"So, What Did I Just Agree To?"

The Incorporation by Reference Clause

Some 30 years ago, we starting writing articles for the crane, rigging, millwrighting, and specialized transportation (CRMST)industry about how to protect the family business.

Everything starts with the same premise: It's all about making sure that each industry member understands what they can do to protect their company.

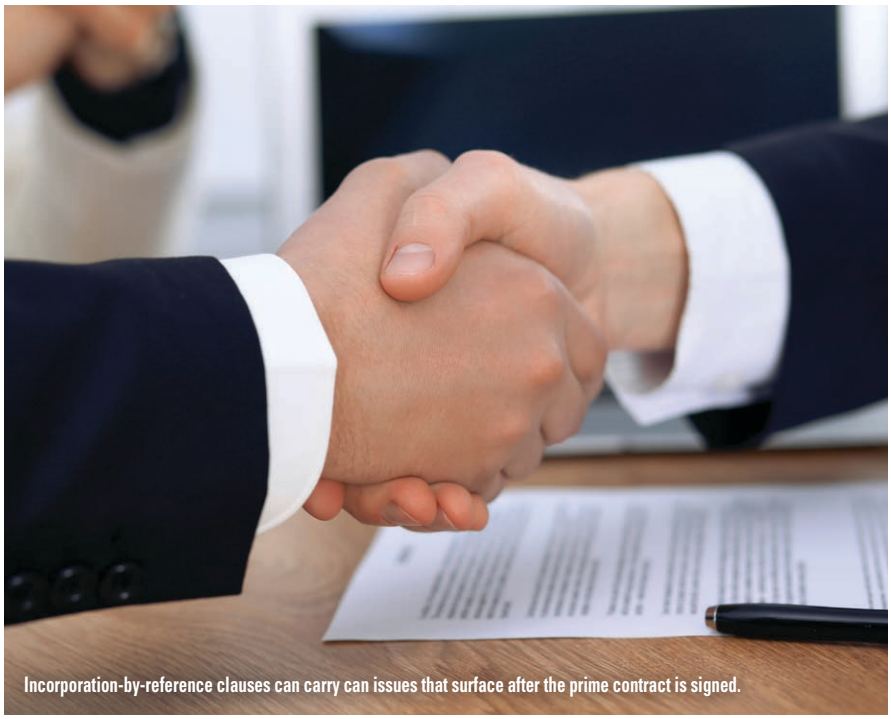
Recently, an industry member wanted to go back to the old 5X7 format on the daily work tickets. Ten years ago, this would not be possible, but now with modern technology, we have a solution. Dan Schulz and I have restarted the series of articles, with each article providing some insight on various issues that we now see in the industry. The purpose is to alert and to discuss the issues, but also to see what can be offered to the industry so new technology can be used to protect the family business.

This article covers the Incorporation by Reference Doctrine. This is very important because just about every industry member is seeing contract verbiage that adds the kitchen sink to the contractor's short agreement via a sentence in the purchase order.

You are being forced to sign an agreement that has all the upper-tier contracts incorporated into your simple work day.

Reading fifteen thousand pages for a $3,000 job? That makes no economic sense, and that's if you can find the upper-tier contracts. It used to be that a copy was provided. Now, the upper- tier contractor says you have to ask for the specific documents.

I would like to say Robot B9 first said "Danger, Will Robinson! Danger!" when it first read a contract with an incorporation-by-reference clause, but the Doctrine of Incorporation by Reference started a long time before the Lost in Space show came onto TV. However, that well-known line often runs through my mind every time I review a contract. The incorporation-by-reference clause is prevalent today, and I am always amazed at the number of documents and issues that are incorporated by reference but have nothing to do with contractor's work.



Incorporation-by-reference clauses can carry can issues that surface after the prime contract is signed.

Incorporation by Reference Clauses

Commercial contracts, particularly those used in construction, are complex and technical. They are often made more complex by an incorporation-by-reference clause, also called a "flow-down clause" or "pass-through clause," which lets documents outside the direct agreement be incorporated as though they were fully set forth. Incorporation-by-reference clauses are generally accepted in the United States. They are used for speed and efficiency, greater uniformity, a clearer statement of intent, and the upper-tier contractor's convenience.

