full indemnity and cover all of the loss. Only if the general contractor is 100 percent responsible, will indemnity be barred. If the general contractor is 99% responsible, and 1% of the responsibility lies elsewhere, with anyone, the subcontractor will still be required to make the general contractor whole. Remember too that indemnity is not insurance, and is not linked to insurance. The duty of the subcontractor to indemnify may be in addition to the duty to provide insurance coverage, and the existence of an insurance policy, paid for by the subcontractor, to cover the general contractor, may not limit the general contractor from choosing to seek indemnity from the subcontractor instead of insurance coverage. The simple lesson for subcontractors is that the indemnity provisions of the subcontract can be very onerous, and they should be fully understood before the subcontract is signed.

C. Termination Provisions:

Generally speaking, a subcontract can be terminated by one party if it has been materially breached by the other party. Examples of material breaches include nonpayment, anticipatory breach, an unprepared site,

and a contractor interfering with a subcontractor's operations. The parties should be able to look to the subcontract for their rights, duties and obligations in the face of a termination event.

Additionally, a termination "for convenience" may arise if the contractor or owner is given the right to terminate the contract, if it becomes economically unfeasible to continue the project. In such a case, the general contractor and/or subcontractor will only be compensated for completed work and costs incurred up until the date of termination. Compensation in the event of termination for convenience should be clearly spelled out in the subcontract.

D. Privity of Contract:

Generally, before one party can sue another for breach of contract, there must be a contractual relationship between those two parties. This can pose a problem in the construction context, as subcontractors and owners are not in privity with each other. Their only relationship arises through the owner/contractor and contractor/subcontractor relationships. Michigan case law has recognized a few situations where a claim can be brought by a subcontractor directly against an owner, even though no direct contract exists, such as a negligence or interference theory.

E. Differing Site Condition Clauses:

A differing site condition is a physical condition other than the weather or act of God which affects a site and somehow is different from what was reasonably expected or anticipated of the site based on the contract documents. The condition must be physical, and cannot be a change resulting from economic, labor or political conditions. The differing condition may have been in existence at the time the contract was made, or it could have come into existence after the contract was awarded. It can consist of unknown and unusual conditions not ordinarily encountered in the kind of work provided for in the contract. For a thorough analysis of differing site condition clauses, please refer to Chapter IV of this Guide.

F. Inspection:

Most construction contracts contain provisions requiring contractors to inspect the site, the contract documents and the preceding work of others; and many such provisions state conclusively that such inspections have taken place. Subcontractors need to be aware of such clauses, as they are often included in subcontracts, or are incorporated into the subcontract via the flow-down clause.

The affect of an inspection provision is to place the risk of unsuitable sites or underlying work on the subcontractor. If, after inspecting the site or the underlying work, the subcontractor proceeds to place its own work after it, it will be deemed to have accepted those conditions. Along with that acceptance comes the responsibility for correcting its work should the underlying site or work prove to be unsuitable. Therefore, it is ideal if the subcontractor can inspect the site as best as possible in order to avoid the risk of unsuitable site or underlying work conditions. This can often be impractical or even impossible. If an inspection requirement is impossible or impractical, the subcontractor should insist on an appropriate "differing site condition" provision in the subcontract, in order to protect itself against these risks.

G. Scope of Work Provisions:

The subcontract should set out all the work that is to be done under the subcontract and all accompanying or incorporated documents. A subcontractor should demand that this provision contain a clear and concise description of the work to be done, so as to avoid an over-broad definition of the work to be done, and to eliminate any overlapping of work among subcontractors. This provision should also contain an order-of-priority clause ranking the incorporated documents, so that in the event of a conflict among those documents the contractor and subcontractor will know which governs.

This provision in the subcontract should be essentially the same as that contained in the subcontractor's bid. Also, the subcontract should state that any work not covered by the scope-of-work clause will be subject to an "extra" or "change order," provision, with a resulting price and time adjustment.

H. Change Order and Extra Work Provisions:

A change order is a modification to work already agreed upon in the subcontract. An extra is an item of work beyond the original scope-of-work that is added during the course of the project.

The subcontract should contain a provision indicating what procedures should be followed for approving change orders and extras, whatever the source of the order (i.e., changes resulting from concealed conditions on the site, changes resulting from the unavailability or increased price of materials, or a simple change of mind by the owner).

Both contractors and subcontractors should insist on a written change order (or at the least, a written work directive) specifically describing the change and an agreed price (or agreed upon method of determining price) before performing change or extra work, so to ensure there are no disputes concerning compensation for that work.

I. Notice Provisions:

These provisions are included in the contract and deal with the manner (usually writing), timing and circumstances under which a subcontractor must notify the general contractor of various events. These provisions are very dangerous, as the lack of notice can easily shift the risk. Whether a subcontractor complies with these provisions can make the difference between winning or losing a claim.

