

Critical Construction Contract Clauses

Owner, Contractor, and Subcontractor Perspectives

By Bruce W. Merwin, Joanne Linley, and Tracy L. Steedman

Bruce W. Merwin is a partner at Thompson & Knight LLP, Houston, Texas. Joanne Linley is a partner at Peckar & Abramson, P.C., Miami, Florida. Tracy L. Steedman is a partner at Niles Barton & Wilmer, LLP, Baltimore, Maryland.

It is well known in the industry that owners and developers are attempting to shift more risk downstream when negotiating construction contracts. Tony Illia, *Owners Shift More Financial Risk as Recovery Remains Sluggish*, Engineering News-Rec., Oct. 29, 2013, available at http://enr.construction.com/business_management/finance/2013/1029-owners-shift-more-financial-risk-as-recovery-remains-sluggish.asp. The overarching goal in contract negotiations is to create a contract that clearly expresses the parties' intentions based on reasonable and realistic expectations and incorporates incentives for cooperation and performance. This article will offer strategic insights and practical tips on negotiating a fair contract and allocating risk.

Each Party's Perspective

As with most contract negotiations, the parties to a construction contract have varying interests that they seek to satisfy with favorable contract language. This article considers the position that each party is likely to take on a variety of common contract issues.

Owners, for example, want their projects built to be fully functional and completed on time and under budget. The owner's suggested provisions in this article reflect an aggressive owner attitude designed to maximize the contractor's accountability, risk assumption, and indemnity responsibility while permitting the owner to achieve maximum leverage over the contractor by controlling the work description, site conditions, change orders, and payment and warranty procedures. The owners further seek the right to terminate the construction contract for convenience.

One of every contractor's major concerns is the exposure to risk. Because of the past economic climate, contractors had been willing to assume additional risks and liabilities to procure work. One way contractors dealt with this trend was to require their subcontractors to assume more risk—even risks that other parties were better-positioned to handle. Despite the current improved economic climate, owners now expect contractors to continue this trend of undertaking more risk, and in turn contractors attempt to shift this risk to architects and subcontractors. The contractor's suggested contract provisions below reflect such vision of the proper allocation of risk.

Subcontractors were hit the hardest during the economic downturn. They now perform almost all of the work on projects, in part because some were willing to take any job that came their way. Others, however, controlled their risk by working with contractors with whom they had trusted relationships. Subcontractors should reevaluate their risk management policies and approach each new project as they would any other venture—negotiating a deal that assesses risk appropriately among the parties by carefully defining roles, responsibilities, and scope. If the subcontractor chooses to accept more risk, the additional exposure should be tied to additional compensation. To the extent that a contractor proposes a “nonnegotiable” subcontract with a substantial level of risk, the subcontractor should consider whether it is prudent to work with that contractor. On other contract provisions, the subcontractor's position typically will align with or mirror the contractor's position. Thus, unless the subcontractor's position varies from that of the contractor, the subcontractor's perspective will not be separately mentioned in the following discussion.

Description of Work Under Contract Documents and the Meaning of “Reasonably Inferable”

Owner: Any failure to ensure that the description of the work is accurate and comprehensive can frustrate an owner's reasonable expectations at a later date. The contractor should be required to execute the work described in the contract documents “and reasonably inferable by the Contractor as necessary to produce the results intended by the Contract Documents.” The “reasonably inferable” language is important because no set of plans and specifications is perfect. “Reasonably inferable” should refer to nonmaterial additional costs and minor changes in sequencing and scheduling and should not relate to additional documents required versus minor submittals. The contract must contain provisions resolving discrepancies between the drawings and specifications or dimensions and any after-contract documents. As to which documentation controls in the event of discrepancies, modifications should have the highest degree of priority, followed by the main body of the construction

contract itself, the supplement to general conditions, the contractor's proposal, the general conditions, and the drawings and specifications (with differences in the drawings and specifications to be resolved by the architect).