But incorporation-by-reference clauses can cause problems. A court may misinterpret an ambiguous or inadequate clause; the scope of the reference may be misconstrued; or incorporation clauses may create conflicts between contractual provisions. Finally, incorporation clauses discourage careful review of all terms because the incorporated materials may be unavailable or voluminous. That often puts the parties in unequal positions and creates a potential defense to enforcement of the contract.

The incorporation-by-reference clause gained credence in the early 1900s. The U.S. Supreme Court blessed the technique by saying it is critical to know the exact

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language of any reference to another document. In Guerini Stone Co. v. P.J. Carlin Constr. Co., 240 U.S. 264 (1916), a reference to "drawings and specifications" was held not sufficient to bind the subcontractor to the owner's changes and time extension clauses. The court said:

> *...in our opinion the true rule, based upon sound reason and supported by the greater weight of authority, is that in the case of subcontracts, as in other cases of express agreements in writing, a reference by the contracting parties to an extraneous writing for a particular purpose makes it a part of their agreement only for the purpose specified. Id at 277.*

These clauses are now well accepted in the United States. The general rule: Contracts, clauses, designs, drawings, agreements, writings, URL sites, or matters referred to in a written contract may be regarded as incorporated by reference.

The referenced item becomes part of the contract, and may therefore be used to express duties and obligations.

Incorporation by reference is generally effective for its intended purpose where the provision has a reasonably clear meaning. Also, courts have said the reference must be called to the attention of the other party, that they must consent to it, and that the terms of the incorporated document must be known or easily available to the parties.

See Walls, Inc. v. Atlantic Realty Co., 186 Ga. App. 389, 390 (367 S.E.2d 278) (1988); ADC Constr. Co. v. McDaniel Grading, 177 Ga. App. 223, 225 (338 S.E.2d 733) (1985); Hartline-Thomas, Inc. v. Arthur Pew Constr. Co., 151 Ga. App. 598, 599 (260 S.E.2d 744) (1979). See Also, Williams Constr. Co. v. Standard-Pacific Corp. (1967) 254 Cal. App.2d 442, 454 [61 Cal.Rptr. 912].

While the general rule allowing incorporation by reference clauses is well established, states have made varying interpretations of specific clauses. That can lead to pitfalls.

YOUR DEFENSES

Referenced Documents Not Easily Found

In the case of Chan v. Drexel Burnham Lambert, Inc., 178 Cal. App. 3D 632, 1986 Cal. App. LEXIS 2684, plaintiff Adora Chan was employed as a stockbroker by Drexel Burnham Lambert (DBL). As a condition of employment, Chan was asked to sign a form entitled Uniform Application for Securities and Commodities Industry Representative and/or Agent ("U-4"). When Chan later brought a wrongful-discharge suit against DBL, the company raised an arbitration defense, claiming that the U-4 incorporated by reference certain rules of the New York Stock Exchange (NYSE), including Rule 347, which called for arbitration of employment disputes.

However, the California appellate court held that the rule was not incorporated by reference. The court said: "For the terms of another document to be incorporated into the document executed by the parties, the reference must be clear and unequivocal, the reference must be called to the attention of the other party and he must consent thereto, and the terms of the incorporated document must be known or easily available to the contracting parties.'" Id. At 14. See Also, Williams Constr. Co. v. Standard-Pacific Corp. (1967) 254 Cal.App.2d 442, 454 [61 Cal.Rptr. 912], italics added; accord King v. Larsen Realty, Inc., supra, 121 Cal.App.3d at p. 357.

The U-4 had a provision requiring the applicant to agree to abide by the statutes, rules, constitution, and bylaws of NYSE, but had no specific reference to arbitration or where the arbitration provision could be found. The court held that while the arbitration provision may have been available to Chan, the U-4 did not clearly refer to Rule 347. Because of that failure, the court held that the arbitration provision was not binding. Id at 21-22.

