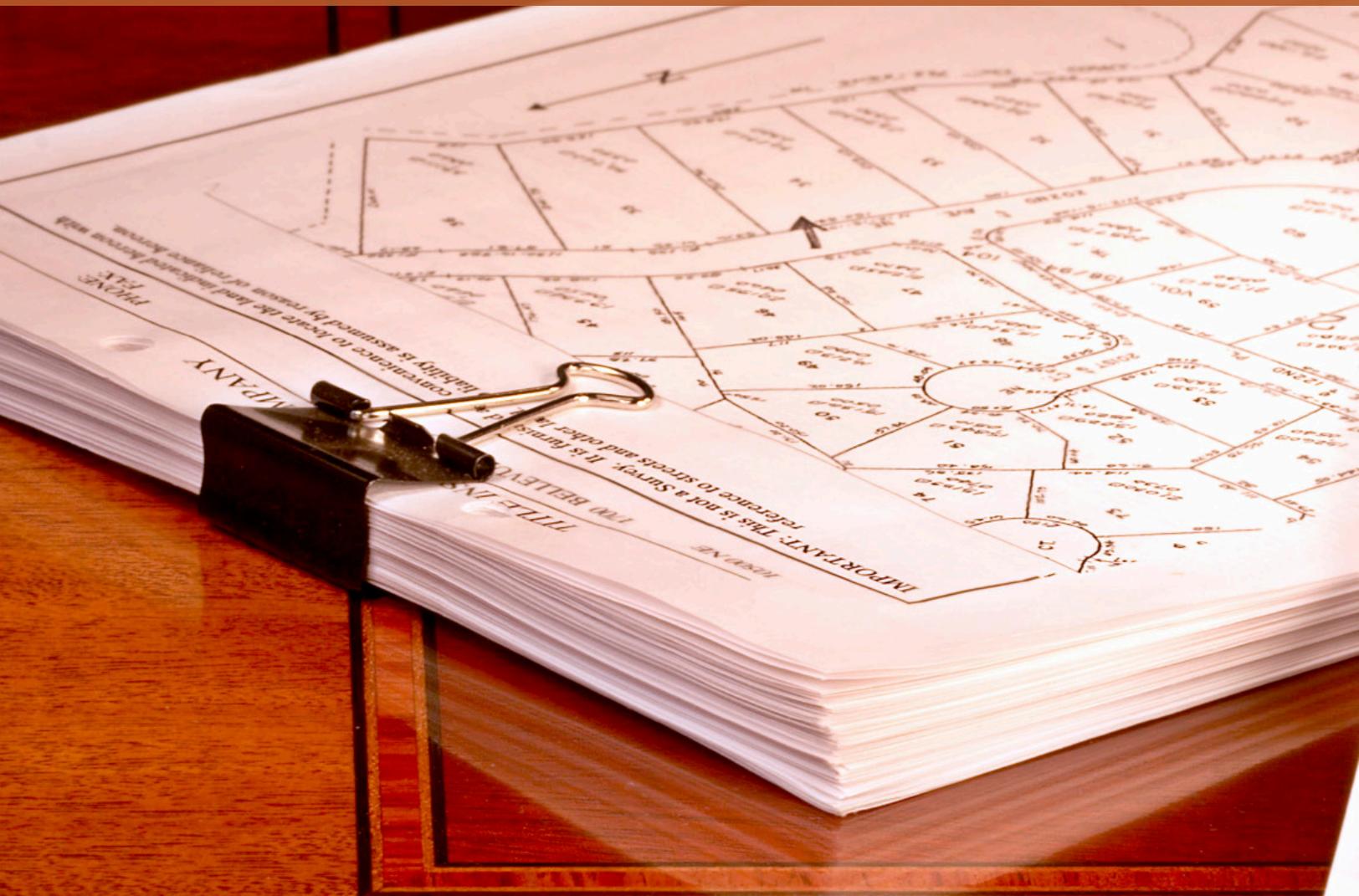


# The Importance of Carefully Reviewing Contract Terms



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# The Importance of Carefully Reviewing Contract Terms

*How "Flow-Down" Clauses Can Impact Contractual Liability*

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## I. Overview

A flow-down provision states that the terms of the contract at a higher tier are also binding on the lower-tier contractor. For instance, the subcontract between the general contractor and the electrical installer usually contains a flow-down provision stating the terms and conditions in the owner-contractor agreement are binding on the installer as well. This means there may be terms in the general contract affecting the electrical installer, even though they are not found in the subcontract.

