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BY: JONATHAN MILES[1]

# FREEDOM OF CONTRACT AND ITS LIMITS: SELECTED ISSUES FOR THE CONSTRUCTION INDUSTRY

## I. INTRODUCTION

Freedom of contract has deep roots in American law. It argues for a basic right of individuals or firms to make agreements to acquire or dispose of property or services or to create formal legal relationships. It is recognized even as a fundamental right and is considered essential to the functioning of a rules-based market economy and resultant human flourishing.[2]

The Texas Supreme Court recently noted that "perhaps no principle of law is as deeply engrained in Texas jurisprudence as freedom of contract."[3] Freedom of contract is embedded in Texas' constitution[4] and common law.[5] And, as the Court noted, "[w]e reinforce this public policy virtually every Court Term."[6]

Freedom of contract "allows parties to...allocate risk as they see fit"[7] "The liberty to make contracts includes the corresponding right to refuse to accept a contract or to assume such liability as may be proposed."[8] An "indispensable partner" to the freedom of contract is contract enforcement.[9] "The role of the courts is not to protect parties from their own agreements, but to enforce contracts that parties enter into freely and voluntarily."[10] For example, on freedom of contract grounds Texas courts have upheld the validity of contractual jury waivers, "as is" clauses in commercial real estate contracts, and reliance disclaimers or merger clauses that bar fraudulent inducement claims.[11]

But fidelity to freedom of contract has its limits: "[a]s a rule, parties have the right to contract as they see fit as long as their agreement does not violate the law or public policy."[12] Texas courts often decline to enforce freely reached contractual provisions to vindicate competing common law principles or on public policy grounds.[13] The result is tension between the commitment to freedom of contract and contract enforcement and the need to

1. Jonathan Miles is Senior Counsel with the Houston office of Peckar & Abramson, P.C. He has extensive private practice and in-house experience in complex litigation and transactions in commercial and energy-related construction. He is a graduate of Washington & Lee University and Drake University Law School. Mr. Miles appreciates the valuable insights into the subject of this article from Will Allensworth and Jeff Ford.
2. *See Ogden v. Saunders*, 25 U.S. 213, 222 (1827) (freedom of contract "springs from a higher source: from those great principles of universal law, which are binding on societies of men as well as on individuals"); *Shields Ltd. P'ship v. Bradberry,* 526 S.W.3d 471, 482 (Tex. 2017) ("[f]reedom of contract is a policy of individual self-determination" and that "individuals can control their destiny and structure their business interactions through agreements with other competent adults of equal bargaining power"); *St. Louis Sw. Ry. Co. of Tex. v. Griffin*, 106 Tex. 477, 171 S.W. 703, 704 (1914) ("The citizen has the liberty of contract as a natural right which is beyond the power of the government to take from him"). Freedom of contract is "an aspect of individual liberty, every bit as much as freedom of speech, or freedom in the selection of marriage partners or in the adoption of religious beliefs." Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. Chi. L. Rev. 947, 953 (1984). *See also,* DAVID N. MAYER, LIBERTY TO CONTRACT: REDISCOVERING A LOST CONSTITUTIONAL RIGHT (2011) (comprehensive examination of the historical and philosophical foundations of freedom of contract in the United States). The idea that freedom of contract contributes to individual and community welfare is summed up in the Restatement (Second) of Contracts § 72 cmt. B (1981):

   Bargains are widely believed to be beneficial to the community in the provision of opportunities for freedom of individual action and exercise of judgment and as a means by which productive energy and product are apportioned in the economy. The enforcement of bargains rests in part on the common belief that enforcement enhances that utility.
3. *Energy Transfer Partners, L.P. v. Enterprise Products Partners, L.P.*, 593 S.W.3d 732, 740 (Tex. 2020).
4. Tex. Const. art I, § 16 ("No bill of attainder, ex post facto law, retroactive law, or any law impairing the obligation of contracts, shall be made").
5. *See Energy Transfer*, 593 S.W.3d at 738 and n.18.
6. *Id.* at 738.
7. *El Paso Field Services, L.P. v. MasTec North America, Inc.*, 389 S.W.3d 802, 812 (Tex. 2012) (citing *Gym-N-I Playgrounds, Inc. v. Snider*, 220 S.W.3d 905, 912 (Tex. 2007)).
8. *St. Louis Sw. Ry. Co.*, 171 S.W. at 704.
9. *El Paso Field Services*, 389 S.W.3d at 812 (citing *Fairfield Ins. Co. v. Stephens Martin Paving, L.P.,* 246 S.W.3d 653, 664 (Tex.2008)).
10. *Id.* at 810–11.
11. *In re Prudential Ins. Co. of Am.*, 148 S.W.3d 124 (Tex. 2004) (enforcing pre-suit waiver of jury trial); *Prudential Ins. Co. of Am. v. Jefferson Assocs.*, 896 S.W.2d 156 (Tex. 1995) (enforcing "as is" clause); *Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 179–80 (Tex. 1997) (enforcing disclaimer of reliance in fraudulent inducement context).
12. *Zachry Const. Corp. v. Port of Houston Authority of Harris County*, 449 S.W.3d 98, 117 (Tex. 2014).
13. *See, e.g., In re Poly-America, LP*, 262 S.W.3d 337, 348 (Tex. 2008) (provisions precluding workers' compensation benefits unconscionable and void under Texas law); *Formosa Plastics Corp. USA v. Presidio Engineers and Contractors, Inc.*, 960 S.W.2d 41, 46 (Tex. 1998) (party is not bound by a contract procured by fraud or mistake); *Mem'l Med. Ctr. of E. Texas v. Keszler*, 943 S.W.2d 433, 435 (Tex. 1997) (not enforcing exculpatory clauses that exempt a party for its gross negligence or intentional misconduct). *See also Fairfield Ins. Co.*, 246 S.W.3d at 655 n. 20 (listing cases declaring contracts unenforceable on various public policy grounds).

sometimes deviate from that commitment. That tension is apparent in three issues of interest to the construction industry:

- Contractual risk allocation and due diligence;
- No-damages-for-delay clauses; and
- Conditions precedent to partnership formation.