Contractor: Complete, constructible contract documents are critical to the contractor's ability to accurately bid and execute the work. The scope of work, plans, and specifications should be sufficiently detailed to avoid dispute. The project architect should be accountable for conflicts, design errors, and omissions. If additional cost or delay is incurred because of inadequate or inaccurate contract documents, the contractor should receive a change order. The contractor will build only what is drawn and specified and should not infer or guess the intent of others. If necessary, the contractor should incorporate assumptions and clarifications into the contract documents to supersede all other contract terms.

Site Conditions

Owner: The owner should consider providing the contractor with a contingency fund in exchange for the contractor's assumption of full responsibility for site conditions, including any concealed conditions, with shared savings if the contingency is not fully used. The contract should require the contractor to study and compare the contract documents, including all tests and studies furnished by the owner, to confirm its ability to perform the work for the contract payment and within the contract time. The contractor should perform any additional examinations, investigations, and tests deemed necessary by the contractor. The contractor also should take field measurements and verify field conditions before commencing the work. The owner should require the contractor to agree to review soils and other geotechnical tests, as well as any other documents delivered by the owner, without warranty from the owner.

Finally, the contractor should review the contract documents before performing each portion of the work. If the contractor performs the work in conformity with any contract documents it knows to be inconsistent with another contract document or legal or code requirement, without obtaining approval from the owner, the contractor should correct the work at its own expense.

Contractor: Review of the information provided by the owner (on which the contractor has a right to rely) and a visual site inspection should be all that the contract requires to verify the site conditions. The contractor should report differing site conditions to the owner on discovery but should not assume any obligation to perform additional investigation or testing. Furthermore, the contractor should not assume

any risk for latent, concealed, or subsurface conditions. If the conditions differ from what was disclosed by the owner, the contractor should receive a change order for any additional time and costs incurred.

Change Orders

Owner: The owner maintains the right to add to or deduct from the scope of the work under the contract, and, thus, the contract should expressly state the procedure for adjusting the contract payment. Agreement on any change order should constitute a final settlement of all matters relating to the changed work, including any adjustments to the contract payment and the contract time. No course of conduct or dealing or implied acceptance of changes should result in the contractor's right to a change order. Even if no agreement is reached on the cost of a change order, the owner should require the contractor to perform it under a construction change directive with the price to be determined later under an agreed formula.

Contractor: Additive change orders involving time and money should be processed within a specified time frame, and work should not proceed until the change order is executed so that the contractor does not fund the project. For deductive change orders, the contractor should receive overhead and profit for the deducted scope of work. The contractor also should incorporate a provision reserving its right to seek additional time under a change order if the full effect of the change cannot reasonably be evaluated in time to submit or approve the necessary documentation. Written directives to perform work should not substitute for change orders. The parties should incorporate flow-down provisions into subcontracts, allowing the contractor time to receive claims from subcontractors and submit them to the owner, thus ensuring the contractor will not be liable to the subcontractors for the cost of changed or extra work until the owner has authorized a change order or construction change directive. When the owner is a public entity and authorization for the change order is not guaranteed until given at a public meeting, the contractor should not perform the work described in the change order until the change order is approved by the owner.

Subcontractor: Subcontracts typically provide that the subcontractor will get paid only if the change order is in writing and agreed to, despite the fact that the contractor has verbally directed the work in the field. A competing provision requires the subcontractor to continue to perform the work so as not to delay the project. The subcontract should expressly state that the subcontractor will not be required to perform any changed work until a change order is signed by an authorized representative of the contractor (or approved by the owner, if applicable). Subcontractors also should

be cognizant of the difference between owner-directed changes and contractor-directed changes because contractors may attempt to deflect payment obligations to the owner for both types. When asked to prepare a cost estimate for changed work, subcontractors should ask for additional time, if required. Finally, subcontractors should be aware of any notice provisions affecting their right to submit a claim for a change order.