Indemnity Clauses May Require Specific Reference

In Bernotas v. Super Fresh Food Mkts., Inc., 581 Pa. 12, 863 A.2d 478 (PA Sct. 2004), the Pennsylvania Supreme Court addressed the issue of pass-through indemnity clauses in construction contracts. Barbara Bernotas was injured while at Super Fresh Food Market when she fell into a hole in the floor that was part of a construction project.

Benotas sued the store, which then filed cross claims against the general contractor, Acciavatti Associates, and the electrical subcontractor, Goldsmith Associates. The store owner's cross-claim included claims for contractual indemnification.

Bernotas settled her claims for $200,000, with each party contributing an equal share. Post settlement, the cross claims regarding indemnity continued to be litigated. At the heart of the dispute was the issue of whether a pass-through or incorporation-by-reference clause could be used to transfer indemnity obligations from the prime contract to the subcontractor.

In holding that the prime contract indemnity obligations could not be transferred to the subcontractor, the court said:

> *...unless expressly stated, pass through indemnification clauses violate the long standing policy underlying the rule narrowly construing indemnification provisions. When the provision sought to be "passed through" involves indemnification for acts of another party's negligence, the theory will not be applied, unless the contract language is clear and specific. Sound public policy requires an unequivocally stated intention to be included in the subcontract for this particular type of provision to pass through from the general contract. The general language of a standard incorporation clause cannot trump the specific language of the subcontract, when the former supports indemnification for negligent acts but the latter is ambiguous regarding the circumstances under which indemnification will occur. Id. At 15-16.*

Under such an analysis, a careful reading of these provisions may reveal a defense due to the lack of care in drafting. See also, Goldman v. Ecco-Phoenix Electric Corp., 62 Cal. 2d 40, 396 P.2d 377, 41 Cal. Rptr. 73 (Cal. 1964) and Allison Steel Manufacturing Co. v. Superior Court of Arizona, 22 Ariz. App. 76, 523 P.2d 803 (Ariz. Ct. App. 1974). Both held that that without specific and unambiguous language in the subcontract, a subcontractor was not obligated to indemnify the contractor against its own negligence, even when the subcontract provided that the subcontractor was bound in the same manner and to the same extent as the

contractor is bound to the owner in the prime contract.

Incorporation Clause so Vague it Creates a Question of Fact

In the matter of Schenkel & Shultz, Inc. v. Hermon F. Fox & Assocs., P.C., 362 N.C. 269, 658 S.E.2d 918 (N.C. Apr. 10, 2008), the North Carolina Supreme Court addressed the issue of whether an indemnification clause could be applied by a general contractor against a subcontractor, through the use of a "flow-down clause" in a prime contract.

The Charlotte-Mecklenburg Board of Education (Board) contracted with the architectural firm of Schenkel & Shultz, Inc., to design a vocational technical high school in Mecklenburg County, N.C. Schenkel, in turn, hired Hermon F. Fox & Associates, P.C., an engineering firm, to design the project's structural steel. Defects in the structural steel design caused rework and delay. The prime contract between the Board and Schenkel contained a valid indemnification clause, which the Board enforced against Schenkel. The clause said: "Consultant's [Fox's] services shall be performed according to this Agreement with the Architect [Schenkel] in the same manner and to the same extent that the Architect is bound by the attached Prime Agreement to perform such services for the Owner [the Board]. Except as set forth herein, the Consultant [Fox] shall not have any duties or responsibilities for any other part of the Project."