## II. CONTRACTUAL RISK ALLOCATION AND DUE DILIGENCE

Owners and contractors often have inadequate information about a construction project. That may be in the form of incomplete or non-existent information regarding site conditions, or faulty, incomplete plans or specifications. How owners and contractors allocate the risks of that uncertainty is critical.

When a contract is silent on risk allocation, a possible default rule is that the risk should fall on the "Superior Risk Bearer" – the party in a better position to prevent the risk from materializing.[14] In the construction context, the default rule might allocate risk of unknown site conditions to the owner, who is better positioned to know its site than is the contractor. Likewise, the default rule might allocate risk of faulty plans to the owner who supplies them, because the owner is better positioned to specify what it wants built, and the owner usually retains the professionals responsible for the design.

These default rules, while defensible, do not reflect long-standing Texas law. In the 1907 case of *Lonergan v. San Antonio Loan Trust*, the owner sued the contractor for breach of contract because a house under construction collapsed.[15] The contractor responded that the owner's plans were defective.[16] The Court found that the owner was not in a better position to discover the plan's defects and there was no express or implied contractual language that the parties intended the owner to be responsible for their defects.[17] Sounding the call of freedom of contract, the Court held that "in the absence of fraud or other improper influence, competent persons may make their own contracts for lawful purposes and will be required to perform them."[18] Thus, despite the owner's defective plans, because the contract that was silent on risk allocation, the contractor was not excused from its obligation to build the house.[19]

*Lonergan* established a straightforward rule: absent fraud or other wrongdoing by the owner, the contractor bears the risk of faulty specifications unless the contract contains terms that could fairly imply the owner's guaranty of the specifications [20] That reflects "the practically universal rule" that "where one agrees to do, for a fi ed sum, a thing possible to be performed, he will not be excused or become entitled to additional compensation, because unforeseen difficulties e encountered."[21]

The *Lonergan* rule makes parties' contractual risk allocation and due diligence obligations critically important. That was illustrated in *El Paso Field Services, L.P. v. MasTec North America, Inc.*, where the Texas Supreme Court held that a pipeline contractor had to bear the costs of overcoming unknown underground conditions far diffe ent than were described in specifications supplied by the owner.

El Paso Field Services decided to replace an underground pipeline between Victoria and Nueces Bay.[22] It hired a surveyor to examine the route and create alignment sheets that showed 280 foreign crossings in the pipeline right-of-way, including other pipelines, utility lines, and other structures.[23] The alignment sheets were given to bidders, including MasTec, along with encouragement to inspect the right-of-way by air.[24] MasTec did so, was the low bidder, and won the work.[25] In the contract, MasTec represented that it:

> has visited the site of the Work, is familiar with the local and special conditions under which the Work is to be performed and has correlated the on

14. Eric D. Beal, *Posner and Moral Hazard*, 7 Conn. Ins. L.J. 81, 86 (2000).
15. *Lonergan v. San Antonio Loan & Tr. Co.,* 101 Tex. 63, 104 S.W. 1061 (1907).
16. *Id.* at 1062.
17. *Id.* at 1065–66.
18. *Id.* at 1066.
19. *Id.* at 1067.
20. *See also Interstate Contracting Corp. v. City of Dallas,* 407 F.3d 708, 720-21 (5th Cir. 2005) ("In order for an owner to breach a contract by supplying inadequate plans to a contractor, [Texas law] require[s] that the contract evidence an intent to shift the burden of risk of inadequate plans to the owner."). The same might be said of claims arising out of differing site conditions. *D2 Excavating, Inc. v. Thompson Thrift Const., Inc.*, 973 F.3d 430, 434 (5th Cir. 2020) ("The default rule in Texas, dating back to [*Lonergan*], is that the party doing the work bears the risk that it will end up being more difficult than anticipated unless the contract shifts that risk to the buyer of the services.").
21. *City of Dallas v. Shortall*, 131 Tex. 368, 114 S.W.2d 536, 540 (1938).
22. *El Paso Field Services*, 389 S.W.3d at 803.
23. *Id.* at 803–04.
24. *Id.* at 804.
25. *Id.*

> site observations with the requirements of the Contract and has fully acquainted itself with the site, including without limitation, the general topography, accessibility, soil structure, subsurface conditions, obstructions and all other conditions pertaining to the Work and has made all investigations essential to a full understanding of the difficultie which may be encountered in performing the Work, and that anything in this Contract or in any representations, statements or information made or furnished by [El Paso] or any of its representatives notwithstanding, [MasTec] assumes full and complete responsibility for any such conditions pertaining to the Work, the site of the Work or its surroundings and all risks in connection therewith; ….
>
> That the Contract is sufficientl complete and detailed for [MasTec] to perform the Work required…and comply with the requirements of the contract; ….[26]

The specifications also stated that El Paso "will have exercised due diligence in locating foreign pipelines and utility line crossings. However, [MasTec] shall confirm the location of all such crossings and notify the owner prior to any [ditching or horizontal directional drilling] activity in the vicinity of the crossings."[27]

As work proceeded, MasTec discovered several hundred more foreign crossings than were identified in the alignment sheets, resulting in substantial additional costs incurred by MasTec.[28] MasTec sued for breach of contract.[29] The jury found that El Paso breached the contract by failing to exercise due diligence in locating the foreign crossings and awarded MasTec over $4 million in damages.[30] The case ultimately arrived in the Texas Supreme Court.