Liquidated Damages

Owner: Liquidated damages generally include a per-day amount, with or without a grace period, and the per-day amount may increase after 30 to 60 days of delay. If the delay exceeds a specified number of days, the owner will want the right to seek additional recovery without a cap on damages.

Special consideration is required for liquidated damages for projects being built under the Leadership in the Energy and Environmental Design (LEED) certification system. If a project fails to achieve LEED certification, LEED liquidated damages may permit use of up to 50% of a contingency by the contractor to obtain the necessary LEED points; but the owner should also require payment of a substantial liquidated amount per insufficient LEED point caused by the contractor's default, plus the cost of corrections necessary to cause the work to comply with LEED requirements.

Contractor: Time is of the essence in construction, and a liquidated damages provision provides both parties the ability to control damages if the project is delayed. The contractor should negotiate a liquidated damages provision reasonably tied to the owner's potential losses, and not a windfall to the owner, if delays occur. This provision should expressly cover all direct and indirect damages suffered by the owner, and ideally should include a grace period of 30 days or more before the clock begins running; a cap on the contractor's total liability for liquidated damages; and a waiver if the owner's acts or omissions cause delays to project completion. Incentives or bonuses for early completion are a useful tool to encourage timely progress of the work. Any liquidated damages payable to the contractor should flow down to the subcontracts, proportionate to the subcontractor's responsibility for delay.

LEED compliance is not within the contractor's control. The AIA "Sustainable Project" family of documents recognizes this fact and includes disclaimers of any warranties or guaranties by the contractor (and subcontractor) that the project will achieve LEED certification. LEED project contracts, therefore, should not allow liquidated damages for failure to achieve LEED certification.

Subcontractor: The advantage of liquidated damages is that in the event of delay, the subcontractor knows its exposure from the beginning of the project, allowing for focused risk management. In addition to the limitations iterated by the contractor, the subcontract should expressly limit assessment of liquidated damages to the subcontractor's percentage of responsibility for the delay. If liquidated damages are included in the subcontract, subcontractors also should require the contractor to waive actual and consequential damages for delays.

Consequential Damages and Limits on Liability

Owner: Owners prefer to delete the mutual waiver of consequential damages or provide solely for the contractor's waiver of consequential damages. Alternatively, owners attempt to carve out from the mutual waiver the owner's right to recover additional construction interest/financing costs, lost rental income, lost tax credits and abatements, and other increased costs as constituting actual damages. Owners also should resist allowing contractors to limit the contractor's liability for defaults under the contract.

Contractor: A mutual waiver of consequential damages is probably the single most important clause for the contractor. It allows for management of risk and potential exposure. If the owner refuses to mutually waive all consequential damages, the contractor should seek to narrow the clause to exclude specific consequential damages. Having identified the exclusions, the clause should specify pricing or methodology for calculating those damages excluded from the waiver and should include a reasonable limitation on total liability, thus ensuring that the contractor bears an appropriate level of risk.

Right to Withhold Payment

Owner: The owner should have the right to withhold payment for nonconforming work, delays, potential liability claims, liens (or threats of lien claims), and other reasons to protect the owner. The owner also should have the right to withhold payment for anticipatory breach for potential failure to meet substantial completion when required performance is unlikely or impossible.

Contractor: Payment drives the contractor's ability to perform the work. In addition, the owner is protected by withholding retainage (typically 10% of contract payment) until the project is completed. Consequently, the contractor should limit the owner's right to withhold payment to very narrow and specific circumstances. Payment for undisputed portions of the work must be timely issued despite an ongoing dispute.

The architect should act as an independent arbiter, perform a good faith review of the schedule of values and progress of the work, and certify the contractor's payment application. The contractor should reject outright any attempt by the owner to include language allowing the owner to withhold payment for anticipatory breach of the contract.

