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INTRODUCTION AND OVERVIEW OF CONSTRUCTION "LAW"

Introduction

One of the most common myths in the construction industry is that if you get into a dispute with your contracting party, the judge or arbitrator will attempt to reach a fair result in his or her decision. While it may come as a shock to you, this is simply not true. A fair result is not the court's objective, nor is the role of an arbitrator to be fair regardless of what the contract says. The proper role of a judge or arbitrator is to enforce contract terms as written, *regardless of considerations of fairness or reasonableness.* The most important thing you can learn from this chapter is this:

> **There is no fairness and reasonableness standard applicable to construction contract disputes. The terms of your contract govern, even if the impact on you is harsh and unfair.**

Contract terms can be like a gun aimed at the heart of your business, or a shield to protect yourself against unscrupulous parties. Contractors who simply sign contract forms presented to them without a thorough review and complete understanding of what they are signing are inevitably going to find themselves in serious difficulties.

In the Construction Industry, Your Contract is "the Law"

When one thinks of the term "law" three things usually come to mind: statutes, judicial decisions, and governmental regulations. *Construction law is considerably different than most other areas of the law.* Statutes, case decisions, and regulations play a distinctly secondary role in governing the relationships among participants in the construction industry. In a very real sense, *construction contractors write their own law,* in the process of negotiating the terms and conditions of their contracts and purchase orders. As a federal judge in Virginia put it recently:

> The Court's guidepost in determining the legal responsibilities of the parties at bar is the contract itself. The contract, unless it is illegal or violates public policy, constitutes the law that governs the parties' relationship.

While there is a considerable body of law governing Government contracts, on private construction jobs there is little point when disputes arise in referring to precedent in other cases, because the chances are that those other cases were decided on the basis of different contract language. As one federal appellate judge commented:

> Little purpose would be served by discussing other cases. None involves language matching this contract's.

Contract Language is the Foundation of Construction Contractor Relationships

It would be hard to overemphasize the importance of the precise contract language negotiated by the parties in determining the outcome of disputes and claims on construction projects. Subtle differences in language -- merely changing a few words -- can make the difference between getting paid or not, or between having a winning or losing claim.

For example, by simply adding the words "condition precedent" to an otherwise standard pay-when-paid subcontract clause, the clause becomes a *"pay-if-paid"* clause. In a recent Maryland case where the "condition precedent" language was included, after the owner filed for bankruptcy, the court found that the construction manager had no duty to pay the subcontractors, who suffered major losses. In response to the subcontractors' argument that it would be improper to interpret the clause in question to place the credit risk on them, the judge stated:

> It may not be sound business practice to accept such a business proposal, but that is what occurred. The provision unambiguously declares that [the construction manager] is not obligated to pay [subcontractors] until it first received payment from the Owner.

In another example, a general contractor added language to a routine "no-damages-for delay" clause in its standard form subcontract which denied its subcontractors any compensation if the general contractor "interfered with or hindered" its subcontractors' performance. The general contractor caused major delays to the project, and the court denied the subs any additional money, on the basis of the contract clause in question, finding:

> This is the contract of the parties, and however strongly we might feel that plaintiff has been more severely damaged, this court can declare the rights of the parties only by the contract, as the language of that instrument dictates.

There are endless such examples, where a subtle change in contract language has meant the difference between a successful, profitable job and a financial disaster. Even where the outcome seems blatantly unfair, courts adhere rigidly to the precise contract language chosen by the parties. In one extremely painful lessen, a "hold harmless" clause in a $100 a year contract, granting a metal fabricator the right to use a small shed located on a railroad's right-of-way, was found to relieve the railroad of any responsibility when a fire caused by the railroad's negligence resulted in a loss of the fabricator's entire shop. The court explained:

> On numerous occasions in the past the courts have been asked to, in effect, reform an agreement that one party realizes too late is not in his best interests or does not say what he thought it said. Here the plaintiff must shoulder the loss of his business when the only benefit he received from the agreement was the use of a small parcel of the defendant's right-of-way, for which he had to pay only a nominal sum. But it is not the court's province to pass on the wisdom of a particular agreement, even though its terms may have been accepted by one party as the result of oversight or poor cerebration. Absent special circumstances, the court cannot correct for the mistake of one party when he had the responsibility, and opportunity, to protect himself.

The courts' strict adherence to contract language is not limited to interpretation of the words used. Claims are frequently denied due to the *absence* in the contract of a provision granting relief on the basis of a particular contingency. Where a contract provides for relief in the event of the happening of a specific event, full compensation is normally available if that event occurs. The courts assume that the contractor included no contingency money in its bid price. In contrast, the theory is that in the absence of a clause providing compensation for foreseeable problems, contractors have an obligation to include contingency money in their bids in the event of such problems. As one judge stated:

> [The subcontractor] had the opportunity to raise its bid to account for anticipated damage in its contract. The absence of such a clause forecloses relief.

The Importance of Contractual Duties Implied by Law

In addition to contract language, one of the most important aspects of construction law are the duties implied by law. Implied in every contract is a duty upon each party to carry out its performance in good faith and fair dealing. In the construction industry, where no contract clause either provides for or denies relief for losses suffered by a project participant at the hands of its contracting party, the implied duty of good faith and fair dealing is frequently the basis for monetary claims.

It must be kept in mind, however, that even the implied duty to cooperate can be voided by contract language which gives your customer the right to interfere or hinder your performance. Thus you cannot rely on the existence of implied duties as an excuse not to carefully review contracts before signing them.

The Limited Use of Trade Custom and Usage

Under certain, very limited circumstances, "trade custom" can be used to either supplement or interpret a construction contract. Beware, however, that proof of a trade custom is difficult, and to the extent that custom directly conflicts with contract language, the terms of the contract will be enforced.

Trade custom and usage can play a role in construction contracting in two ways. First, trade custom can add supplemental terms to a contract, where there is evidence that contract was made with reference to such custom, and there is also an absence of evidence that either party had a contrary intention. Secondly, both customs and usages of trade can be used to interpret or explain the meaning of words used in a contract.