MasTec argued that the broad "all risks" provision set out its *general* responsibility, but the specifications allocated to El Paso *specifi* responsibility to locate foreign crossings by the exercise of due diligence.[31] The Court rejected MasTec's argument. It noted that the contract contemplated a joint effo t by the parties: El Paso would exercise due diligence in locating foreign crossings and MasTec would confirm their locations.[32] And while the contract said that El Paso "will have exercised due diligence," MasTec agreed to assume the "all risks" of unknown foreign "notwithstanding" any information supplied by El Paso.[33] In short, "all risks" meant "*all* risks."[34]

Notably, there was evidence that El Paso's due diligence may have been less than industry standard because so few crossings were identified in its alignment sheets.[35] The Court declined to write a numerical standard into the contract to define "due diligence" or to set aside the contract's express risk allocation.[36] It held that to do so would mean that the parties could not determine for themselves what diligence is due or how to allocate risks for foreign crossings.[37]

The Court noted that its construction of the contract was consistent with *Lonergan* because El Paso did not guarantee that accuracy of the alignment sheets.[38] Instead, the contract made clear that MasTec assumed *all* risks of unknown site conditions and accepted the contract documents (including the alignment sheets) as sufficient Finally, the Court tied the result to Texas' commitment to freedom of contract and its "indispensable partner," contract enforcement.[39] "Were we to hold in MasTec's favor, and conclude that El Paso must bear the risk of unknown underground obstacles under this contract, we would render meaningless the parties' risk-allocation agreement and ultimately prohibit sophisticated parties

26. *Id.* at 806. Other portions of the contract contained similar language confirming the allocation of subsurface conditions risk to MasTec. *Id.* at 806–07.
27. *Id.* at 807.
28. *Id.* at 804–05.
29. *Id.* at 805.
30. *Id.*
31. *Id.* at 808.
32. *Id.* at 809.
33. *Id.* at 807–09.
34. *Id.* at 808.
35. *Id.* at 809–10.
36. *Id.* at 810.
37. *Id.* at 810.
38. *Id.* at 811. It is worth noting that MasTec did not pursue a fraud claim, thus taking the case out of the *Lonergan* "absent owner fraud" standard for defective owner-supplied plans. *Id.* at 805, n. 3.
39. *Id.* at 811–12.

from agreeing to allocate risk in construction contracts."[40] Because *someone* had to bear the risk, the Court looked to the contract to determine who that would be.

The result in this case required the Court to reconcile "all risks" provision with the due diligence provision. The Court elevated the former and narrowed the latter. On its face, it is fair to read a provision that refers to "all risks" broadly. And the representations from MasTec that was "fully acquainted" with the site and had "made all investigations" made that both easy and fair. But the Court read the due diligence provision narrowly – as a mere confirmation that El Paso had investigated. Indeed, the lack of importance attached to the due diligence language is supported by the language immediately following it, which merely referred to MasTec's obligation to notify El Paso before commencing work in the vicinity of the crossings. A diffe ent result might have obtained if the contract contained any language that could fairly have been read as either a warranty of the information supplied by El Paso or that the information, complete or not, could be relied upon by MasTec.

It is worth noting that the Legislature created an exception to *Lonergan* in the 2019 session through Transportation Code Chapter 473, which applies to certain public road and highway projects.[41] As of this writing, the Legislature appears poised to pass SB 219, which would broaden a shift away from *Lonergan*.[42]

### Practical Points on Risk Allocation and Due Diligence

"The bargain struck by the parties allocated the risk and there it ends. We enforce the contract."[43] Parties have "an obligation to protect themselves by reading what they sign."[44] So contract language matters. Risk-allocation and due diligence clauses are critical to conforming parties' contracts to a risk allocation scheme that each understands and can live with.

These clauses create an owner's guarantee of plans and specifications or allocate risks to the  wner:

- "The Contractor shall not be liable to the Owner or Architect for damage resulting from errors, inconsistencies or omissions in the Contract Documents unless the Contractor recognized such error, inconsistency or omission and failed to report it to the Architect.[45]
- "The Contractor shall carefully study and compare the Contract Documents and shall at once report to the Architect any error, inconsistency or omission he may discover. The Contractor shall not be liable to the Owner or the Architect for any damages resulting from any such errors, inconsistencies or omissions in the Contract Documents."[46]
- "The Contractor will be furnished additional instructions and detail drawings as necessary to carry out the work included in the contract."[47]
- "Contractor shall be entitled to rely upon the accuracy and completeness of information provided by or on behalf of owner regarding subsurface conditions at the work site. If such information is inaccurate or incomplete and materially affects contractor's ability to perform the work as originally priced and scheduled, then contractor shall be entitled to seek a change order."[48]

These clauses allocate risk of faulty plans and specifications to the contractor:

- "The Owner, Architect and Construction Manager disclaim any responsibility for the accuracy, true location and extent of the soils investigation that has been prepared by others. They further disclaim responsibility for interpretation of that data by Bidders, as in projecting soil-bearing values, rock profiles, soil stability and the presence, level and extent of underground water."[49]
- "Contractor assumes all risks related to, and waives any right to claim an adjustment in the contract price or schedule as a result of and conditions of the

40. *Id.* at 812. A similar result was reached by the Fifth Circuit Court of Appeals in *D2 Excavating*, 973 F.3d 430 (5th Cir. 2020). In that case, plans supplied by a contractor were inadequate and caused the subcontractor to incur substantial additional expense. *Id.* at 432. But the subcontract allocated the risk on the subcontractor, where it stated that the subcontractor visited the site, would evaluate conditions, and not be entitled to additional costs if the conditions were different. *Id.* at 434 (citing *Interstate Contracting Corp.*, 407 F.3d at 720–21; *El Paso Field Services*, 389 S.W.3d at 811; *Lonergan*, 104 S.W. at 1065–66).
41. Tex. Trans. Code § 473.1, *et seq*.
42. The version of the bill as of the time of this writing may be found at: https://capitol.texas.gov/tlodocs/87R/billtext/pdf/SB00219H.pdf#navpanes=0.
43. *Milgard Corp. v. McKee/Mays*, 49 F.3d 1070, 1073 (5th Cir. 1995).
44. *Id.* at 811 (citing *Thigpen v. Locke*, 363 S.W.2d 247, 253 (Tex. 1962)).
45. *Alamo Cmty. Coll. Dist. v. Browning Constr. Co.*, 131 S.W.3d 146, 155 (Tex. App.—San Antonio 2004, pet. dism'd by agr.).
46. *N. Harris County Junior Coll. Dist. v. Fleetwood Constr. Co.,* 604 S.W.2d 247, 253 (Tex. Civ. App.—Houston [14th Dist.] 1980, writ ref'd n.r.e.).
47. *Bd. of Regents of the Univ. of Tex. v. S & G Constr. Co.,* 529 S.W.2d 90, 95 (Tex. Civ. App.—Austin 1975, writ ref'd n.r.e.).
48. Author-drafted provision.
49. *Milgard Corp.*, 49 F.3d at 1071.