Subcontractor: Remember, subcontractors do all of the work and should not be required to finance the project through additional withholdings that are generally covered by retainage. Instead, the subcontractor should negotiate a reduction of retainage as the project progresses or should require the contractor to reduce its retainage withholding when the owner reduces its retainage withholding.

Contractors also often include a right of setoff that allows the contractor to withhold payment on all projects on which the subcontractor is working in the event of a dispute over one of the projects. Enforcement of this clause almost guarantees a default on all projects. Thus, the subcontractor should reject outright a setoff provision.

Subcontracts may include a "pay-if-paid" clause, which conditions the contractor's obligation to pay subcontractor on its receipt of payment from the owner. (Contract drafters should check state law on this point, however—for example, California and New York do not enforce pay-if-paid clauses.) The potential problem is that the owner's failure to pay the contractor may arise out of a dispute between the owner and contractor that does not involve the subcontractor, and the subcontractor should reject this clause. If the contractor will not agree, then the subcontract should include the right to stop work if not paid within 60 days of invoicing, and language stating that the pay-if-paid provision does not waive the subcontractor's right to file a mechanic's lien or make a bond claim. (Again, drafters are advised to refer to applicable state law—for example, Maryland does not allow any contract provision to waive rights to a lien or a bond claim.)

Delay Claims

Some jurisdictions have recognized exceptions to the enforceability of "no-damages-for-delays" clauses, such as owner/contractor interference and gross negligence.

Owner: Owners prefer to limit remedies for delay claims to time extensions only; and, if not limited to time extensions, to direct costs and increased general conditions costs. Delay claims for adverse weather and other force majeure causes should be limited to conditions that adversely affect the critical path of construction and are not

caused by the contractor. Notice provisions should require the contractor to file a request for an extension of the contract time within 21 days after the occurrence of the event causing the delay or grant the right to seek an extension if the occurrence is waived by the owner.

Contractor: Successful construction is measured largely by the timeliness of completion. Unfortunately, the potential for delays is high, and the contractor's cost to mitigate such delays can be significant. A clause that restricts the contractor to a time extension and prohibits monetary claims to compensate for delays (a no-damages-for-delays clause) is a red flag to a contractor. Key components of clauses addressing time and delay include the definition of "delay," which should exclude acceleration, disruption, loss of efficiency, or changed conditions, all of which should remain fully compensable to the contractor and not subject to a no-damages-for-delays clause; compensation for direct and indirect monetary damages to the contractor for all delays except those caused solely by the contractor, although indirect damages may be waived if the parties have included a consequential damages waiver; adequate time to submit delay notices, with a separate deadline for submission of claims; and no requirement that the claim be accompanied by a critical path schedule analysis. As with most critical contract clauses, those related to time and delay should flow down to the subcontracts but ideally include no-damages-for-delays clauses in the subcontracts.

Subcontractor: Avoid no-damages-for-delays clauses. If unavoidable, then specify or narrow down the types of delay for which no damages are paid; exclude unforeseen delays; exclude delays not caused by the subcontractor; exclude delays caused by omissions, errors, incorrect or incomplete owner information, defects in design documents, reports, and other matters outside of the subcontractor's control; exclude delays caused by active interference of the owner, architect, engineer, contractor, and other subcontractors; and require a mutual waiver of consequential damages for delays. A subcontractor also should account for the risk associated with a binding no-damages-for-delays clause in its bid.