J. Insurance/Additional Insureds:

Some subcontracts contain a provision requiring that the subcontractor name the general contractor as an additional insured under its insurance program and that the subcontractor's insurance be primary. The general intent is to provide coverage for the general contractor for vicarious liability "arising out of" the negligence of its subcontractor. Subcontractors should be aware that the affect instead, may be that the subcontractor's insurance covers the general contractor even for negligent acts unrelated to the subcontractor's scope of work.

K. Retainage Provisions:

Almost all subcontracts contain this provision, which provides that a certain percentage of each progress payment (usually 5 to 10 percent) will be held as "retainage" until some later date (usually substantial completion of the job) so to insure that the project will be completed and to correct defects in the subcontractor's work.

Retainage provisions can have a negative financial impact on both general contractors and subcontractors. It is often argued that these provisions are unnecessary and counter-productive. Contractors should strive for payment in full from the owner for the completed work of subcontractors that provide work early on in the project; and, as the project nears completion, the amount of retention should be proportionally reduced.

L. Attorney Fee Provisions:

Some subcontracts contain provisions which award attorney fees to the prevailing party under any contract dispute. If the subcontract contains an arbitration clause, either expressly or via incorporation, a clause should be added to the attorney fee provision calling for the prevailing party in arbitration to be awarded attorney fees as well.

M. Forum Selection and Choice of Law Clauses:

A forum selection clause declares the court or forum in which any contract dispute will be resolved, and a choice of law clause determines which state's law will govern the contract. These clauses are particularly prevalent in subcontracts when dealing with an out-of-state general contractor.

Because these clauses can declare that any disputes will be decided in another state, and under another state's law, even if the project is taking place in Michigan, there is the potential that a subcontractor can subject itself to a state with laws unfavorable to subcontractors. Further, the subcontractor may be required to pursue any collection action or arbitration in a distant state. Therefore, subcontractors should be cognizant of these clauses whether in the subcontract, or in the owner/general contractor agreement, which may thus be incorporated into the subcontract agreement.

N. Arbitration:

A subcontract agreement will frequently have a provision requiring that any dispute concerning the subcontract be submitted to arbitration, and/or, as a prerequisite to arbitration, submitted to a facilitative mediation process. The contract provision could require that the parties use the American Arbitration Association process, or some other method of alternative dispute resolution. Note that, even if the subcontract is silent on arbitration, arbitration might be required in connection with any dispute as a result of the flow-down clause, incorporating an arbitration provision in the general contract. Subcontractors should be aware that, although the subcontract contains a provision requiring arbitration, there may be no right to add additional parties to the arbitration, and there may be no right for the subcontractor to join as a party in any arbitration between the general contractor and the owner. Such a limitation on joining parties to an arbitration is principally for the purpose of maintaining the privacy of arbitration. The impact on a subcontractor, however, could be that the subcontractor is required to assist or cooperate with the general contractor in its arbitration against the owner, but that the subcontractor can not join in as a party to the principal arbitration, and thus save itself expense and time in resolving the disputes. The subcontractor should bear in mind that arbitration provisions, like all other provisions of the subcontract, are negotiable, and if the subcontractor is going to be bound to an arbitration procedure in the general contract, the subcontractor may want to negotiate for itself the ability to join in other arbitrations, or have other parties join in its arbitration against the general contractor.

O. Bonds/Liens:

Chapter VI of this Guide deals at length with the process for complying with the Michigan Construction Lien Act, recording a claim of lien, and also the various bonding statutes for work on public jobs and how to protect one's rights. Without repeating all of the material contained in Chapter IV, suffice it to say to the subcontractor who is performing work on a private job, that in order to best protect its right to be paid for work, a subcontractor should:

1. Request a notice of commencement immediately upon obtaining a subcontract for work;
2. File and provide a notice of furnishing within 20 days of first providing labor and materials to the project; and
3. If unpaid, or if adequate assurance of payment has not been provided, record a claim of lien against the property within 90 days of the date of last furnishing of labor and materials.

Following these three steps may not guarantee that the subcontractor will get paid on every project. However, failing to follow these steps could easily limit or perhaps even void the subcontractor's right to file a claim against the property, as leverage for payment.

With regard to public projects, to protect oneself with the surety in the event the contractor does not make payment, one must follow the requirements of the bond itself and/or, the requirements of the statute. To comply with the statute, a subcontractor is required to give a statutorily mandated notice within 30 days of first providing labor or materials to the project, and again a statutorily mandated notice prior to the expiration of 90 days from last furnishing if payment hasn't been made. Frequently, the payment bond itself sets out similar, but different terms for notice, which will be enforced as long as they are less

restrictive than the notice requirements of the statute. Although nothing can guarantee payment in every instance, a subcontractor on a public job is always well advised to:

1. Request a copy of the bond immediately upon entering into the subcontract.
2. Provide notice within 30 days of first furnishing, as that notice is set forth in the statute.
3. Provide notice before the expiration of 90 days from last furnishing that full payment has not been received.

Both with regard to claims of lien and bond claims, all notices should be sent by certified mail, so that a proof of the mailing is retained.

