ALFA International
THE GLOBAL LEGAL NETWORK

2023 Construction Law Seminar

July 26-28, 2023

Avoiding the Wipe Out Between Contract and Completion

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Ten Provisions to Consider When Drafting or Negotiating Your Next Construction Contract

The construction industry is rife with form contracts; the forms developed by the American Institute of Architects (AIA) or the ConsensusDocs forms endorsed by the Associated General Contractors of America (AGC) and many other construction industry professional organizations come chiefly to mind. But as well intentioned, and comprehensive as these form contracts might be, that does not make them right for every project. Not every project, for instance, demands the 43 pages that make up the AIA A201 General Conditions to the Contract. In fact, most construction projects in the United States – certainly those under $1 million – are often best served by the parties' developing their own contracts that work best for their project.

But where does a construction contractor or developer/owner start when drafting their contract? Utilizing the AIA or ConsensusDoc form might be a good place to start, but those forms are copyrighted documents and utilizing them without paying for the form could bring about its own problems. Hiring a qualified construction attorney may be advisable, at least to prepare an initial form to be utilized by your company or to review a heavily edited document received from the other contracting party. Regardless of whether your company is drafting the construction contract or whether you have been offered a contract from another party to review and edit, included here are 10 significant sections that a party to a construction contract should be most mindful of given their significance to the project, to potential liability and financial risk, or to the parties' profit and bottom line.

1. Scope of Work.

It is certainly arguable what the most significant contract provision might be, but the scope of work must be near the top. It is imperative that both parties to a construction contract enter into the agreement with a clear understanding of the expected work to be performed. Absent a clear agreement on the scope of work, there is a high likelihood a dispute will develop later. The scope of work should be clear and concise. From the perspective of an owner contracting with a general contractor, that might mean incorporating the architect's plans and specifications as contract documents. From the perspective of a general contractor, that might mean attaching as an exhibit the subcontractor's bid or estimate, though being sure the general contractor is cross-referencing each subcontractor's bid to ensure no gaps in the work. A contracting party should also utilize clear exclusions from the scope of work as may be necessary. A contractor that clearly defines what work will not be performed is often part and parcel with defining the work that will be performed.

An ancillary provision to the scope of work provision is that related to changes in the work, particularly the change order process. A good construction contract will clearly define under what circumstance a change order might be acceptable and when one is not. Of recent significance, escalating material prices have resulted in a significant number of change orders in construction contracts. The construction contract should clearly define under what circumstance – if any – a materials escalation would warrant a change order. Typically, this means defining a percentage of the increase in cost that warrants a change order, such as a 20% price increase, for example, which must be supported by documentation of the bid cost and the escalated cost. Beyond a price increase, the contract should define the circumstances under which time extensions are warranted. If a change in the scope is expected to impact the construction schedule, the schedule modification should be included in the change order.

2. Completion

At first blush, defining what constitutes completion should be a simple task without much emphasis in the contract – when the scope of work as defined in the contract is complete, the job is complete. But when "completion" can drag on because of punch list or other nominal work that does not impact occupancy or use, issues can arise. It is preferable, therefore, to tie completion to a specific point in time or objective achievement. In many jurisdictions, the building department will issue a certificate of use or certificate of occupancy, either of which might be a suitable benchmark for completion. Some industry form agreements tie completion to the architect's written acceptance of the work, which might also be another suitable option, particularly for an owner that is in privity with the architect.

3. Termination/Suspension

Unfortunately, one cannot always count on the work being performed correctly, on time, and on budget. Therefore, termination and suspension clauses in contracts are a necessity, as they define when and under what circumstances a party can be terminated or suspended. For instance, some contracts might allow an owner or contractor to terminate for convenience – for any reason, at any time, for any cause. Because of the ramifications, such clauses should rarely be included in contracts. But if a termination for convenience must be included, the contractor should look to ensure that it is paid for all work and services up to the date of termination, including overhead, profit, and general conditions. The contractor would also be well within its rights to negotiate compensation for lost profit on the job because of the owner's termination for convenience. Likewise, a subcontractor should never want to allow a general contractor to terminate for convenience, unless it is the result of the owner's termination. Even then, the same clauses the general contractor might seek from the owner to mitigate or eliminate all losses should be sought by subcontractors from the general contractor as well.

