



CONTRACTPROBE



Top 10 Issues when Entering into a Subcontract



Subcontracting arrangements are a common feature of the procurement landscape. They are typically used when a company has agreed to supply goods or services and cannot supply all of them itself, and so obtains some of the supplies from another company. The subcontractor is often a specialist in providing those goods or services and so in this way the end customer can get a solution that is best of its type. At times the supplies obtained from the subcontractor are the most important part of the solution delivered to the customer.

Subcontracts perform a critical function in defining the relationship between contractors and their subcontractors. They don't need to be complicated or lengthy, but are prone to errors if not carefully drafted. This guide sets out some of the key issues to consider when entering into a subcontract. Whether from the position of the prime contractor or the subcontractor, ContractProbe can make this process more efficient, while reducing the chance of errors.

The threshold question: Copy the Prime Contract or Start with a Totally New Contract

The terms of the subcontract will nearly always be prepared by the prime contractor. A common approach is to start with a copy of the prime contract and change the party names so that references to the customer are replaced with references to the prime contractor, and references to the supplier are replaced with references to the subcontractor. Advantages of this approach include:

- Consistency between the prime contract and the subcontract.
- Quick production of the first draft of the subcontract.
- Automatic flow-down of critical obligations.

However, this approach can also raise significant challenges, such as:

- Irrelevant clauses being flowed-down.
- Dependencies of what the end customer needs to provide in order for the subcontractor to do its work can be overlooked.
- The risk allocation clauses from the prime contract can be inappropriately flowed-down to the subcontract, where a totally different risk allocation may be appropriate.

Although the mirroring approach to creating a subcontract will create a first draft quickly, there will normally need to be a lot of work on that draft before it will be fit to sign. There will often be a real question as to whether the time taken in modifying the mirrored subcontract would be better spent in preparing a subcontract which has been specifically prepared to meet the circumstances of the subcontractor's supplies.



Key Issues in a Subcontract

The types of issues that are important in any supply contract are also important in a subcontract. You can look at one of the other guides on www.contractprobe.com for information on these common issues. The following lists some of the key issues which are particularly relevant to the circumstances of a subcontract.

1. Managing Dependencies

The subcontractor's work will often require access to information or property owned by the end customer. The prime contractor and the subcontractor need to agree on how, practically speaking, those requirements will be made available to the subcontractor when they are needed. The subcontractor may not always be in direct contact with the end customer and the prime contractor and subcontractor need to agree on a process to ensure that the subcontractor gets what it needs, when it is needed, so that progress is not delayed.

TIP: Nominate a particular person within the prime contractor's team who will be responsible for handling requests from the subcontractor. This person should also be required to act as the liaison with the end customer if needed.

2. Scope of Services

The scope of services provided by the subcontractor goes to the root of the subcontract. Without a clear definition of the scope of service to be provided by the subcontractor, both parties risk confusion and later disputes. To ensure that misunderstandings do not occur and that both parties are clear as to their obligations under the contract, vague or ambiguous words should be avoided. Key issues to include are:

- The tasks that the subcontractor is expected to perform;
- The deliverables for which the subcontractor is responsible;
- The functional and performance specifications required of those deliverables;
- The timeline the subcontractor needs to meet; and
- Milestones to be achieved.

TIP: This is an area where mistakes are frequently made when the subcontract is prepared by copying the terms of the prime contract. That approach can easily lead to irrelevant matters being included in the subcontract. Even if the legal terms of the prime contract are copied for the subcontract, it will generally be preferable for the scope of work to be prepared specifically for the circumstances of the deliverables to be supplied by the subcontractor.



3. Payment Terms

There should be a clear definition of all the payment terms, including the amount to be paid, the time for payment of invoices and any conditions for payment. Payment delays can hinder progress and strain the relationship between the parties.

TIP: Consider whether the subcontract falls under the security of payment laws throughout Australia. Those laws aim to protect subcontractors in the construction and building industries and ensure they get paid promptly. If they do apply then you need to ensure the subcontract is consistent with them.

BONUS TIP: If you are the subcontractor, make sure that you get paid even if the prime contractor has not been paid. You do not want your payment to be delayed because of the head customer's delay in making payment, possibly as a result of some dispute between the prime contractor that does not relate to the subcontracted supplies.