The term "usage" means a habitual or customary practice, or a continuous repetition of acts. The term "custom" refers to a general rule which results from constant repetition.

In order to establish the existence of a "custom" in a particular geographical area, it is not enough for one particular contractor to testify that "this is the way I always do it," or that "this is what is generally done." In order for a custom to become binding on parties to a contract, such custom must have "antiquity, uniformity, and universality." That is, the practice must have been long standing, it must have been performed in the same manner by members of a trade, and it must be followed by nearly all members of a trade. Put another way, it must appear that the practice in question has been uniformly consented to by the members of a trade for such a period of time that it can be presumed that members of that trade enter into contracts with reference to that custom.

In proving the existence of a custom, it is normally necessary to offer the testimony of several witnesses, each of whom should have long-standing experience in the trade within the community in question. Testimony that the custom is understood and recognized by the construction industry generally is of considerable assistance.

The rules or code of standard practice of the claimant's trade association can also be helpful evidence in proving the existence of a custom. The fact that such rules may be changed from time to time does not prevent them from being recognized as evidence of trade custom.

In order to establish that a trade custom should be effective to supplement or interpret a contract, there must also be proof that the other party knew or could reasonably be expected to know of that custom. Proof, for example, that the other party did not live in the area and that the custom was a local one, or that the other party was a neophyte contractor with insufficient experience to know of the custom.

On occasion, trade custom and usage overlaps with the concept of implied duties. For example, it has been held that there is a custom in the industry that an owner has a duty to coordinate the work of multiple prime contractors -- a duty which is often also found as an implied contractual duty.

Custom has also been invoked in the context of contract formation issues. In one Virginia case, for example, proof was offered that there was a custom in the area that required prime contractors to accept its subcontractors' bids within thirty days of acceptance by the owner of the prime contractor's bid. Otherwise, each subcontractor was released from its obligation to the prime contractor. In Washington state, a custom has been recognized that where a general contractor requests and obtains a subcontractor's bid for a portion of the work and uses that bid in its own bid for the general contract, if the general contractor is awarded the job it is bound to use the services of that subcontractor.

Reference is frequently made to trade custom and usage in order to interpret a contract. Although court decisions often state the general principle that trade usage may only be used to clarify an ambiguity, in fact custom and usage are routinely used as the basis for finding the meaning of contract clauses.

Evidence of trade practice does not trump unambiguous contract language, and cannot be used to vary or contradict contract language. The role of custom and usage in contract interpretation is limited to explaining contract terms that have particular meaning in a trade.

Statutory Limits on Freedom of Contract

While contracting parties have *almost* unlimited freedom to determine the terms under which they will deal with each other, there are certain contract terms which some state legislatures have determined are in violation of public policy and hence void. Quite a number of states, for example, prohibit indemnification agreements under which one party agrees to indemnify another party for the other party's sole negligence. A fewer number of states have determined that pay-when-paid clauses are void.

In the public contract arena, several states have enacted "naming" statutes, under which prime contractors are required to list the subcontractors who will perform work in the event the prime contractor is awarded the job -- subject only to change upon approval of the public body.

It should also be noted that nearly all states have enacted contractor licensing statutes, which contain severe if not total restrictions on the ability of unlicensed contractors to obtain payment for work performed while in an unlicensed status.

Statutory Protection for Subcontractors and Suppliers

There are also a number of statutes which offer payment protection to subcontractors and suppliers. These statutes fall into several categories:

* State mechanics' lien statutes, which permit unpaid contractors, subcontractors and suppliers to obtain a lien on the real property and improvements to which they have supplied labor and/or materials

* Federal (Miller Act) and state (Little Miller Acts) requirements that prime contractors on public projects provide payment bonds assuring that persons who supply labor and/or materials to the jobs are paid

* State trust fund statutes which require payments received by owners or upper-tier contractors for work performed by lower tier contractor be held in trust and used exclusively for payment to such lower-tier contractors

* "Stop loss" statutes, which prohibit certain payments to a lower-tier contractor once notice is received from a next-lowest tier contractor of non-payment

The Law of Negligence --
Personal Injury and Property Damage

Until this point, the discussion has been devoted to the law governing relationships *between contracting parties.* Contractual remedies are generally limited to those parties with whom one is in direct contract. Where personal injury or property damage is involved, however, there is no such restriction, and under the law of negligence, the threshold issue is whether the law mandates that there is a *duty of care* between the negligent actor and the injured party. So long as a duty of care exists, there need be no other relationship between the injured party and the negligent actor for the law to require compensation.

With respect to both personal injury and property damage, contractors should be aware of the fact that they are responsible for the negligent actions of their employees, to the extent such employees' actions are within the general scope of their duties. The requirements for liability for negligence are merely the existence of a duty of care to the injured party, a breach of that duty, a causal link between the breach and the injury or property damage, and proof of damages.

With respect to damage to the building under construction, the standard method of avoiding multiparty lawsuits arising out of construction accidents is the use of builder's risk insurance.

With respect to personal injury, the matter of monetary recovery for the injured parties themselves is for the most part beyond the scope of this work, with one exception: "third party" lawsuits by persons obtaining workers' compensation benefits, brought by one of your injured employees against some other project participant. The reason such suits arise is as follows: under state workers' compensation laws, an employer is immune from suit by its employees for on-the-job injuries. The employer is required, however, to provide an injured worker workers' compensation benefits regardless of fault.

There is an incentive for both the employer and the employee for the employee to sue any third parties who may have been responsible for the injuries. As to the employer, once an employer (or an insurer on the employer's behalf) pays its employee's claim, the employer (or its insurer) is granted by law a right of action against any non-immune third parties who may be responsible for the employee's injuries, to recover up to the amount paid out to the employee. Further, employees are often dissatisfied with the payment limitations contained in the workers' compensation statutes, and are thus eager themselves to increase their chances of greater recovery by proceeding with a lawsuit against negligent third parties. Thus the employer and employee can join together to seek compensation from any parties whose negligence contributed to the employee's injuries, with the employer (or its insurer) recouping the amount of workers' compensation benefits paid out, and the employee keeping the balance.