For the more likely termination for cause scenarios, the termination clause should specifically set forth what circumstances permit termination for cause. Certainly the default of one party would be one broad circumstance where termination for cause might be appropriate, but, more specifically, termination might be appropriate as the result of defective or deficient work, excessive or avoidable delays, lack of competent trade contractors, or bankruptcy by the contractor or owner. Indeed, the circumstances calling for termination are innumerable and should be carefully addressed with as much specificity as possible in the contract.

4. Warranties

Warranty obligations are a critical aspect of a completed construction project and, so too, it is critical to set forth the warranty obligations in the contract. Often this can be done by attaching the written warranty to the construction contract as an exhibit, as this eliminates all doubt as to the obligations. But if a form warranty is not attached, the contract itself should delineate the length and scope of the warranty, and whether the warranty is exclusive or in addition to other statutory or common law warranties. If exclusive, then the contract should clearly and explicitly state that all other warranties, including statutory or common law warranties, are disclaimed to the extent permitted by law.

5. Delay Damages

Delay damages are another subset of damages that must be specifically addressed in the construction contract, at least as to whether delay damages should be actual or liquidated. Actual damages are those damages that the injured party can show directly arose out of the breach of the agreement. For instance, if a project is delayed one month because of a subcontractor's delay, the general contractor can typically show a calculation of one month of additional general conditions and its overhead and profit as a way of calculating the general

contractor's actual damages suffered because of the delay. Actual damages are typically best when the damages are easily quantifiable and verifiable through records and other evidence.

But often actual damages can be difficult to calculate. For that reason, many construction contracts will include liquidated damage provisions that establish a set amount of damages per day or per month in the event of a delay. These liquidated damages, then, are predetermined in the contract. Importantly, though, to be valid, the liquidated damage amount must bear a reasonable relationship to the anticipated harm or breach and cannot be viewed as a penalty. On the positive side, liquidated damages can be easily calculable and help avoid protracted litigation, as the arithmetic is simply the number of delay days/months multiplied by the liquidated damage amount per day/month. Liquidated damages also allow a contractor or subcontractor to know their exposure to delay damages at the time of contracting. However, on the downside, liquidated damages may prove insufficient to cover all damages incurred.

If liquidated damages are to be included in the construction contract, it is recommended that the amount be laid out in detail, along with the accrual rate (typically per day or per month). The parties can also negotiate and include varying liquidated damages, such that, perhaps the amount increases over time; after all, a brief delay of a week or two is perhaps not as costly to the injured party as a delay of a month or more. For this reason, it is also advisable for a general contractor to negotiate a grace period between the contract completion date and when liquidated damages are to be instituted, perhaps a week or two weeks to allow for some flexibility in the completion date before damages begin to accrue. Of course, whatever damages provisions the general contractor ultimately agrees to with the owner should also flow down to the subcontracts that the general contractor executes.

6. Dispute Resolution

In the absence of a contract setting forth otherwise, a construction dispute will be resolved in litigation before a court with competent jurisdiction, with any party having the ability to demand trial by jury as is their right unless waived. Thus, it is imperative for parties to a construction contract to decide at the outset whether they wish to have disputes resolved in litigation or in arbitration. It must also be decided whether there are any condition precedents to filing a claim – such as mediation.

The author does not believe there is a "one size fits all" approach to dispute resolution. Both litigating and arbitrating have their benefits. Arbitration is often viewed as a more concise, efficient, and cost-effective alternative. But those virtues can depend on the arbitration outfit chosen in the contract. The American Arbitration Association (AAA) is perhaps the gold standard for arbitrating, particularly construction disputes where the AAA has adopted specific construction arbitration rules, but that comes at a price. For instance, under the current pricing, a $500,000.00 dispute will cost almost $12,000.00 in filing fees, which do not include the arbitrator(s) rate.

If arbitration is the preferred dispute resolution mechanism, the construction contract should clearly set forth the arbitration forum (AAA, JAMS, etc.), the number of arbitrators that will hear the dispute, whether the arbitrators are required to have any particular background, experience, or training, and how the arbitrators' fees are to be paid during the proceeding.

If litigation is the chosen dispute resolution mechanism, the contract should delineate the forum and venue for the litigation. If possible, should the dispute be resolved in federal court, or state court? If state court, should the venue be the location of the project, or some other pre-determined location chosen by the parties? The dispute resolution provision might also include a choice of law provision, if it makes sense for one state's law to be applied over, for instance, the state where the project is located.

