SUBCONTRACT DROP-DOWN AND STEP-OVER CLAUSES

By: Bill Preston

Do you know the risks which these clauses transfer to subcontractors? If not, you're in the majority. My years of experience have seldom found a contractor who adjusted their pricing of the Subcontract Work to include a margin for these risks. So, I thought I would report a couple of recent cases from Alberta and Ontario to warn you that these clauses can come back to bite a subcontractor very hard.

DROP-DOWN CLAUSES

What do they usually look like? Here's one:

> **15. The subcontractor shall supply all the labour, supervision, material, tools, and equipment necessary to construct, install and complete the following portion…**
>
> **all… in accordance with the requirements and on the terms and conditions of both the Prime Contract (including, without limitation,…general and/or special conditions…**

In the Alberta case of *Online Constructors Ltd. v. Speers Construction Inc.* this was the very term which became the eye of the storm in Court. For many years Priddis Greens Golf Club, just outside of Calgary, had depended upon an earthened dam for its water source. But, in 2005 the dam substantially failed so the Club engage AMEC to design a repair of the earthen works and a concrete spillway. AMEC thus eventually included in the Bid Documents of a Unit Price Contract a seldom used payment term:

> **The Owner to pay only for the volume of concrete as measure and required by the drawings and specifications ("neat line volume").**

Speers could do the earthworks with its own forces and equipment, but it needed a concrete trade as a subcontractor to do the spillway. It thus sent Online the drawings and spec's because Online had worked well with them on an earlier project. Online did have the requisite knowledge to phone Speers to ask what was in the Prime Contract, but Speers wasn't much help. It simply faxed back that it seemed to have "all the Standard Terms, but you should at least see it before you tender a price."

Online didn't see the Prime Contract terms; rather, it simply bid a unit price of $711.13 per m3 on the premises that the measure for concrete was actual volume poured. Speers won the project and Online, still being unaware of the neat-line measure in the Prime Contract, drafted, signed, and sent to Speers the Alberta Standard Construction Subcontract form containing the above drop-down clause. At trial, a construction expert on behalf of Speers testified that Online's decisions in this regard were careless and non-compliant with usual industry standards. My reading of what I have learned over the years is that most subcontractors are thus careless!

Unfortunately for Online, the earthwork elevations levels left by Speers required a lot more concrete than AMEC's design contemplated, and it was not until near the end of the concrete pour that Online learned that it wasn't going to be paid in full for all of this concrete because of the neat line volume cap. Online's response was to abandon the balance of its contract work and eventually Speers and Online ended up in Court, with Online claiming that it was entitled to the actual concrete poured, while Speers relied upon the drop-down clause and counterclaimed for its costs of completing Online's Work.

The trial judge concluded that the drop-down subcontract clause clearly limited Online's contractual price claim to AMEC's neat-line measure. Still, he gave Online the win by ruling that Speer's had breached its duty to disclose the peculiar neat-line payment measure term to Online when it invited Online's bid. It was this latter finding which went to the Alberta Court of Appeal; it reversed the trial judge by rationalizing:

- Speers warned Online to check the Prime Contract;
- Online had a right to see the Prime Contract and had no reasonable excuse for choosing not to;
- And, Online could have drafted the Subcontract without the drop-down clause, but having done so it was bound by the clause.

Just a note:

The CCA 1-2008 subcontract form does spec an optional drop-down term which does permit the subcontractor a little more wiggle room than the Alberta Standard Subcontract Term. It reads:

> **Article 2A**
> **2.1 The requirements, terms and conditions of the Prime Contract as far as they are applicable to the Subcontract, shall be binding upon … the Subcontractor …**

This term recently was the eye of the storm in an Ontario case, *Central Welding v. Man-Shield*, where the Judge concluded that the words "as far as they are applicable" rendered this clause less clear than the Alberta Standard Subcontract form. Thus, Manshield could not force Central Welding to pay the costs of the lien bond to vacate a construction lien as required by Man-Shield's Prime Contract.

STEP-OVER CLAUSES

How do these clauses read? Here is a common sample:

> **2. To the extent that the Contractor is required under the Prime Contract to obtain rights, powers or remedies for the direct benefit of the Owner as against the Subcontractor, the Subcontractor hereby grants such rights, powers and remedies to the Owner. The Subcontractor agrees that … the Contractor is contracting as agent for the Owner in respect of the granting of such rights, powers and remedies in favour of the Owner…**

Subcontractors in the industrial sector, particularly for petrochemical and mining projects, have had them in their contracts many times, but we are now starting to see stop-over clauses creeping beyond the industrial sector. Their principle purpose is to empower an Owner to enforce a Subcontractor to complete its work and warranties even if the General Contractor has failed. But, in this step-over, does the Owner necessarily have to pick-up the failed General's obligations to the Subcontractor, like paying defaulted progress payments and purchasing replacement insurance coverage and bonding? A recent Ontario insurance case, *Castonguay Construction (2000) v. Commonwealth Plywood* concluded, probably not. This case did not arise because of a step-over clause. Rather, the Prime Contract required the General to purchase a Wrap-up liability policy which would have included coverage for the Subcontractor's Design Consultant. But, the General never read the Prime Contract and never purchased the Wrap-up policy so, what happens when the Subcontractor's Design Consultant is sued? The Court weaseled. It concluded that because the Design Consultant was not a party to the Prime Contract it is quite possible that the Design Consultant is not able to take advantage of the Prime Contract term. For Subcontractors, this is instructive when considering the risks of a step-over clause: given the clear language in all subcontracts that the subcontractor has no contractual claims against the Owner, if the Owner steps over and enforces the subcontract remedies against the Subcontractor, the Subcontractor can't complain that the General has failed its obligations. A Subcontractor's only hope is that it has terms in the Subcontract and facts on the ground which permitted it to pull its forces.

CONCLUSION

Here, as I see it, are the lessons for Subcontractors:

1. Before pricing a job, be sure to look at the Prime Contract – you're entitled;

2. Or, if you must blindly bid/quote a job, be sure to clearly qualify your bid to proscribe drop-down clauses and step-over clauses;

3. While, if you must live with these terms in your Subcontract, then price the risk and assure that you can quickly pull your forces if the General defaults Insurance, Bonding and/or Payment obligations.