Why, a contractor may ask, would an employer be so eager to recoup for his insurer benefits paid out on a workers' comp claim? The answer is found in the method by which insurers set workers' comp insurance premiums. As is discussed in further detail in Chapter 16, under the retrospective rating system used in workers' comp policies, by reducing claims experience a contractor can save substantial amounts on its annual premiums.

There are two major obstacles to recovery in third party actions for personal injury on construction projects, which vary substantially from state to state. The first is the scope of immunity granted under state law to the general contractor and other project participants. Under what is generally known as the "statutory employer" doctrine, upstream employers are often deemed statutory employers of downstream contractors, and thus covered by the employer's immunity from suit under the workers' compensation statutes. Secondly, the availability of recovery often depends on whether the state law related to personal injury permits recovery under circumstances of shared negligence, or bars recovery where the injured party's negligence contributed to his injuries.

Limits on Recovery for Negligence Where There is Only Financial Loss

Construction project participants frequently suffer financial losses arising out of delays and disruption which are caused by other project participants with whom the injured party has no contractual relationship. Where there is a physical manifestation in the form of personal injury or property damage resulting from negligent conduct or intentional wrongdoing, the law generally provides a remedy. Where, however, the impact on the injured party is limited to financial losses stemming from delay or disruption of its operations, the majority of American jurisdictions deny recovery, on the basis of a rule which denies recovery in negligence cases where the only losses suffered are financial rather than physical.

Project Participants and the "Chain of Contracts"

The organization of the typical construction project involves a series of interrelated contracts, with each individual participant's rights and obligations defined by the terms of its contracts. This series of contracts is frequently referred to as the "chain of contracts," in which obligations (and payments) flow downward from the owner through a general contractor or construction manager to subcontractors, sub-subcontractors and suppliers. An alternative structure, involving multiple prime contracts, shortens the "chain," but the basic concept of obligatins flowing down in through a series of contracts remains nonetheless accurate.

In the series of interrelated contracts on construction projects, your contracting party and anyone above your customer in the chain are referred to as "upstream" parties, while your suppliers or subcontractors are known as "downstream" parties. The basic principles are as follows:

* Each party in the chain is responsible not only for its own performance, but also the performance of all parties beneath it in the chain of contracts.

  -- For example, a general contractor is responsible to the owner for the performance of its subcontractors and suppliers.

  -- Subcontractors are similarly responsible to the general contractor for the performance of its sub-subcontractors.

* Liability to third parties (including the public) exists without regard to contractual relationships where there is personal injury or property damage caused by negligence or intentional wrongdoing.

* Downstream claims -- that is, claims for losses alleged to have been caused by either one's immediate downstream party or a party below it in the chain of contracts -- tend to be handled by the withholding of payment, commonly referred to as "backcharges." In some cases backcharges may be passed down several rungs on the chain of contracts. Backcharges are difficult to contest because the other party already has your money, and you must usually file suit or go through some other formal dispute resolution procedure to recover it -- sometimes at considerable expense.

* Since breach of contract claims can only be filed against one's immediate contracting party, in the case of upstream claims, it is only possible to file suit against one's own customer.

* Upstream claims against parties above your customer in the chain, may be accomplished using the mechanism known as Claims Liquidating Agreements, which can be made two ways: by your customer filing your claim on your behalf, or by your customer assigning to you the right for you to pursue your claim in its name.

Chapter Summary

The foundation of construction "law" is your contract. The role of judges and arbitrators in contract disputes is to enforce the contract as written, regardless of considerations of fairness. If you consent to an unfair contract, you can expect an unfair result if a dispute arises.

Your written contract is supplemented by contract terms implied by law, trade custom, and statutory protection such as mechanics' lien laws.

The relationships among construction project participants is frequently referred to as the "chain of contracts," involving "upstream" and "downstream" parties. Downstream claims tend to be handled by withholding of payments, or "backcharges." Regardless of the source of the problem, "upstream" claims can only be made against your direct contracting party, and then passed up the chain to the next party. Claims Liquidation Agreements provide a mechanism by which a claim on the part of a lower-tier party can be passed up the chain.

Where personal injury or property damage is suffered as the result of a party's negligence of wrongful acts, the party causing the damage is liable to the injured party as a matter of law. Such liability exists independently of contractual relationships among project participants.

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THE OWNER / GENERAL CONTRACTOR CONTRACT

Introduction to Alternative Risk Allocation Philosophies

In framing the terms of a prime contract, one of the key considerations is the risk allocation philosophy of the owner. Every construction project involves risk of loss from unforeseeable events, including weather impact, design defects, unforeseen underground conditions, defective performance on the part of individual trade contractors, shortages of skilled labor, and shortages of materials, not to mention fires, floods and other "Acts of God." Generally speaking, the more risk the owner desires to shift to the prime contractor, the more the owner will have to pay. The issue for the contractor is how much contingency money should be included in its bid, to cover its risks.

Some owners, most notably the United States Government, have developed a risk allocation philosophy based on the long view, which assumes that the savings from reduced prices on numerous contracts far exceeds the costs of equitable adjustments to those few projects where unexpected events justify increasing the price. Federal procurement contracts provide for an "equitable adjustment" to the contract price and completion time in the event of unforeseen events beyond the control and caused by no fault of the contractor. Even under circumstances where the Government takes no direct action to order a change or extra work, a Government contractor can be entitled to an equitable adjustment under the "constructive change" doctrine, where Government action has the effect of increasing the contractor's costs or extending the duration of its performance. The purpose of making it easy to obtain an adjustment to the contract price on Federal projects is to discourage contractors from including extra money in their bids to cover unanticipated contingencies.

In contrast, many state and municipal Governments, and many private owners, operate on the basis of an exact opposite theory. Where an owner is operating on a limited budget, and has no ready access to additional funds to pay for unexpected events, contractors are *encouraged* to include contingency money in their bids, so that the owner can rely on the bid price as the final price.

