

Pass-Through Agreements¹

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Many subcontractors run into problems when an owner refuses to pay a general contractor for work properly performed by a subcontractor or the subcontractor incurs damages in excess of its subcontract amount due to an owner's breach of its contract with the general contractor, i.e., delay, interference, improper design. While suit to foreclose a proper mechanic lien is a possible avenue to recover monies against the property of the owner, sometimes this is not an option because the lien may be unenforceable for one reason or another, or the property may not have sufficient equity to pay the lien even if it is enforceable and can be foreclosed. Also, suit on a payment bond may be a possibility if one exists, however this avenue is fraught with even more "surety defenses." Typically, claims under mechanic lien and payment bond statutes are also limited to the amount of the subcontract, and do not provide for recovery of damages in excess of the subcontract price or perhaps the amount of the payment bond.

The only other possibility for recovery was for the subcontractor to sue the owner directly. However, in Texas, a subcontractor generally may not recover from an owner in contract without first establishing privity of contract. Because the subcontractor normally did not have a contract directly with the owner, the subcontractor could not establish privity and would lose the suit. Instead, Texas law required the subcontractor to sue the contractor (with whom it had a contract), who in turn looked to the owner (with whom it had a contract). Suing the contractor for something the owner caused is not normally good for continued business relationships with the contractor, and with a valid pay-if-paid clause in its contract, the contractor generally had a valid defense to any claim by the subcontractor, i.e., the subcontractor loses the suit and loses that contractor for work in the future. Additionally, if it was the owner's conduct which caused damages to the subcontractor in excess of its contract price, the general contractor was normally not responsible to the subcontractor in any event for those damages because the general contractor's conduct did not cause the damages.

In an attempt to "get around" the privity problems, a contractor and subcontractor sometimes entered into what the industry refers to as a "pass-through" or "liquidating" agreement. These type of agreements allow the contractor to pursue the claim of the subcontractor against the owner, but in the name of the contractor. Under the typical pass-through arrangement, the contractor must remain liable to the subcontractor, but only to the extent the contractor receives payment from the owner, i.e., conditional liability.

Pass-through agreements have long been recognized in actions against the federal government, as well as in a number of states other than Texas. However, this vehicle for recovery had never been approved by the Texas Supreme Court as a proper vehicle to avoid the privity defense, and, even if enforceable, it was unclear exactly what the terms of such an agreement should contain and whether the subcontractor could recover

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more than the amount of the subcontract . A contractor and subcontract which tried to enforce such an agreement against the owner almost always faced a defense by the owner that a pass-through agreement was unenforceable and against public policy. The basis of the defense was that Texas courts had previously held unenforceable "as against public policy" agreements, somewhat similar to pass-through agreements, between a defendant and plaintiff in a personal injury case which allowed the sharing of a recovery from another defendant in the same personal injury case. Of course the person injury agreements related to tort recovery and not recovery in contract.

In April of this year, the Texas Supreme Court brought Texas in line with federal law and eighteen other states specifically recognizing "pass-through" claims in Texas. This means that when a contractor remains at least conditionally liable to a subcontractor for damages sustained by the subcontractor resulting from breach by the owner, the contractor can bring an action against the owner for all of the subcontractor's damages, even those in excess of the subcontract amount.

Pass-through claims allow a subcontractor to recover damages from an owner and alleviates the necessity of the subcontractor suing the contractor for these damages, and then the contractor suing the owner for the amounts claimed by the subcontractor. This new remedy (or as the case may be, the specific recognition of the validity of an old remedy) is in addition to and does not affect the protections afforded by the lien and payment bond statutes.

The Texas Supreme court established three requirements of a basic pass-through agreement:

- 1) the general contractor must acknowledge its liability to the subcontractor;
- 2) the general contractor's liability is liquidated to the extent of its recovery against the owner; and
- 3) the general contractor agrees to pass its recovery to the subcontractor.

In other words, the subcontractor releases all claims it may have against the contractor in exchange for the contractor's promise to pursue those claims against the owner and remit any monies recovered to the subcontractor. While the contractor must remain liable to the subcontractor for damages sustained by the subcontractor, this liability may be conditional. (This requirement is met in Texas without written agreement under the prompt payment statute which cannot be waived. Under the prompt payment statute, the contractor is conditionally liable to the subcontractor for any amount recovered from the owner that is attributable to the subcontractor's work.)

Typically, an advantage to the contractor of this type of agreement is that the contractor and subcontractor work together to prosecute the subcontractor's claim against the owner, and the owner can not "play" the contractor or subcontractor against the other. This type of agreement will typically reinforce the business relationship between the subcontractor and general contractor and focuses their attention on the breaching party, i.e. the owner, and not each other. Another advantage is that the contractor's liability to the subcontractor is limited to any monies received from the owner. Finally, this procedure costs far less in legal fees because typically the contractor and subcontractor are not required to each hire attorneys, instead only one attorney is required to prosecute the claim.

The advantage to the subcontractor is similar, i.e. the subcontractor maintains its business relationship with the contractor. The contractor typically assists the subcontractor instead of working against the subcontractor, and the subcontractor recovers its money from the breaching party, i.e. the owner, without being required to sue the contractor.

A pass-through agreement may be included in the subcontract itself but many times takes the form of a separate agreement when the dispute arises. These agreements will delegate the cost of prosecuting the subcontractor's claim and the option to prosecute may be with the general contractor or subcontractor. Whether the claim is going to be presented by the contractor, or by the subcontractor using the subcontractor's name, there is almost always an additional "prosecution agreement" entered into when the claim arises to more clearly define the contractor and subcontractor's rights regarding the claim being pursued.

As with any matter involving legal issues relating to construction, both the subcontractor and contractor should consult with competent legal counsel familiar with construction litigation and the above concepts relating to pass-through agreements before entering into a pass-through agreement or pursuing litigation against an owner under such an agreement.