site or other location where work is to be performed including (i) river levels (excluding Force Majeure events), topography and subsurface soil conditions disclosed in information provided by or on behalf of the owner (excluding Force Majeure events), (ii) climatic conditions and seasons (excluding Force Majeure events)…."[50]

These clauses address due diligence in site examination or review of plans and specifications

- "Execution of this Agreement by the Subcontractor is a representation that the Subcontractor has visited the Project site, become familiar with local conditions under which the Work is to be performed and correlated personal observations with requirements of the Contract Documents. The Subcontractor shall evaluate and satisfy itself as to the conditions and limitations under which the Work is to be performed, including without limitation: (1) the location, condition, layout, and nature of the Project site and surrounding areas; (2) generally prevailing climactic conditions; (3) anticipated labor supply and costs; (4) availability and cost of materials, tools, and equipment; and (5) other similar issues. Accordingly, Subcontractor shall not be entitled to an adjustment in the Contract Price or an extension of time resulting from Subcontractor's failure to fully comply with this paragraph."[51]
- "In addition, the CONTRACTOR represents that he has satisfied himself as to subsurface conditions at the site of the work. Information, data and representations contained in the contract documents pertaining to the conditions at the site, including subsurface conditions, are for information only and are not warranted or represented in any manner to accurately show the conditions at the site of the work. The CONTRACTOR agrees that he shall make no claims for damages, additional compensation or extension of time against the OWNER because of encountering actual conditions in the course of the work which vary or differ from conditions or information contained in the contract documents. *All risks of differing subsurface conditions shall be borne solely by the CONTRACTOR.*"[52]
- "Subsurface information shown on these drawings was obtained solely for use in establishing design controls for the project. The accuracy of this information is not guaranteed and it is not to be construed as part of the plans governing construction of the project. It is the bidder's responsibility to inquire of the City of Dallas if additional information is available, to make arrangements to review same prior to bidding, and to make his own determinations as to all subsurface conditions."[53]
- "Bidders are expected to examine the site and the subsurface investigation reports and then decide for themselves the character of the materials to be encountered."[54]
- "Contractor has satisfied itself as to the apparent correctness and completeness of the data and information contained in the Contract Documents that were supplied by Company. However, Contractor shall have no independent obligation to verify the accuracy and completeness of any data and information supplied by Company."[55]

## III. NO-DAMAGES-FOR-DELAY CLAUSES.

"The common law permits a contractor to recover damages for construction delays caused by the owner, but the parties are free to contract otherwise."[56] Under a typical no-damages-for-delay clause, the contractor agrees to excuse the owner from liability for delay caused by, for example, changes in plans, even if the owner is at fault or negligent.[57] In *Zachry Constr. Corp. v. Port of Houston Authority of Harris County*, the Texas Supreme Court addressed whether a no-damages-for-delay clause shielded an owner for delay when it deliberately and wrongfully interfered with the contractor's work.[58] The Court answered, "no."[59]

Zachry contracted to construct a 1,660 foot wharf on the Bayport Ship Channel for the Port of Houston Authority.[60] The wharf would be a concrete deck supported by piers, extending out over the water, and large enough for two

50. Author-drafted provision.
51. *D2 Excavating*, 973 F.3d at 432.
52. *Interstate Contracting Corp.,* 407 F.3d at 721.
53. *Id.* at 714.
54. *Milgard Corp.*, 49 F.3d at 1071.
55. Author-drafted provision.
56. *Zachry Const. Corp.*, 449 S.W.3d at 101.
57. *Id.*
58. *Id.*
59. *Id.*
60. *Id.*

containerized ships to dock stern to bow.[61] It would be built in fi e sections, each 135 feet wide and 332 feet long.[62] The channel would be dredged to 40 feet around the wharf and a revetment built along the shore to prevent erosion.[63] The Port set a two-year completion schedule and the total project cost was to be $62,485,733.[64]

The contract provided that the Port had no right to control Zachry's work and that, as an independent contractor, Zachry was "solely responsible for supervision of and performance of the Work and shall prosecute the Work at such time and seasons, in such order or precedence, and in such manner, using such methods as [Zachry] shall choose."[65] The contract also contained a no-damages-for-delay provision:

> [Zachry] shall receive no financial compensation for delay or hindrance to the Work. In no event shall the Port Authority be liable to [Zachry] or any Subcontractor or Supplier, any other person or any surety for or any employee or agent of any of them, for any damages arising out of or associated with any delay or hindrance to the Work, regardless of the source of the delay or hindrance, including events of Force Majeure, AND EVEN IF SUCH DELAY OR HINDRANCE RESULTS FROM, ARISES OUT OF OR IS DUE, IN WHOLE OR IN PART, TO THE NEGLIGENCE, BREACH OF CONTRACT OR OTHER FAULT OF THE PORT AUTHORITY. [Zachry's] sole remedy in any such case shall be an extension of time.[66]

Zachry's "innovative" plan to construct the wharf included building an 8-foot wide, U-shaped berm extending from the shore into the channel and surrounding the worksite. A refrigerated piping system would freeze the wall to keep water out.[67] The water inside the berm would be removed so that Zachry could construct the wharf "in the dry."[68] Timing was critical: two sections of the wharf had to be completed within 20 months so that a ship from China could dock and deliver cranes to be used on the wharf.[69] Zachry agreed to pay $20,000 per day as liquidated damages for missing the deadlines.[70]

After the project started, the Port decided to add another 332-foot section to the wharf.[71] Zachry proposed to install another freeze wall. A "cutoff wall," through the middle of the project so that so that the new section could also be built and completed on time "in the dry" and the rest of the wharf could then also be completed "in the dry."[72] The Port had concerns that the cutoff wall might destabilize already-constructed piers supporting the wharf but was also concerned that if it refused to follow Zachry's plan, Zachry might not agree to perform the additional work.[73] The Port issued a $12,962,800 change order based on Zachry's plan.[74]

Two weeks later, the Port directed Zachry to submit a new plan without the freeze wall. Zachry objected that the Port did not have the right under the contract to dictate how Zachry performed the work, but the Port would not relent.[75] Zachry completed the section of the wharf needed for delivery of the cranes, removed the freeze wall, and continued work on the rest of the wharf and the 332-foot extension "in the wet," which substantially delayed completion of the project.[76]

In negotiating the change order, the Port agreed to not impose liquidated damages if the ship delivering the cranes could dock when it arrived but refused to put its promise in writing.[77] After the ship arrived, the Port withheld $2.36 million in liquidated damages from progress payments to Zachry.[78] Zachry completed the project more than two-and-a-half years after the original deadline.