Risk Allocation Between Owner and Contractor

A contract between an owner and a contractor necessarily involves a compromise among three values:

* cost
* time
* quality

In some situations, time is absolutely critical. School buildings, hotels and convention centers are often scheduled to be used on a date certain, and cost considerations must give way to scheduling issues. The most extreme case the author has been involved in was a stadium in which a nationally-televised professional football game was scheduled to be played three weeks after the scheduled completion date. On that project, all project participants knew in advance that there was absolutely no possibility of obtaining a time extension, for any reason.

For other types of projects, say a research laboratory, or a high-technology manufacturing plant, quality issues prevail over both time and cost considerations. In contrast, where, say, an investor-owned commercial building is involved, the owner may be willing to compromise on quality issues in favor of time and cost considerations.

The major issues for negotiation between an owner and a contractor on a private construction job are:

1. Are there unique cost, time or quality considerations that would warrant a deviation from the standard fixed price contract?

2. Who should bear the risk that cost estimates will be exceeded? Should the contractor accept all the risk and agree to perform the work for a fixed price, or should the work be performed on a cost plus fee basis, with the risk of a "budget bust" placed on the owner? Or is there a compromise between these extremes, where the risks of both gains and losses are shared according to an agreed formula?

3. What penalties, if any, should the contractor be assessed for failure to meet the target completion date? Should the contractor be awarded a bonus for early completion?

4. Who will bear the risk of unforeseen site conditions?

5. Who will bear the risk of adverse weather, or other "Acts of God" type of events which are beyond the control of either party?

6. Who will bear the risk of project impact caused by accidents?

7. Who will bear the risk of project impact caused by interference by Governmental regulatory authorities?

8. Who will bear the risk of design defects, or other mistakes on the part of the architect?

9. Who will bear the risk of labor or material shortages?

10. Who will bear the risk of labor strikes or other labor strife?

Issues of risk allocation are generally resolved on the basis of which party is best able to control and mitigate the impact of an event, or if such event is not subject to control by either party, the extent to which the impact of the event can be covered by insurance.

Alternative Forms of Project Delivery

The traditional way to deliver a job is for the owner to hire an architect to prepare detailed plans and specifications, which the owner then puts out for bid on a fixed price basis. The standard form contract for architects, prepared by the American Institute of Architects (AIA), protects the architect from "budget busts," in the event bids come in higher than the cost forecast by the architect.

The job of the contractor, and each of the trade contractors performing work in the sixteen sub-areas of the project, in a traditional, "design specifications" job is to simply perform the work as designed, with the risk of defects in the design borne by the owner.

An alternative form of fixed price contract involves providing the contractor with objective performance standards, rather than detailed drawings and specifications. In a "performance" specification, the contractor's job is to build a project that will meet the stated objectives of the owner, with authority to exercise judgment and discretion in meeting the specified performance criteria.

Rather than utilizing a prime contractor, projects with either design or performance specifications can instead be built using a Construction Manager. On "CM" jobs, the owner may contract directly with the trades, or the owner may contract only with the CM, and the CM in turn will contract with the individual trades. In either case, the Construction Manager schedules and coordinates the work of the trades.

CM-managed jobs vary as to the extent of financial responsibility of the CM. At one extreme, the CM simply provides services to the owner on a fee basis, with no financial stake in the outcome of the project. On other "CM" projects, the Construction Manager takes on full financial responsibility for bringing in the project for a fixed price and according to an agreed schedule, subject to adjustment for owner-directed changes.

There are a number of alternative methods of project delivery to the "standard" prime contract involving construction based on detailed plans and specifications to be built for a fixed price.

Phased ("Fast Track") Design and Construction

During the Second World War, the Federal Government developed a method of project delivery known as "fast track," which involved allowing construction to begin on the first stage of a project as the drawings are being prepared for later work. Private fast track contracts are generally limited to relatively simple projects, such as a warehouse or a no-frills office building, where there is severe time pressure to build a facility.

Design-Build

Design-build is a construction delivery method which involves placing all design and construction responsibilities in a single entity. In a typical design-build job, the architect works not for the owner, bur rather for the contractor. Thus the risk of design defects is placed on the contractor, and the contractor rather than the owner is ultimately responsible for the quality of the design and construction.

In the traditional contractual framework, where the owner hires the architect, and then provides the architect's plans to the contractor, the warranty of the adequacy of the plans flows from the owner to the contractor, and thus the owner bears legal liability to the contractor for losses arising out of defects in the design. By shifting responsibility for design to the contractor, the owner relieves itself of one of the primary sources of construction litigation.

Historically, design-build has been most commonly used on major industrial projects, such as refineries, sewage treatment plants, and "process" plants, where aesthetic considerations are minimal, and where performance criteria, for production or output, can be quantified. In recent years, however, design-build has been used in a wide variety of commercial and governmental projects.

Design-build is often performed using techniques borrowed from fast-track projects, where construction is begun on the basis of conceptual drawings, and detailed design for the later stages of the project is being performed as the early part of the project is already under construction.

Use of Standard Forms for Prime Contracts

In the typical Government contract, whether involving a Federal Government construction project or a state or local job, the terms of the prime contract are governed by the applicable procurement regulations, and there is little or no negotiating room as to contract terms. On private jobs, the owner usually submits to the contractor a standard form, pre-printed agreement prepared by a trade or professional organization, as the starting point for the deal. Then both parties negotiate modifications to the standard form that are appropriate for the particular project involved, or which are viewed as being in the respective interests of the parties.

The most neutral of the standard form construction contracts are those offered by the American Institute of Architects (AIA). The most frequently used owner / contractor contract form for private construction jobs is the Contract for Stipulated Sum (AIA Document A101), which is supplemented by a set of General Conditions (AIA Document A201). The AIA also has available a form for a Cost Plus Contract (AIA Document A111), which can be adapted to provide for a contract for a Cost Plus with Guaranteed Maximum Price, with various types of incentives for beating the GMP. For smaller projects, the AIA offers an abbreviated form of contract (AIA Document A-107). A detailed description of the contracts offered by the AIA is available on the AIA website.

Because of their widespread use, the AIA forms have the advantage of having been interpreted in quite a number of court decisions, which gives the use of such forms a certain predictability.