P. Warranties:

Typically in the subcontract agreement, the subcontractor will warrant that the materials used will be new and of good quality, and conform to specifications, and that the work will conform to all contract requirements and be completed in a workmanlike manner. Further, the subcontract will require that the subcontractor obtain and forward any relevant equipment or material warranties from the manufacturer, and the subcontract may require the subcontractor to warrant all materials and work from defect for a set period of time, typically one year.

Without sounding like a broken record, the subcontractor again must be cognizant of the warranty provisions of the owner-general contractor agreement, and the breadth of the flow down clause. For example, the subcontract agreement may state only that the subcontractor must provide the manufacturers' warranty on materials, but the flow down clause may incorporate a broader provision, requiring the subcontractor itself to warrant the materials for a period of time, or to warrant materials more fully than the manufacturer.

II. BANKRUPTCY

Once a subcontractor has filed a petition for bankruptcy, the general contractor should not, without Bankruptcy Court authorization, attempt to collect from the subcontractor, or terminate an on-going subcontract agreement. Once a general contractor files a petition for bankruptcy, payments to a subcontractor may be protected by the Builder's Trust Fund Act.

Because bankruptcy is such a specialized area, please see Chapter XII of this Guide for a complete analysis of the impacts of bankruptcy on the general contractor and subcontractor.

III. BUILDER'S TRUST FUND

The Builder's Trust Fund Act (a.k.a. the Michigan Building Contract Fund Act) provides that when an owner or a general contractor makes a payment to a general contractor or a subcontractor, that money is considered a "trust fund," with the party receiving the payment acting as the trustee. The act only applies to private, and not public, projects. It includes both civil and criminal penalties for violations.

For a more thorough understanding of the implications of the Builder's Trust Fund Act, please read Chapter VI of this Guide.

IV. RELIANCE ON PROPOSAL

In the public project context, the entity accepting the bids is often obligated to accept the bid offered by the lowest, responsive and responsible bidder. If a bid is responsive, it means that it conforms in all material aspects to the terms, conditions, etc. of the solicitation. A responsible bidder is one who has demonstrated the ability to properly perform the work.

The general contractor's bid is comprised of a number of subcontractor proposals or bids. After submitting its bid to the public agency, the general contractor's bid is irrevocable for a pre-determined

period of time while the agency determines which bid it will accept. During this same time period, the subcontractor's bid to the general contractor may not be irrevocable, and if a subcontractor chooses to withdraw its bid, the general contractor could find itself in significant trouble. Some courts have determined that, through the doctrine of promissory estoppel, a subcontractor can still be held responsible for its bid to the general contractor so long as the general contractor can establish: (1) a clear and definite offer from the subcontractor (usually the bid); (2) reasonable expectation on the part of the subcontractor that the contractor would rely on its bid; (3) actual reliance by the contractor on the subcontractor's bid (i.e., use of the subcontractor's bid in preparing its own bid); and (4) detriment to the contractor as a result of its reliance on the subcontractor's bid. Subcontractors should be aware that this doctrine is not available for subcontractors to use, to obligate the general contractor to accept the subcontractor's bid if the general contractor's bid is accepted by the owner.

Chapter II provides a complete break-down of all the aspects of bidding, including references to Michigan cases dealing with these types of disputes.

V. PASS-THROUGH CLAIMS

A liquidating agreement is one way of pursuing a pass-through claim. These agreements are used when a subcontractor is trying to obtain payments from its general contractor, who is in turn involved in a dispute with the owner. The subcontractor and general contractor bind together and agree to share legal fees, and the subcontractor agrees to forgive the general contractor for the payment it seeks, unless the general contractor receives its payment from the owner.

There is a further difficulty with pass-through claims in federal construction projects, where subcontractors cannot sue the government, because it is the general contractor who is in contract with the federal government. Sometimes the general contractor will pursue a claim against the government on behalf of the subcontractor. However, such pass-through claims will often be barred by the "Severin Doctrine." Under this limitation, the general contractor can file suit against the government for damages suffered by the subcontractor, only if the general contractor has already paid the subcontractor's claim, and therefore suffered damages itself.

Endnotes

Information contained in this chapter was obtained from the following sources:

- (1) Fundamentals of Construction Law, (Carina Y. Enhada, Cheri Turnage Gatlin, Fred D. Wilshusen eds., American Bar Association 2001).
- (2) Article-"The Contract for Construction: Standard Forms and Common Risk Transferring Provisions," Joseph W. DeLave, Dickinson Wright.
- (3) Presentation Outlines-"Risk Management: Practical Keys to Managing the Time, Payment and Communication Risks in Construction" and "Construction Law Outline," John T. Clappison, Clark Hill, (2002 and 2004).
- (4) Construction Litigation: Representing the Contractor, § 10.11 (John D. Carter, Robert F. Cushman, William J. Palmer eds., 2d ed. 1992).
- (5) National Sand, Inc v Nagel Constr, Inc, 182 Mich App 327, 331 (1990).