Flow-down clauses and their interpretation are a common source of disputes with respect to construction contracts. There are a number of grounds on which a subcontract can be held to govern over the prime contract. The general rule is that if the subcontract has clearly stated the parties' intentions at the time of contracting, a flow-down clause cannot be read to render those clear intentions meaningless.

## II. Beware of Flow-Down Provisions

When an architect is hired by the general contractor under a design-build agreement, he or she may be affected by the terms in the contract between the owner and the contractor. This was the scenario in *Centex/Worthgroup, LLC v. Worthgroup Architects, L.P.* In this case, the owner contracted with Centex, a design-build contractor, for an expansion and renovation project. Centex then entered into a subcontract with the architect to perform the

design work on the project. The work of the architect included the design of a mechanically-stabilized earth (MSE) wall.

When the MSE wall subsequently began to fail, the owner demanded that Centex remedy the defects and repair the damages to the adjacent structures. Despite having demanded that the architect redesign the wall and repair the damage caused by its failure, Centex spent over \$6 million for others to redesign and repair the wall. Centex requested payment from the architect's insurance carrier and received the policy limits ? being \$3 million. Centex subsequently sued the architect for more than \$6 million in damages for the incurred redesign and repair costs. The architect filed for summary judgment, asserting that its monetary obligations had been satisfied by the payment of the insurance proceeds. The trial court granted the architect's motion and Centex appealed. The New Mexico Court of Appeals reversed the trial court's decision.

In coming to its decision to reverse the trial court's ruling, the Court of Appeals examined the wording of both the prime contract and the subcontract. The prime contract between the owner and Centex contained a "limitation of liability" clause requiring the design subcontractors to Centex to obtain errors and omissions (E&O) insurance in an amount not less than \$3 million. The clause further stated the owner agreed to limit Centex's liability to whatever sums the owner was able to collect from such insurance.

The subcontract with the architect contained a flow-down provision, which stated the architect would, except as otherwise provided, assume all rights and obligations toward Centex that Centex had toward the owner under the prime contract. The subcontract also contained an incorporation-by-reference clause, which required the architect to perform its work in strict

accordance with the prime contract and incorporated the prime contract by reference. Finally, the subcontract had a general liability clause that made the architect responsible for redesign costs and additional construction costs of Centex and/or the contractor required to correct the architect's errors or omissions.

Applying rules governing the applicability of the flow-down clauses that are widely accepted in other jurisdictions, the Court determined that the subcontract's terms regarding liability governed. The wording of the flow-down clause limited the incorporation of the prime contract into the subcontract by stating the architect "shall, except as provided herein, assume all obligations, risks and responsibilities toward Centex which Centex has assumed toward the Owner...."

Under the prime contract, Centex's liability to the owner for design defects was limited to the proceeds of the architect's errors and omissions insurance. The limitation of liability would not flow-down to the benefit of the architect, however, because the subcontract specifically addressed the allocation of liability of the architect's liability to Centex. The subcontract stated that the architect would be liable for any redesign and additional construction costs required to correct the architect's errors and omissions. No mention was made of any limitation to the responsibility.

The Court ultimately found that limitation of the liability provision in the general contract could not be reconciled with the subcontract's specific language. The Court held that since the more specific provision in the subcontract controlled, the architect was responsible for the excess costs. The Court noted that even without the flow-down clause's wording, the subcontract's allocation of liability would still prevail under general contract

interpretation principles. It is a common rule that when the prime contract has been incorporated into a subcontract through a flow-down clause, and the specific provisions of the subcontract conflict with the prime contract, the terms of the subcontract prevail.

#### IV. Takeaways

Contracts are meant to lay out the framework for the allocation of liability when things don't go as planned – i.e. which party bears responsibility for the risk for errors and omissions, and for how much. A limitation of liability clause is one way a party can set a cap on how much damage it would incur in a worst-case scenario. However, such provisions must be carefully thought out and coordinated with the remainder of the contract.

The general rule is that if the subcontract has clearly stated the parties' intentions at the time of contracting, a flow-down clause cannot be read to render those clear intentions meaningless. Many times this works to the subcontractor's advantage. In this case, however, it worked against the subcontractor due to conflicts in the terms of the subcontract and prime contract – which was incorporated by reference. The takeaway is that, in examples like this one where the architect's contract consisted of several documents including some incorporated by reference, care must be taken to ensure the whole transaction works as intended.

An attorney knowledgeable about construction law in the jurisdiction of the project should be consulted in preparing contracts. The bigger the project, the more important this becomes.

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