Given the important duties which the AIA prime contract forms delegate to the project architect, care must be taken to modify such forms when the contract between the owner and the architect fails to include an obligation on the part of the architect to perform such duties.

As an alternative to the AIA forms, the Associated General Contractors of America offers a series of prime contract forms, including forms for a Fixed Price, Guaranteed Maximum Price, Construction Management Contract, Design-Build Contract, and General Conditions Between Owner and Contractor.

For engineering projects, there are form contracts available from the National Society of Professional Engineers, which were developed by a joint committee of the NSPE, the American Consulting Engineers Council, the American Society of Civil Engineers, and the Construction Specifications Institute.

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RISK ALLOCATION BETWEEN THE PRIME CONTRACTOR AND SUBCONTRACTORS

Introduction

The trend in the construction industry on large commercial, industrial and governmental projects is for the general contractor to do less and less self-performed work, and to act more like a construction manager -- subcontracting out all work, and then scheduling and supervising the subcontractors. As part of this trend, general contractors have become increasingly adept at shifting the risks inherent in the construction industry downstream, to their subcontractors.

In the negotiation of a subcontract, there are a number of recurrent issues concerning risk allocation:

1. To what extent is the general contractor responsible to the subcontractors for defects in the plans and specifications?

2. To what extent is the general contractor responsible to the impacted subcontractors for delay and interference caused by other subs?

3. Whether the subcontractors are entitled to time extensions for various types of delays, including those beyond the control of any project participant, and those caused by owner changes and the defaults of other subcontractors.

4. Whether impact costs are to be compensated in the event of unforeseen conditions.

5. Between the general contractor and the subcontractors, who should bear the risk of a payment default on the part of the owner?

6. Who should be responsible for carrying insurance against property damage and personal injury?

7. What penalties should be assessed if the prime contractor fails to make timely payment to the subcontractor (interest and attorneys' fees)?

8. What penalties should be assessed by the prime contractor against the subcontractor for causing delay or interference impacts to the project schedule (including liquidated damages payable to the owner, extended general contractor costs, and extended subcontractor costs)?

9. Where there are ambiguities in the plans and specifications as to what trade is responsible for a specific item of work, how should scope of work issues be decided? If neither the prime nor the impacted sub included the work in its scope, who should bear the loss?

10. How should disputes between the parties be resolved?

Use of Industry Forms as a Substitute for General Contractor-Drafted Contracts

There are two trade association-sponsored forms that can be used as "neutral" subcontract agreements, in lieu of forms drafted by a general contractor. The American Institute of Architects offers a subcontract form, AIA Document A401, which is specifically designed to be compatible with the AIA prime contract forms, and the AIA General Conditions (AIA Document A-201).

There is an alternative form which is offered jointly by trade associations representating general contractors, subcontractors and speciality contractors, which evolved out of long and extensive meetings of representatives of Associated General Contractors of America, American Subcontractors Association and Associated Speciality Contractors. The combined AGC/ASA/ASC contract is available from all three organizations, and is intended to represent a reasonable compromise between general contractor and subcontractor interests.

Contractual Protection for Lower-Tier Parties

"Standard form" subcontract agreements tend to be drafted by general contractors in a manner designed to give them maximum power and leverage over their subcontractors. GCs tend to have a distinct advantage in subcontract negotiation. All that the GC needs to do is threaten to withhold award of the job unless the sub agrees to the GC's terms. There are, however, a number of ways in which subcontractors can modify general contractor's standard forms to better protect themselves.

The following discusses issues which frequently arise in the GC / subcontractor relationship, and presents some of the alternatives which subcontractors can use to their advantage:

"Flow-Down" Clauses and Incorporation by Reference

Although the legal basis for the contractual relationship between a prime contractor and its subcontractors is normally a formal subcontract document, that document frequently incorporates by reference many terms from the general contractor's contract with the owner as well. The method by which such incorporation by reference is normally accomplished is through the use of what are known as"flow-down" clauses -- also known as "conduit" clauses -- which are intended to transfer obligations undertaken by the general contractor to the owner down the chain of contracts to subcontractors. Although the typical subcontract states that the owner-general contractor contract has been made available to the subcontractor, in actual practice very few subcontractors take the time to review the upstream contract either before submitting their bids or even before signing their contracts.

The normal way in which this problem is dealt with is for the subcontractor to include proposed terms in its bid terms and conditions which anticipate and counter most of the risk-shifting clauses normally included in prime contracts.

As a method of obtaining additional protection from clauses which would otherwise have the effect of waiving a subcontractor's rights, it is also recommended that you include in your bid terms a "non-waiver" clause:

> No term or condition set forth in any Contract Documents which is not physically appended to the Subcontract Agreement shall have the effect of waiving any right to payment or any other substantive right of Subcontractor.

Another alternative approach is to include in your bid terms a provision that states that there will be no incorporation by reference of any terms that limit subcontractor's rights that are not expressly disclosed in the subcontract or purchase order.

A third alternative is to limit incorporation by reference to scope of work matters only. In other words, the terms and conditions of the Contract Documents other than the specifications section for the work to be performed would not be incorporated by reference.

A fourth consideration involves making incorporation of obligations and rights contained in the prime contract a mutual proposition. This involves adding a provision to the subcontract which grants to the subcontractor the same rights granted to the general contractor in the prime contract.

The Right to Stop Work

A subcontractor's standard form contract terms should contain a clause which gives it the right to stop work if you are not paid. A sample of that type of clause, taken from the standard form subcontract issued jointly by the ASA, AGC and ASC, states:

> **PAYMENT DELAY.** If for any reason not the fault of the Subcontractor, the Subcontractor does not receive a progress payment from the Contractor within seven (7) calendar days after the time such payment is due, or within fourteen (14) calendar days after the time payment is due from the Owner to the Contractor for such contract work as defined in the Contract, then the Subcontractor, upon giving seven (7) calendar days' written notice to the Contractor, and without prejudice to and in addition to any other legal remedies, may stop its Subcontract Work until payment of the full amount owing to the Subcontractor has been received. The Subcontract Price and Subcontract Time shall be increased by the amount of the Subcontractor's reasonable cost of shutdown, delay and start-up, which shall be effected by appropriate Subcontract Change Order.