61. *Id.*
62. *Id.*
63. *Id.* at 101–02.
64. *Id.* at 102.
65. *Id.*
66. *Id.*
67. *Id.*
68. *Id.*
69. *Id.*
70. *Id.*
71. *Id.*
72. *Id.*
73. *Id.* at 103.
74. *Id.*
75. *Id.*
76. *Id.*
77. *Id.*
78. *Id.*

Ultimately, Zachry sued and claimed $30 million damages from delays caused by the Port.[79] The Port refused to pay, citing the no-damages-for-delay clause in the contract as well as releases Zachry signed in submitting progress payments.[80] At trial, the jury found that the Port breached the contract by rejecting Zachry's cutoff wall plan and therefore caused Zachry to incur $18,602,697 in delay damages.[81] The jury also found that the delay "was the result of the Port's ... arbitrary and capricious conduct, active interference, bad faith and/or fraud."[82] The jury did not find that Zachry released its claim to the $2.36 million in liquidated damages the Port withheld, but found that the Port was entitled to offset $970,000 for defective work.[83]

The Court of Appeals reversed the judgment for Zachry, finding that the no-damages-for-delay clause barred Zachry's recovery of delay damages and that Zachry released its claim to the payments withheld by the Port.[84] It held that the Port was entitled to $970,000 for defective work and $10,697,750 in attorney's fees.[85]

In enforcing the no-damages-for-delay clause, the Court of Appeals relied heavily on its "plain language," under which Zachry agreed that it would not seek such damages even if the delay was caused by the Port's "breach of contract, negligence, or other fault."[86] It also concluded that Zachry failed to establish the clause was also not intended to apply to the Port's arbitrary and capricious conduct, active interference, bad faith, or fraud.[87] In reaching that "harsh result," the Court of Appeals emphasized the parties' freedom of contract and declined to rewrite the contract to affo d Zachry relief. The Supreme Court granted Zachry's petition for review.

The Supreme Court noted that under Texas law, a contractor may agree to assume the risk of delays and to seek no damages for them.[88] But the Court cited the court of appeals decision in *City of Houston v. R.F. Ball Constr. Co.*, which recognized four exceptions to enforcement of a no-damages-for-delay clause: where the delay (1) was not intended or contemplated by the parties to be within the provision's scope, (2) resulted from fraud, misrepresentation or other bad faith, (3) extended for so long that the delayed party would be justified in abandoning the project, and (4) is not within the enumerated delays to which the provision applies.[89] The Supreme Court noted that in *Green Int'l, Inc. v. Solis,* the Court of Appeals had recognized a fifth exception based on active interference with the contractor or other wrongful conduct including "arbitrary and capricious acts" or "willful and unreasoning actions."[90] Zachry argued that the second and fifth e ceptions applied.[91]

Addressing the "other fault" language in the no-damages-for-delay provision, the Court doubted that it could be interpreted to include the kind of deliberate, wrongful conduct in which the jury found the Port engaged.[92] It cited a cogent point made in an amicus brief: contractors can assess potential delaying events by making judgments on the quality of plans, possible material shortages, weather, or soil conditions, "but they cannot assess potential delays that may arise due to an owner's direct interference, willful acts, negligence, bad faith fraudulent acts, and/or omissions."[93]

The Court held that the purpose of the second recognized exception under *Ball* was to preclude a party from insulating itself from liability for its own deliberate, wrongful conduct.[94] It noted that pre-injury waivers for future liability for gross negligence, and contractual provisions exempting a party from tort liability for causing harm intentionally or recklessly, are both unenforceable on public policy grounds.[95] "We think the same may be said of contract liability."[96]

79. *Id.*
80. *Id.*
81. *Id.* at 104.
82. *Id.*
83. *Id.*
84. *Id.* at 105. *See Port of Houston Auth. of Harris Cty. v. Zachry Constr. Corp.*, 377 S.W.3d 841 (Tex. App.—Houston [14th Dist.] 2012).
85. *Port of Houston*, 377 S.W. at 850.
86. *Id.*
87. *Id.*
88. *Zachry Constr. Corp.*, 449 S.W.3d at 114–15 (citing Green Int'l, Inc. v. Solis, 951 S.W.2d 384, 387 (Tex. 1997)).
89. *Id.* (citing *City of Houston v. R.F. Ball Constr. Co.*, 570 S.W.2d 75 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ ref'd n.r.e.)).
90. *Id.* at 115.
91. *Id.* at 115.
92. *Id.* at 115–16.
93. *Id.* at 116 and n. 85 (citing Brief of the Associated General Contractors of Texas, Inc. as Amicus Curiae, at 2). Zachry's position was strongly supported by several amici from the construction industry. *Id.* at n. 85.
94. *Id.* at 116.
95. *Id.* (citing *Fairfield Ins. Co.*, 246 S.W.3d at 687 and Restatement (Second) of Contracts § 195(1) (1981)).
96. *Id.*

It then turned to the Port's argument that not enforcing the no-damages-for-delay provision is in derogation of freedom of contract:

> But that freedom has limits. 'As a rule, parties have the right to contract as they see fit as long as their agreement does not violate the law or public policy.' Enforcing such a provision to allow one party to intentionally injure another with impunity violates the law for the reasons we have explained.[97]

*Zachry* will continue to be the subject of interest and debate. In one sense, it is conceptually related to fraud-in-the-inducement cases, in which courts will not enforce contracts procured by fraud.[98] That is a pro-freedom of contract position. The case affirm that courts should not incentivize bad behavior.[99] Thus, the Court declined to enforce a clause that excused a party from intentional misconduct. Again, that is a pro-freedom of contract position, but *Zachry* obviously concerns conduct during performance. While the court made it clear that it was not recognizing a duty of good faith in performing a contract,[100] a substantive look at how a party performs under a contract is an inevitable byproduct of *Zachry*. The Court may have rejected a "good faith" standard, but it at least adopted a "no deliberate misconduct" standard. Some level of cooperation is implied in every contract: without that, the bargained-for rights and obligations are illusory. The "no deliberate misconduct" standard is akin to the concept of prior material breach, which excuses the non-breaching party from further performance. But inquiries into how parties perform may cause or deepen disputes that will turn on what may look a lot like an inquiry into parties' good or bad faith.