Indemnification

Jurisdictions vary on the enforceability of indemnification provisions. A state-by-state survey of anti-indemnity statutes has been prepared by a Georgia construction law practitioner. See Kamy Molavi, *A Review and Update of Anti-Indemnity Statutes* (Sept. 2012), <http://www.google.com/>

url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0CCkQFjAA&url=http%3A%2F%2Fwww.dri.org%2Fmaterials%2F2012-construction%2Fpdfs%2F11_Molavi.pdf&ei=JObJUuf5Oeq0sQSiz4GIDw&usg=AFQjCNFsYjjG_ iyWoVYUAIiNR2eUiY_0GT

Owner: Owners seek the broadest possible definition of claims covered by the contractor's indemnity and defense obligation, including the contractor's default, violation of laws, and negligent acts or omissions, including those in which the owner has concurrent, but not sole, negligence. Claims asserted by the contractor's or subcontractor's employees against the owner should be covered by the contractor's indemnity, regardless of whether the owner was negligent or otherwise responsible for such liability. Finally, any indemnification provision must be subject to limitations prescribed by applicable law.

Contractor: Indemnification is subject to local laws, but as a general rule the contractor should indemnify the owner only for the contractor's own negligence and only commensurate with the contractor's percentage of fault. Indemnification also should be limited to third-party claims for bodily injury or property damage. If the indemnification clause is broadened to include the negligence of other parties (such as the architect), it should be limited to those parties with whom the contractor has a contract and for which the contractor's insurance will cover the loss. The indemnification clause should establish a right but not a duty for the contractor to defend under an indemnification claim.

Termination for Convenience

Owner: The termination for convenience provision should establish a step-by-step procedure for stopping work and transitioning to a successor contractor, provided the owner makes payment for all work done to date, but without payment of profit or overhead on unperformed work. The owner should retain the right to assume certain subcontracts and purchase orders and should indemnify the contractor against any claims thereunder. The owner should require the contractor to continue to warrant work performed before termination, as long as the owner can demonstrate that the contractor (or its subcontractors) caused the problem.

Contractor: Termination by the owner on a whim can drastically affect the contractor's finances, so a termination-for-convenience clause must compensate the contractor for work in place, materials purchased, overhead, and general conditions through the date of termination. In addition, a termination-for-convenience clause should include payment of early termination penalties, lost profits, lost overhead, and general conditions for the unperformed work for the remaining schedule duration. The

contractor should have no warranty obligations if the owner terminates for convenience because it should not be liable when it no longer has control over its ability to protect and maintain work in place, materials, equipment, and systems.

Subcontractor: The subcontract should not allow the contractor to terminate for convenience unless the owner has exercised its right, nor should it allow a wrongful termination to be deemed a termination for convenience unless the contractor is obligated to pay all costs associated with the termination, as well as overhead and lost profits on subcontract work not performed.

Warranty

Owner: Warranty provisions require specific procedures for performance of warranty repairs within specific time periods, and the owner's right to perform warranty work if the contractor fails to timely perform. In addition to the contractor's one-year warranty, the contractor should assign the subcontractor/supplier warranties to the owner. The contract should extend the owner's one-year warranty on items repaired during the warranty period. The owner also should retain the right to accept defective or nonconforming work, obtain a deduction from the contract sum, and have others make the repairs.

Contractor: Generally, contractors have statutory and implied warranty obligations to owners for construction projects. The contractor should not agree to additional warranty obligations. A one-year warranty on workmanship is typical and acceptable and should be required from subcontractors. Timely notice must be required, and the one-year warranty should not be extended for remedial work—a warranty is not a maintenance program. Warranties for equipment and materials should pass through from the manufacturer and supplier directly to the owner.

Conclusion

The goal of counsel for owners should be to end up with contract documents that reflect the requirements of the project and the respective abilities and expertise of all parties involved to reasonably satisfy the requirements and the expectations of the parties. Although the owner's perspective on various provisions attempts to shift liability to the contractor, contract documents that do not reasonably satisfy the requirements of the construction project and the expectations of the parties ultimately result in problems. The owner, contractor, and subcontractor will be best positioned to minimize problems and achieve their respective goals if the contract documents are understandable, provide for each party to assume risk when that party

is capable of assuming such risk, promote cooperation and teamwork between the parties, and otherwise strike a balance between the rights, remedies, duties, and obligations of the parties. n