Retainage

In those circumstances where retainage is withheld, subcontractors should insist on line-item release of retainage, that is, release of retainage upon completion and acceptance of your work, rather than waiting until the completion of the entire job.

Lien Waivers

It is standard practice in the construction industry for general contractors to require that all subcontractors and suppliers sign documents which attest to the fact that all of their sub-subcontractors and suppliers have been paid, and which releases their mechanics lien rights. Care must be taken not to inadvertently give up rights you intend to keep -- such as pending claims -- when signing partial and final lien waivers.

On waivers signed as part of your monthly progress payment requisitions, the effective date should be the date of the period covered by the requisition, not the date of the payment.

Where there is a possibility that you may be filing a claim in connection with something that has happened on the project, strike out of partial lien waivers any language that waives your right to file claims.

Design Responsibility

There is a trend in the construction industry as a whole to shift responsibility for building code compliance and other design issues from the architect-engineer to general contractors, and then from general contractors to subcontractors. This is a major deviation from the standard view of a contractors responsibility -- which traditionally has been simply to comply strictly with the plans and specifications. In light of this trend, unless you have included design services in your bid price, including a clause in your standard terms which disclaims any responsibility for design is recommended.

Personal Guarantees

As a matter of policy, your company should deny requests by your customers and suppliers for you to personally guarantee your company's obligations arising out of routine business operations. Your best negotiating strategy is to respond that your other customers and suppliers do not require personal guarantees, and that such guarantees would interfere with your banking relationship.

Warranty Issues

One method of limiting your exposure on warranty issues is to limit your warranty for materials supplied to the scope of the warranty provided by the product's manufacturer, and to limit your liability for installation to the replacement of any defectively installed material. A sample clause to be included in the "Special Terms" section of your Scope of Work description is as follows:

> Materials are guaranteed for the same period of time, and to the same extent, of the warranty extended by the manufacturer. It is the duty of the Contractor to inspect and approve the Subcontractor's installation, and Subcontractor's liability extends only to the replacement of the materials installed. THIS WARRANTY IS IN LIEU OF ALL OTHER WARRANTIES, EXPRESS OR IMPLIED, INCLUDING ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE.

Differing Site Conditions

The most important contract clause for construction contractors who perform any type of underground work is the differing site conditions clause. Differing site conditions also frequently arise in renovation work.

A differing site condition is any unknown or hidden condition which is either not disclosed by owner-provided documents, or an unusual condition which site inspection did not disclose. Although the clause applies to the work of all types of contractors, the clause is essential for excavation, caisson, and underground utilities contractors,

The most important thing to remember with respect to this type of problem is this:

> **If there is no contract clause giving you the right to recover for hidden or differing conditions, then the assumption is made that you took the risk by signing a fixed price contract, and you will not be entitled to any recovery.**

In the most frequently-used differing site conditions clauses there are two recognized categories of claims, as follows:

Type I Conditions

A Type I condition is one that differs materially from that indicated in the contract document. It is not necessary for the conditions in question to differ from an express representation in the plans or specifications. A representation that is implicit in the contract documents is sufficient.

In order to qualify, a condition has to be both different and unknown. Where a contractor has actual knowledge of a condition it can obtain no relief.

Type II Conditions

A type II condition exists where the owner elects not to specify anticipated conditions, and it turns out that actual conditions are both unknown and materially different than what would usually be expected.

The most frequently used site conditions clause describes Type II conditions as:

> ... unknown physical conditions at the site, differing materially from those ordinarily encountered and generally recognized as inhering in work of the character provided for in this contract.

Such events as adverse weather, material or labor shortages, inflation, etc. are not covered by the clause. Only physical conditions at the job site are covered.

When a potential differing site condition is discovered, the contractor must promptly notify the owner (or, in the case of a first-tier subcontractor, the general contractor), before the site is disturbed. The notice does not have to specify the amount of anticipated lost time or money -- that can come later as part of a claim.

Once it has been determined that a differing site condition exists, the contractor is normally entitled to both a time extension and recovery of the additional costs required to perform the work.

Differing site claims are sometimes overcome by inspection clauses, requiring pre-bid inspections of the site. When such inspections occur, the results should be documented, both in writing and by photographs or videos, in order to provide the basis for a later claim if actual conditions are not revealed by the inspection.

Damage to Installed Work

A difficult problem for a number of trades is the frequency with which other trades cause damage to already installed work: for example, damage to electrical fixtures, drywall, or insulation. It is important for subcontractors to include in their contract terms a disclaimer for responsibility for damage caused by others after their work has been completed.

Chapter Summary

Contract negotiation between a prime contractor and its subcontractors involves risk allocation with respect to numerous types of events, including defects in the plans and specifications, nonpayment by the owner, and responsibility for delays and interference caused by various other parties.

General contractors tend to have a natural advanatge in subcontract negotiations. Some of the methods by which subcontractors can shift the power balance include:

* avoiding taking on unknown obligations by means of "flow-down" and "incorporation by reference" clauses, which bring such terms into the subcontract without your awareness;

* making sure subcontract agreements contain a "differing site conditions" clause, which permits you to recover additional compensation where an unknown physical condition appears at the site, which is either different from the plans or different from what is normally expected;

* providing for your right to stop work in the event of nonpayment;

* avoiding personal guarantees of your company's obligations to customers and suppliers; and

* the avoidance of using lien waiver forms which inadvertently also waives your right to file valid claims.

4

LEGAL LEVERAGE FOR CONTRACTORS -- THE LAW OF CONTRACT FORMATION

Introduction -- The "Battle of the Forms"

Urging construction contractors to insist on doing business on their own terms is like an NBA coach telling his players "No matter what, don't let Michael Jordan near the basket!" It's easy to say, but a lot harder to actually do.

Before even launching into this section of this manual, your author needs to confess, up front, that after twenty-five years of contract negotiation, there are frequently times when I have to recommend to a client to sign a marginally acceptable contract in order to get a job. It happens with everyone. In negotiations over contract terms, no one wins every point every time. If you are fortunate enough just to win sufficient points to turn a horribly unfair contract into one that you can live with, then you have done well.