4. Variation Process

The prime contract will often specify a process for agreeing to any changes in requirements that occur over the course of the supply arrangement. This may include clauses that allow for changes to the original scope of work, how the work is to be performed and other terms that are relevant to the subcontractor agreement. When preparing a subcontract it is important to include a process that will allow changes to the subcontracted supplies to be negotiated in a manner consistent with changes to the prime contract.

TIP: Ensure that any time frames specified in the prime contract's change control process are shortened when flowed down to the subcontract, to build in enough time for the prime contractor to manage the variation process properly.

5. Dispute Resolution

The contract should include an alternative dispute resolution clause and require that the methods listed there are exhausted by the parties before the issue is referred to a Court. This will reduce legal fees for both parties and minimise time wasted. Some alternative dispute resolution methods include expert determination, mediation or arbitration.

TIP: Consider if the subcontractor should be required (or entitled) to be involved in resolving any disputes that arise under the prime contract that relate to the subcontractor's deliverables.



6. Interface with Prime Contractor and Other Subcontractors

Large projects are complex, involving different individuals, teams and stakeholders. An effective communication in this environment is essential to ensure that everyone is on the same page and that challenges that arise during the project are successfully addressed. To prevent misunderstanding and any costly rework or compromised safety that may arise from poor communication channels, the contract should include provisions for regular communication between the contractor and subcontractor. This may include regular status updates, meetings or reporting requirements.

TIP: Consider carefully the circumstances in which the subcontractor should be permitted to communicate directly with the end customer. Such direct communications are often unavoidable. However, the prime contractor needs to be able to stay involved with such communications so that its own position under the prime contract can be managed.

7. Termination Clauses

The prime contract may include clauses relating to the termination of a subcontract. Sometimes the end customer will even have a right to direct that a particular subcontract be terminated. The subcontract will need to be drafted so that the prime contractor can terminate it without penalty if the end customer does exercise such a termination right. Even aside from such a directed termination, the subcontract needs to deal with the consequences of the prime contract being terminated before it is fulfilled. What compensation will be payable to the subcontractor if there is such a premature termination?

TIP: This is an area where merely mirroring the prime contract's terms is unlikely to lead to a sensible position in the subcontract.

8. Intellectual Property and Confidentiality

In the process of subcontracting, parties may produce new intellectual property, including copyright and confidential information. The subcontract needs to specify who will own this new intellectual property. If the subcontractor will retain ownership of the intellectual property which it creates then the terms of the IP licence that it grants the prime contractor need to be carefully considered. Will the prime contractor be limited to licensing that intellectual property to the end customer? Or is a broader licence justified?

TIP: Consider carefully the circumstances, if any, in which the licence from the subcontractor is able to be terminated. The prime contractor does not want to be in a situation where it has undertaken to license certain intellectual property to the customer and cannot grant that licence because the licence from the subcontractor has been terminated.



9. Risk Allocation Provisions

The indemnity clauses and exclusion and limitation of liability provisions are often the most hotly negotiated terms in a supply contract. Having negotiated those provisions in the prime contract, it can be tempting for the prime contractor to insist that those same provisions should apply to the subcontract. However, this simplistic approach might not always be appropriate. The fees paid to the prime contractor may be quite different to the fees paid to the subcontractor, suggesting that any caps on liability in the two contracts should also be different. Similarly the prime contractor will often have incorporated a margin in their prime contract price to cover contingencies and the risks of integrating together all the various components of the solution. The payment of such margin can also be used to justify the prime contractor taking on a bigger share of the risk than that accepted by the subcontractor.

TIP: Before negotiating the risk allocation provisions, workshop internally just what losses may be suffered if your supplies did not perform as expected. Make sure that those particular risks and losses are appropriately addressed in the exclusion of liability and limitation of liability clauses. Too often these clauses are negotiated by reference to meaningless terms such as “market practice”, rather than by reference to what might actually occur in the contract at hand.

10. Flow-Down Provisions

To ensure that subcontractors are subject to the same obligations as the prime contractor, the prime contract may include obligations to include particular clauses in any subcontract. These obligations often include matters such as insurance, security, privacy, confidentiality and intellectual property. The prime contractor needs to ensure that the relevant conditions of the subcontract are at least as comprehensive as those contained in the prime contract.