### Practical Points on No-Damage-for-Delay Clauses

*Zachry* gives force to the fi e recognized exceptions to enforcement of no-damages-for-delay clauses. The case also highlights evidentiary and drafting challenges for contractors, owners, and their counsel.

Some of the exceptions are highly fact intensive. For example, determining what conduct rises to the level of "arbitrary and capricious acts" or "willful and unreasoning actions" or "bad faith" will turn on possibly unclear or conflicting evidence. Contractors and owners will have to stay attuned to how they communicate and what they do as delay-causing events or circumstances arise. Contractors should clearly communicate not only about the facts and their causes, but also about why they believe that they fall outside of the no-damages-for-delay clause and what specific costs they believe are attributable to the delay. Owners should clearly communicate any reservations or disagreements and take care to avoid any internal or external communications that could be construed as proof of intentionally wrongful conduct.

For contract drafters and negotiators, a critical question is whether a no-damages-for-delay clause is either so specific or so global that it will cover and preclude application of the fi e exceptions. A clause that permits conduct that is or could be described as deliberate misconduct would be unenforceable on public policy grounds. But a clause might be crafted to enumerate specific permissible acts that the parties agree will not support a *Zachry*-based deliberate misconduct claim.

Another issue is whether a clause that limits the contractor to only a time extension as relief for the delays would bar monetary relief for acceleration, compression, resequencing, inefficiencies design changes or other matters caused by delays.[101] A precise clause would address and either permit or exclude a range of possible damages, including lost productivity, impact damages, increased performance costs, or other enumerated measures of damage.

Drafters should consider:

- The types of delays that the parties considering and defining
- Whether to define what conduct by the owner is permitted;
- Thetypes of damages that are permissible or precluded; and
- How the no-damages-for-delay clause and a liquidated damages clause may create a substantial hardship to the contractor.

97. *Id.* at 117–18 (citing, *inter alia*, *In re Prudential Ins. Co. of Am.*, 148 S.W.3d at 129). The court reversed the court of appeals on the issue of whether Zachry's progress payment released applied to claim to recover the liquidated damages withheld by the Port and reversed the award of attorney's fees to the Port. *Id.* at 119–20.
98. *See, e.g.*, *Formosa Plastics Corp.*, 960 S.W.2d 46 (party is not bound by a contract procured by fraud or mistake).
99. *Id.* at 116.
100. *Zachry Constr. Co.*, 449 S.W.3d at 117 (citing *English v. Fisher*, 660 S.W.2d 521, 522 (Tex. 1983).
101. *See, e.g.*, *Central Ceilings, Inc. v. Suffolk Constr. Co., Inc.*, 91 Mass. App. Ct. 231 (2017) (no-damages-for-delay-provision did not preclude subcontractor's recovery of damages for increased labor force due to compressed work schedule).

## IV. CONDITIONS PRECEDENT TO PARTNERSHIP FORMATION

Firms often explore the possibility of forming a joint venture or partnership to pursue a business opportunity. They routinely agree to conditions that must occur before they go from a pursuit phase to a formal relationship. In *Energy Transfer Partners, L.P. v. Enterprise Products Partners, L.P.*, the Court enforced contractual conditions precedent to the formation of a partnership to build a pipeline despite conduct of the parties that arguably formed a partnership, even though the contractual conditions precedent had not occurred.[102] In doing so, the Court upheld parties' freedom of contract - specificall , it determined that parties may bargain for conditions precedent to partnership formation to avoid becoming "accidental partners" by conduct.

Energy Transfer and Enterprise Products own and operate oil and gas pipelines and are competitors.[103] In 2011, they entered discussions over a possible joint venture to develop a crude oil pipeline to send oil south from Oklahoma to Texas Gulf Coast refineries [104] They made three preliminary agreements describing their intent and potential relationship.[105] The agreements stated that their exploratory effo ts would not result in a partnership or other binding relationship until two conditions occurred: approval by each company's board of directors and execution of formal documents to create and define the relationship.[106] The e was no provision in the agreements obligating either party to deal exclusively with the other in pursuing a project to develop an Oklahoma-to-Texas pipeline.[107]

ETP and Enterprise took several steps toward the proposed project. They publicly announced an agreement to form a "50/50 JV" to construct the pipeline and marketed the pipeline's capacity under the name "Double E."[108] They sought shipper commitments to determine whether Double E would be economically viable.[109] After determining that the proposed project was not viable, Enterprise and ETP exchanged verbal and written communications that appeared to show a clean break-up.[110] ETP wrote to Enterprise confirming that Double E "was not viable" and the parties "would not move forward" together.[111] Before that occurred, however, Enterprise and another midstream company, Enbridge (US), Inc. began discussions about jointly developing an Oklahoma-to-Texas pipeline. They ultimately did so, and it was a financial success [112]

ETP sued Enterprise, claiming that that the parties engaged in conduct that created a partnership as defined in the partnership provisions of the Texas Business Organizations Code ("TBOC")[113] and that Enterprise breached its statutory duty of loyalty to ETP by taking the Seaway opportunity and leaving ETP out of the mix.[114]

At trial, the jury found that a partnership was formed under the TBOC and that Enterprise breached its duty of loyalty.[115] It awarded ETP $319 million in actual damages.[116] The trial Court entered judgment against