On Government jobs, there is little to negotiate. On private jobs, however, parties at all levels of the chain of contracts tend to rely on pre-printed forms that are designed to give them advantage if a dispute arises.

The main point of this chapter is the importance of preparing your own set of contract terms and conditions, designed to protect you from the unique risks involved in your particular business or trade.

I also fully understand that every time you go into a negotiation over contract terms, in the back of your mind you are thinking, *"I need this work"!!!* and that in your gut there is a tight feeling, a feeling of fear, that there is a competitor just around the corner ready to take the job away if you push too hard.

So what is the solution? Some contractors will sign anything that has the correct price and their name spelled right. Others are so demanding as to the terms they will accept that they do in fact lose work. The solution is:

(a) to learn about the leverage that the law provides to lower-tier parties on construction projects;

(b) to decide in advance what terms you will agree to and what you cannot accept;

(c) prepare your own Terms and Conditions for inclusion in your bids, in order to put you in a good negotiating position; and then;

(d) do your best in your negotiations, keeping in mind that in the battle of the forms, no one wins every time on every point.

Leverage in the Construction Industry, or Why the Deck Appears to be Stacked Against Subcontractors

In a very real sense, most lower-tier parties -- whether subcontractors or sub-subcontractors, go into negotiations over contract terms having already lost the battle, due to a legal concept known as "promissory estoppel."

The way the concept of promissory estoppel works is this: when a lower tier party submits a bid -- say, a subcontractor bidding to a general contractor (GC) -- the sub intends that the GC will use the sub's number as part of the GC's bid to the owner. Since the GC relies on the Sub's bid in calculating its own bid, the law has formulated a rule that if the GC gets the work, the sub is obligated to perform for its bid price. If it refuses and the GC has to get someone else to do the work at a higher price, the original sub is liable to pay the GC the difference between the price it bid and the price it cost the GC to have the work done by another sub.

In essence, the court views a subcontractor bid as a promise to perform if asked. "Estoppel" is a legal concept meaning you are not permitted to deny what you have already committed to. Thus "promissory estoppel" means you are not permitted to refuse to perform for your bid price once your bid has been relied upon.

While it is clear that once a bid has been submitted the concept of promissory estoppel holds the bidder to its price, what is not clear is whether the bidder is required to accept the other party's non-price terms as well. The general view of the courts is that so long as the general contractor's terms are reasonable, the subcontractor is not permitted to back out of its bid. Put another way, if the subcontractor does not submit any terms with its bid, it is required to perform the work on the general contractor's standard terms.

Thus in the typical contract negotiation, the upper-tier party has the law on its side. If a sub tries to back out of a contract on the basis that the GC's terms are unfair, the GC is in a good position to claim that what is actually happening is that the sub is trying to get out of its commitment on its bid price. In such a case, the GC could sue the sub for damages for the increased cost of contracting with another sub. Particularly where the GC can prove that numerous other subs over the years have signed its form subcontract agreement, the GC has significant legal leverage to insist that the sub sign the GC's subcontract form. Further, each time the GC succeeds in obtaining its standard terms, the stronger position it will have in the future to continue to get its own terms.

If the lower-tier contractors are essentially defeated before the battle even starts, why bother to even try? The answer is this:

> **The law of contract formation provides an opportunity for a bidder to shift the legal leverage to itself, at the time the bid is submitted.**

How You Can Gain Legal Leverage Through Knowledge of the Principles of Contract Formation

Although the common understanding of the term "contract" is a document signed by the parties, the law actually defines a contract as a legal relationship -- regardless of whether that relationship is based on an agreement which is written, oral, or partly written and partly oral.

A contract exists when each of the elements of an enforceable agreement have been met. If in the process of negotiation the parties agree that their agreement will not become effective until there is a signed document, then no contract is formed until the written agreement is signed. Otherwise, a contract is formed when one party's offer is accepted exactly as made.

In the construction industry, it is common for a "contract" as that term is used in the law to be formed with the oral acceptance of a bid, with the paperwork which memorializes the existence of the contract to be prepared later.

An offer is defined as a statement of willingness to enter into a bargain, inviting someone else to accept the proposed bargain. In order to qualify as an offer, a proposal must be definite and certain. A bid is a type of offer.

Once an offer is made, all that the other party must do in order to form a contract is to indicate acceptance of the proposed terms. In order to constitute an acceptance, the party to whom the offer is made must accept the material terms *as offered.* Any *material deviation* from the terms of an offer constitutes a rejection of the offer, and is deemed at law a "counteroffer."

When a counteroffer is made, the other party has the choice of either accepting the counteroffer, or making a new offer. In most contract negotiations, the parties continue to make what the law regards as offers and counteroffers, until both sides agree to the same thing, at which time a contract is formed.

One of the most important things you can learn from this chapter is this:

> **When your contract terms are included with your bid, acceptance of your bid constitutes acceptance of your terms as well. Any attempt to change your terms constitutes a counteroffer, which you are then free to accept or reject.**

This rule applies even where the general contractor states in its Invitation to Bid that subcontractors will be required to accept its standard terms. While it is true that by submitting your own terms you may be deemed to have submitted a nonconforming bid, you still will not be required to accept the general contractor's terms.

At law, an invitation to bid is an invitation to make offers. Further, the law of contract formation provides that the person making an offer is the master of the offer. What this means, in practical terms, is that if you submit your own proposed terms at the time you submit a bid, you are no longer obligated to perform the work if the party to whom you are bidding does not agree to your terms.

> **When you submit proposed terms with your bid, you come into control of the negotiations.**

Rather than being in a position where you could end up getting sued for damages if you refuse to agree to the other party's terms, the legal leverage shifts over to you. If your customer objects to your terms, you have the right to simply walk away, with no further obligation. Once your terms[1] are part of your bid, an objection to your terms constitutes at law a rejection of your offer and the making of a counteroffer.

