

Unintended Consequences of Subcontract Flow-Down Clauses

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"Flow-down" or "pass-through" clauses are clauses within subcontracts that incorporate by reference the terms of the prime contract. Flow-down clauses are often found in construction subcontracts. They typically provide that the subcontractor assumes toward the prime contractor all of the duties and obligations the prime contractor assumes toward the project owner. Because they impose legal duties upon the subcontractor, flow-down clauses should be carefully considered.

An issue of concern to subcontractors is to what extent are the prime contract's assignments, allocations and disclaimers of risk incorporated into a subcontract by a general flow-down clause. As the following case reveals, the answer can be surprising.

In the recent case of *American National Electric Corp. v. Poythress Commercial Contractors, Inc.*, 604 S.E.2d 315 (N.C.App. 2004), a North Carolina court ruled that an electrical subcontractor's failure to comply with the prime contract's notice provisions regarding claims — which notice provisions were incorporated into the subcontract by a general flow-down clause — barred the subcontractor's claim for delay damages in its entirety.

In *American National*, the Town of Cary, North Carolina contracted with Poythress Commercial Contractors, Inc., the prime contractor, to construct a fire station. In September 1999, Poythress subcontracted with American National Electric Corporation (ANE) to perform electrical work for the project. ANE's subcontract, which incorporated a CPM project schedule prepared by Poythress, provided for 144 days for ANE to perform the electrical work. Ultimately, ANE spent more than 200 days on the project, due to changes to the scheduling and sequencing of ANE's work by Poythress.

In April 2000, ANE's president gave verbal notice to Poythress that ANE's work was being adversely impacted due to schedule and sequence changes made by Poythress to ANE's work. On September 20, 2000, as soon as ANE's work was completed, ANE provided Poythress with written notice of a claim for damages in an amount not less than \$52,025.00. Later, ANE sued Poythress and the architect for its delay damages.

The subcontract between Poythress and ANE contains a general flow-down clause which incorporates the notice provisions of the prime contract. The prime contract provides that

claims for delay must be made, in writing, to the project architect and owner within 21 days after the occurrence of any event giving rise to the claim or within 21 days after the claimant first recognizes the condition giving rise to the claim.

The subcontract further contains a pay-when-paid clause, which provides that

claims for extra or altered work, changes, modifications, changed conditions . . . shall be governed by provisions of the General Contract [prime contract] and the Contractor shall make payments to the Subcontractor on account of such claims only to the extent that the Contractor is paid thereof by the Owner.

Poythress defended that ANE's failure to comply with the 21-day notice provision of the prime contract defeated ANE's claim. ANE argued that the general flow-down clause is insufficient to impose the 21-day written notice requirement on ANE. Further, ANE argued that the pay-when-paid provision is rendered unenforceable by a North Carolina statute.

The Court agreed with ANE that the pay-when-paid clause is unenforceable and is therefore severed from the subcontract. However, the Court agreed with Poythress that the general flow-down clause properly incorporates the 21-day written notice provision into ANE's subcontract. Therefore, the Court ruled that ANE's claim is barred by its failure to comply with the 21-day notice provision in the prime contract.

The lesson of the *American National* case is:

- subcontractors should not assume that general flow-down clauses or incorporation by reference clauses are mere boilerplate contract language that do not need to be reviewed;
- the prime contract that is being incorporated into the subcontract should be carefully examined;
- if there are terms in the prime contract that the subcontractor would like to change, then the flow-down clause should be altered or more narrowly drafted.

In summary, subcontractors should carefully review and analyze subcontract flow-down clauses to avoid unintended consequences.