102. *Energy Transfer*, 593 S.W.3d 732.
103. *Id.* at 734.
104. *Id.*
105. *Id.*
106. A **Letter Agreement and Non-Binding Joint Venture Term Sheet** described the proposed transaction. It stated, in part: "[n]either this letter nor the JV Term Sheet create any binding or enforceable obligations between the Parties and, except for the Confidentiality Agreement…no binding or enforceable obligations shall exist between the Parties with respect to the Transaction unless and until the Parties have received their respective board approvals and definitive agreements memorializing the terms and conditions of the Transaction have been negotiated, executed and delivered by both of the Parties. Unless and until such definitive agreements are executed and delivered by both of the Parties, either [Enterprise] or ETP, for any reason, may depart from or terminate the negotiations with respect to the Transaction at any time without any liability or obligation to the other, whether arising in contract, tort, strict liability or otherwise." *Id.*
A **Confidentiality Agreement** facilitated sharing information. It stated, in part: "The Parties agree that unless and until a definitive agreement between the Parties with respect to the Potential Transaction has been executed and delivered, and then only to the extent of the specific terms of such definitive agreement, no Party hereto will be under any legal obligation of any kind whatsoever with respect to any transaction by virtue of this Agreement or any written or oral expression….A Party shall be entitled to cease disclosure of Confidential Information hereunder and any Party may depart from negotiations at any time for any reason or no reason without liability to any party hereto." *Id.*
A **Reimbursement Agreement** provided for sharing engineering costs. It stated, in part: "[n]othing herein shall be deemed to create or constitute a joint venture, a partnership, a corporation, or any entity taxable as a corporation, partnership or otherwise…." *Id.*
107. Brief of Respondent at p. 8.
108. *Id.*
109. *Id.* at 736.
110. *Id.*
111. Brief of Respondent at p. 11–12.
112. *Id.*
113. *Id.*; *see* Tex. Bus. Orgs. Code § 152.001, *et seq*.
114. *Id.*; *see* TBOC § 152.205.
115. *Id.*
116. *Id.*

Enterprise in an aggregate amount of $535 million, including $319.4 million in actual damages, $150 million in disgorgement for the alleged benefit Enterprise received due to a breach of fiducia y duties, and prejudgment interest.[117] The Dallas Court of Appeals reversed the judgment and rendered a take-nothing judgment against ETP.[118] ETP appealed to the Texas Supreme Court.

The main issue in the case was whether the TBOC or Texas common law permits parties to conclusively agree that, as between themselves, no partnership will exist unless certain conditions precedent are satisfied [119]

TBOC section 152.051(b)(1) states that "an association of two or more persons to carry on a business for profit as owners creates a partnership, 'regardless of whether the persons intended to create a partnership.'"[120] The statute identifies fi e factors indicating that parties have created a partnership: (1) right to receive a share of the profits of the business, (2) expression of an intent to be partners, (3) participation in control of the business, (4) agreement to share losses of the business or liability for third party claims against the business, and (5) contribution of money or property to the business.[121] Proof of all factors is not required and no one factor is determinative; the factors are considered under a "totality of the circumstances" test and a partnership may be formed regardless of the parties' intent to form or not to form a partnership.[122] The statutory scheme provides and courts have recognized that partnerships can be created by conduct.[123]

ETP argued that the conditions precedent in the parties' agreements were only evidence of factor 2 (expression of intent to be partners) and the unfulfilled conditions precedent did not preclude partnership formation.[124] Conduct that ETP contended created a partnership under the TBOC, including holding the joint venture out as an existing entity, soliciting contracts for the entity, and creating a joint project team and sharing expenses.[125] ETP argued that the TBOC's totality of the circumstances test controls partnership formation despite the common law and that intent was merely one factor to consider.[126] In sum, ETP's position was that parties cannot contractually preclude partnership formation until a condition precedent occurs and to avoid an "accidental partnership" the parties must also avoid conduct that establishes a partnership under the other factors set out in the TBOC.[127]

Principles of law and equity supplement TBOC Chapter 152 "unless otherwise provided" in the TBOC.[128] Texas common law strongly favors freedom of contract.[129] Texas courts resist interfering in risk allocations bargained for by sophisticated parties in substantial commercial transactions.[130] They specifically recognize that agreements can set conditions precedent to partnership formation.[131] Those conditions have been enforced in many other contexts.[132]

Enterprise relied heavily on the parties' freedom of contract, including to contractually protect themselves from unwanted partnerships by agreeing to conditions precedent.[133] It emphasized the preliminary agreements'

117. *Id.*
118. *Id. See Enterprise Products Partners, L.P., et al. v. Energy Transfer Partners, L.P.*, 529 S.W.3d 531 (Tex. App.—Dallas 2017).
119. *Id.* at 733.
120. TBOC § 152.051(b)(1).
121. *Id.* at § 152.052(a).
122. *Ingram v. Deere*, 288 S.W.3d 886, 898 (Tex. 2009). *Ingram* analyzed a predecessor statute containing substantially the same TBOC provisions. *Id.* at 894, n. 4.
123. *See* TBOC § 152.051(b)(1) (five-factor test); *Thompson*, 500 S.W.2d at 209 (condition precedent to partnership formation may be waived if parties proceed with the business of the partnership).
124. *Enterprise Products*, 529 S.W.3d at 538.
125. *See Energy Transfer*, 593 S.W.3d at 735.
126. *Id.* at 740.
127. *Id.*
128. TBOC § 152.003.
129. *Energy Transfer*, 593 S.W.3d at 738 (citing *Gym-N-I Playgrounds, Inc. v. Snider*, 220 S.W.3d 905, 912 (Tex. 2007)). *See also Nat'l Plan Adm'rs, Inc. v. Nat'l Health Ins. Co.*, 235 S.W.3d 695, 702 (Tex. 2007) (Texas law recognizes "right of persons to define the terms of their relationships").
130. *Id.* at 738 and n. 20 (citing *MasTec*, 389 S.W.3d at 811; *Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 180 (Tex. 1997)).
131. *Thompson*, 500 S.W.2d at 209 (Tex. Civ. App.—Dallas 1973, no writ) ("when an agreement provides a condition precedent to the formation of a partnership, it will not come into existence until the condition has been met"). "Persons who have entered into a contract to become partners at some future time or on the happening of some future contingency do not become partners until or unless the agreed time has arrived or the contingency has happened." *Arnold v. Caprielian*, 437 S.W.2d 620, 625 (Tex. Civ. App.—Tyler 1969, writ ref'd n.r.e.); *Root v. Tomberlin*, 36 S.W.2d 596, 601 (Tex. Civ. App.—El Paso 1931, writ ref'd n.r.e.) (recognizing and enforcing existence of condition precedent to partnership formation).
132. Texas courts enforce letters of intent in which parties agree that a relationship or transaction will not be created or binding until formal documents are executed or other conditions are met. *See, e.g., COC Services, Ltd. V. CompUSA, Inc.*, 150 S.W.3d 654, 665-70 (Tex. App.—Dallas 2004, pet. denied) (enforcing letter agreement making execution of franchise agreement a condition precedent); *WTG Gas Processing, L.P. v. ConocoPhillips Co.*, 309 S.W.3d 635, 645-49 (Tex. App.—Houston [14th Dist.] 2010, pet. denied) (enforcing condition precedent to acceptance of terms under a purchase and sale agreement); *John Wood Grp. USA, Inc. v. ICO, Inc.*, 26 S.W.3d 12, 19 (Tex. App.—Houston [1st Dist.] 2000, pet. denied) (enforcing condition precedent to contract for sale of corporate assets).
133. *Energy Transfer*, 593 S.W.3d at 740.