Finally, if the parties wish for there to be a condition precedent to asserting a claim, that should be reduced

to writing in the contract as well. For instance, as a precursor to arbitration or litigation, should the parties be required to mediate? And, if so, where, and how is the mediator to be determined?

7. Consequential Damages

Without being properly addressed in the construction contract, damages in a construction dispute can become unwieldy and bear little resemblance to the work performed. That is particularly the case with consequential damages. Consequential damages are those damages that arise as a consequence of a breach, though typically not directly or immediately from a breach. Consequential damages are recoverable if they were within the contemplation of the parties at the time of contracting. They might include loss of use, loss of rent, additional financing charges, or loss of profit on other jobs. Because these damages are innumerable and litigating over what might have been contemplated at the time of contracting, most in the construction industry seek to simply waive such damages mutually at the time of contracting. This is how both the AIA and ConsensusDoc forms treat consequential damages and how most construction law practitioner seeks to advise their industry clients as well. But, in the case of an owner that might stand to suffer significant consequential damages if a project is faulty or delayed, at a minimum the parties to the construction contract should explicitly list out what consequential damages would be permitted, i.e., what they contemplate at the time of contracting, and those that are specifically excluded (or, better yet, exclude anything not listed in the contract).

8. Indemnification

Indemnity is the concept that one party to a contract assumes responsibility for loss or damage incurred by the other party to the contract under certain circumstances. The party accepting responsibility is the indemnitor and the party receiving indemnity is the indemnitee. As a general rule, the owner should want indemnity from the general contractor and all subcontractors, with the indemnity being in the broadest form possible – "all losses arising out of or related to" the indemnitor's work "in whole or in part" is typical broad-form indemnity language. Likewise, a general contractor should seek and require for itself the same broad-form indemnity from its subcontractors. At the same time, the contractor might want to negotiate a narrower form of indemnity that, at least, limits the indemnity for only damage caused by the general contractor or its subcontractors, with no obligation to indemnify the owner for the owner's fault, in whole or in part. Note that many states have anti-indemnity statutes that must be reviewed and considered for compliance when drafting an indemnity provision in a construction contract.

9. Insurance and Bonding

Perhaps no other clause in a construction contract has gained importance at the rate the insurance provision has in the last decade or so. Many states have seen a proliferation in construction defect suits arising after construction and which, in most states, are considered an occurrence under a typical commercial general liability policy. For that reason, the parties to a construction contract want to specifically address what insurance is required. If a builder's risk policy is to cover the project during construction, the contract should set forth who between the owner and contractor is reasonable for procuring that policy. Owners should universally want their general contractor and all subcontractors to have adequate general liability, auto, and worker's compensation coverage and the general contractor should want the same from all its subcontractors and material suppliers.

For all upstream members of the project to obtain as much coverage as possible, all upstream entities should require downstream entities to provide them with additional insured coverage on general liability policies, with the additional insured coverage to be primary and non-contributory to all other available coverage, and that the coverage extends to completed operations. Owners should require in the contract that such coverage be provided by the general contractor and all subcontractors, just as the general contractor should require it from all

subcontractors and any sub-subcontractors.

As for bonding, the owner and general contractor should determine appropriate bonding requirements at the contract negotiation stage. If the value of the project is significant enough, performance and payment bonds may be necessary. Likewise, the owner may require a general contractor to require subcontractors with high-valued contracts to provide bonds for their work as well. Whatever the case, it is best to set forth bonding requirements in the contract, with specific reference to bond forms or the ratings of acceptable sureties.

10. Attorney Fees

The vast majority, if not all jurisdictions in the United States, follow the "American Rule," meaning that attorneys' fees are only awarded when permitted by contract or statute. Thus, it is imperative for the parties to a construction contract to determine whether the prevailing party in any dispute may recover its attorneys' fees from the non-prevailing party. If the decision is made to include an attorney fee provision, the provision should also clearly define what constitutes "prevailing." If a party to a dispute recovers even one dollar, is it entitled to fees? Or should the provision reflect that the prevailing party is defined as the party that prevails on the "significant issues" in the case? Keeping in mind that it is most often the judge or arbitrator that will determine the issue of fees, it is best to give the decision-maker written guidance in the contract on how the parties intend for the prevailing party to be determined.