The court reviewed North Carolina law on the issue of incorporation and said:

> *To incorporate a separate document by reference is to declare that the former document shall be taken as part of the document in which the declaration is made, as much as if it were set out at length therein. Construction industry contracts commonly incorporate terms of the general contract into the subcontract. The construction contracting process is characterized by the large volume of documents involved. Incorporating by reference a number of documents into a single document is a typical part of the modern construction contract. Aside from being a matter of convenience, the use of incorporation by reference clauses and flow-down clauses represents efforts to ensure consistency of obligations throughout the various tiers of the contracting process. The relationship of the prime contract to the subcontract generates contractual attempts for consistency. Obligations can flow down to insure that subcontractors commit themselves to the performance and administrative requirements of the prime contract. Id. at 921-922*

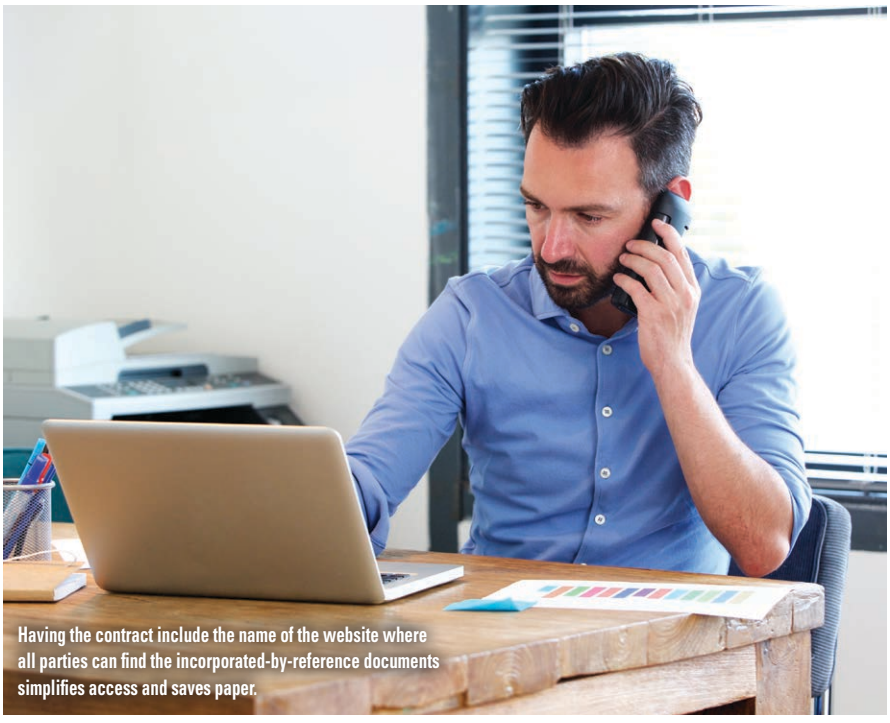
However, despite recognizing the validity of "flow-down clauses," the court held that the issue of whether the indemnification paragraph in the prime contract was incorporated into the subcontract was a matter for the jury. The court believed that the "flow-down clause" was ambiguous because it was subject to more than one interpretation. The court believed that the clause could be read to broadly pass through all prime contract obligations, but could also be read to limit itself to obligations strictly related to Fox's services and not risk-transfer provisions, such as indemnification. Id.

Recently, we were presented with an issue from a crane company that wanted to stay with its 5X7 document format. That does not typically work well in today's world. How do we fit all the terms and conditions while also making sure the contract can be enforced and the rule about hiding terms in the contract is taken out of play? The answer was simple. The most important terms, such as indemnity and insurance would appear on the back, along with the language for the operational use of the load handling equipment or "LHE." The agreement states that the lessee, through its Lift Director, shall, at all times, comply with all applicable local, state, federal, and provincial statutes, rules, and regulations relating to operation of the LHE in accordance with 29CFR1926.1400, ASME P30.1 Lift Planning, and ASME B30.5 Mobile and Locomotive Cranes. A specific section on the back is dedicated to this since the Lift Director is taking on such an important role.

To make all of this work, we have included on the front side, with the two signature boxes, the desired language to make sure that the person signing the agreement before the job starts and at the end of the job, knows that the indemnity, insurance, lift director, and other terms were on the back.

This language is in big bold fonts, but we also included the crane company's URL site. Anyone doing business with the insured can access the site and see the terms and conditions of the work.

We have incorporated all the terms and conditions into the website, and anyone can access it anytime. It's a business-friendly solution that solves one problem that has been with the industry forever. ■



Having the contract include the name of the website where all parties can find the incorporated-by-reference documents simplifies access and saves paper.