clear non-binding language expressing the parties' intent not to deal exclusively with each other.[134]

The Court emphasized Texas' "deeply engrained" devotion to freedom of contract.[135] It also noted that freedom of contract is reinforced where unambiguous contract language results from arm's length negotiations between sophisticated parties should be enforced.[136] In addressing the role of parties' intent in light of the TBOC's test for partnership formation, the Court affirme that evidence probative of other factors should not be considered, otherwise, all evidence of the parties' dealings could be an expression of intent, making "intent" a catch-all factor rather than one to be separately considered and proved.[137] In this case, definiti e, board-of-directors-approved agreements were required to form a partnership. While performance of a condition precedent can be waived by word or deed, there was no evidence that Enterprise disavowed that condition precedent or intentionally acted inconsistently with that requirement.[138] The parties' holding themselves out as partners and working closely on the Double E prospect did not establish a waiver of definiti e, board-approved agreements.[139] Thus, the Court held "that parties can conclusively negate the formation of a partnership under Chapter 152 of the TBOC through contractual conditions precedent."[140]

### Practical Points on Conditions Precedent to Contract Formation

*Energy Transfer* disposed of any uncertainty about parties' ability to set conditions precedent to partnership formation. It is consistent with already-recognized strict enforcement of conditions precedent in other contexts.[141] Parties considering formation of a partnership, joint venture or teaming agreement would be wise to draft preliminary documents carefully.

- Identify the nature and scope of the opportunity being considered and expressly exclude any opportunities not identified
- Express the non-exclusivity of the parties' exploratory relationship if the parties intend to be free to discuss the same or similar opportunities with others. If an exclusivity obligation is intended, limit its duration, and identify the specific opportunity to which the exclusivity applies and, if possible, those to which it does not apply.
- Clearly disclaim the existence of a joint venture, partnership, or other special relationship.
- Identify clear, objectively verifiable conditions to the formation of a further, formal relationship.
- Include an express waiver of claims based on partnership-by-conduct.
- Include a provision that any waiver of conditions precedent must be in writing, executed by all parties.
- Title documents carefully. "Letter of Intent" or "Proposal" are preferred over "Term Sheet" or "Agreement."
- Consider a fi ed term for the exploratory period after which the relationship is terminated unless extended in writing by both parties for an additional specified term and purpose.
- Clearly document the end of the exploratory period and that the parties have no further obligations regarding the opportunity or to each other in connection with the opportunity.
- If an entity must be formed for a preliminary purpose (e.g., to secure licensing or obtain services from third parties), limit that entity's purpose and condition further obligations or undertakings by that entity on clear conditions precedent.

If the parties will or expect to perform tasks during the pursuit phase, specifically identify the tasks and state that they shall not be considered as evidence of the formation of a joint venture, partnership, or other special relationship. The parties should segregate their respective tasks and financial obligations rather than rely on collaboration or shared costs, if practicable.

Conduct and communications matter because they can undermine carefully drafted documents. Parties would be wise to:

134. *Id.*
135. *Id.*
136. *Id.* at 738.
137. *Energy Transfer*, 593 S.W.3d at 737 and n. 9.
138. *Id.* at 741.
139. *Id.* at 742.
140. *Id.* at 741.
141. *See, e.g.*, *Emerald Forest Utility Dist. v. Simonsen Constr. Co.*, 679 S.W.2d 51 (Tex. App.—Houston [14th Dist. 1984, writ ref'd n.r.e.) (if a contract provides for a particular form of notice, "compliance with such provisions is a condition precedent to invoking the contract rights which are conditioned on the notice"). *But see James Constr. Group, LLC v. Westlake Chem. Corp.*, 594 S.W.3d 722 (Tex. App.—Houston [14th Dist.] 2019, pet. filed) (rejecting strict compliance with contractual notice provision as condition precedent to termination of contract).

- Not violate or ignore confidentiality or exclusivity provisions in the exploratory documents.
- Avoid sharing costs, personnel, facilities, or other resources, if practicable. If such sharing is necessary, it should be done in strict compliance with preliminary documents setting out rules for such activities.
- Control and jointly approve communications with third parties, regulatory bodies, and the public.
- Do not characterize the relationship as having been formalized unless and until it has been formalized in strict compliance with the parties' preliminary documents.

A separate concern may arise when two parties commonly engage in joint projects. Each project may be a stand-alone venture, with the parties otherwise remaining at arm's length. However, a course of dealing may be viewed by the other party as having created a deeper relationship or other more permanent obligations, including exclusivity. If parties frequently collaborate, they should carefully document the nature and limits of the ongoing collaborative relationship to avoid misunderstanding or dispute.

## V. CONCLUSION

The dedication to freedom of contract in Texas law is laudable. It gives wide latitude to parties to allocate risks, determine remedies, and otherwise order their commercial relationships as they see fit. The e are limits to the freedom, however, found in common law principles or in public policy considerations. While those limits may sometimes be viewed as undermining freedom of contract, they often support that freedom by ensuring that contracts that are enforced by Texas courts serve a rules-based market economy and encourage commerce. For Texas lawyers and their clients, the maxim may be, "Let freedom ring and watch what you bargain for."