When You Can, Use Your Own Contract Form

Your best negotiating position involves use of your own pre-printed proposal, which contains only your terms. A sample Proposal form is set forth as Appendix 1. Use of your own form saves you the trouble of an in-depth analysis of the other party's standard form subcontract, and permits you to do business on only your terms.

[1] For a sample form of Bid Terms and Conditions, see Appendix, section 2.

The key thing you need to do is to use the psychology of the "standard form" to your advantage. Your bid forms and your terms and conditions sheet, as well as any pre-prepared addenda, should be printed, not typed. The form should have in bold letters on the top, Standard Form Bid Terms, or Standard Form Addenda. I always advise my clients to never make marks on the other party's form -- just attach to the back of their form your additional terms. As long as your terms are presented as simply routine changes applicable to your business or trade, which everyone else always accepts, you should have no problem getting your terms.

Further Negotiating Tips to Obtain Your Terms When a General Contractor Submits its Own Standard Form Agreement

In negotiating subcontract terms with a general contractor, your opponent's best argument is that numerous other subcontractors on both this and other jobs have accepted its terms, and thus there is no reason for you not to accept his terms as well. Your first counter is to label your pre-printed terms and conditions form "Standard Terms and Conditions." You then can argue that *your* terms are standard in the industry for your trade, and since other general contractors have routinely accepted such terms, there is no reason why that particular general contractor should not accept them as well.

As a supplement to that argument, attempt to distinguish your trade from other trades. You may be able to argue that your portion of the job is a relatively small part of the entire project, and that your trade is a special case that does not require risk-shifting clauses that are more applicable to other trades.

By tailoring your terms and conditions to the standard form subcontract agreement which has been issued jointly by the American Subcontractors Association, the American General Contractors Association, and the Associated Specialty Contractors, you can argue that your terms have been determined to be fair by the general contractor's own trade association.

In terms of mechanics, the ideal approach to getting your terms is to attach a copy of your terms and conditions sheet to the back of your customer's standard form -- whether a subcontract agreement or purchase order. Have a rubber stamp prepared which states:

> This agreement is supplemented and amended by subcontractor's bid terms and conditions, a copy of which is attached hereto.

This stamp should be made on your customer's subcontract form just above the signatures. No other markings should be made on the subcontract form, even if your terms wholly cancel their terms.

There is a rule of law that additions to a pre-printed contract prevail over the standard terms. An addendum prevails over the agreement to which it is attached. Thus when you add your terms as an amendment to the other party's terms, in the event of a conflict your terms will prevail.

At the time you submit a bid by telephone, you should send by fax a copy of your standard form terms and conditions, which should include a detailed description of your scope of work.

In light of the trend towards subcontractors submitting their proposed terms with their bid, some clever general contractors are including their standard form subcontract agreement in their Invitation to Bid, and are advising subcontractors in advance that in order to get the job they must accept their standard terms. Even in such circumstances, I recommend disregarding such notices and submitting your proposed terms with your bid. Under the law, an offeror is in control of his offer. While you are taking the chance that your bid will be deemed nonconforming, where the general contractor's terms are unfair, submitting your proposed terms increases your leverage in negotiations over the subcontract terms.

Bid Terms Which Further Increase Your Legal Leverage

Although it is not necessary, some subcontractors have found that they further improve their leverage by including in their bid terms the following notice:

> The terms and conditions set forth herein are a material part of our bid. Notification of acceptance of our bid price constitutes acceptance as well of such terms and conditions, which shall be incorporated by reference into the Contract Documents, and prevail over any contrary terms contained therein.

In many cases, there will be oral notification of acceptance, followed by the mailing of a proposed standard form subcontract. This provision in your bid terms gives you considerable leverage under those circumstances.

An alternative clause used for the same purpose, which becomes effective upon your being directed to start work, provides:

> If Contractor permits bidder to commence any work, bidder's terms and conditions will be deemed accepted in full and will constitute the contract between the parties, notwithstanding any provisions in the Contract Documents to the contrary.

Another provision which helps in the negotiation process is the following:

> This bid contains no monies for unforeseen contingencies, including but not limited to performance delays, payment delays, risks of non-payment by the owner, unforeseen site conditions, and other matters beyond the control of bidder. In the event contractor desires to place additional risks on bidder, there will be a corresponding increase in the bid price for each such risk accepted.

Use of a Contract Addendum to Provide for Your Most Important Terms

Where you are unable to persuade your customer to accept either your Proposal form or your Standard Form Bid Terms, it is recommended that you have ready, as an alternative, a standard form Subcontract Addendum, which contains your most important terms, and to which you can add specific amendments to your customer's contract. Do not attempt to make alterations or deletions on the other party's form. Use of an addendum is much more effective.

Where you use an Addendum, you will need a rubber stamp to be used to add to the bottom of your customer's contract form:

> The attached Addendum forms a part of this Subcontract and its terms and conditions are incorporated herein by reference.

What to Do About Bid Mistakes

As a general rule, the fact that a bidder has made a mistake in preparing its bid does not relieve it from honoring its bid. It is very difficult for a lower-tier bidder to avoid its obligations under a bid, where the bid number was used in formulating an upper-tier party's bid. There are two proof requirements for holding a subcontractor to a bid:

1. Proof that the subcontractor's number was actually used in the general contractor's bid to the owner.

2. Proof that the bid was reasonable, and not known to the general contractor to have resulted from a mistake.

Where a bid is so far out of line that the party receiving the bid has reason to know, or at least strongly suspect, that the bid is based on a mistake, there is an obligation to call the bidder and request a confirmation of the bid.

When you get a call attempting to confirm a bid, you know something went wrong, and you should check your bid very carefully.

Similarly, when you receive a bid that is way out of line from a sub-subcontractor or supplier, do not use the number without confirming the bid.

Summary of Chapter

The law of contract formation favors bidders, and permits bidders to include with their bid number their own terms and conditions, which must be accepted or rejected as a package. Thus your negotiating leverage is maximized by submitting your own terms as part of your bid.

For negotiated contracts where you wish to use your own form as the contract, rather than modifying the other party's contract, the best procedure is to submit a written Proposal containing your terms, with a place for the other party to sign. A copy of such a Proposal is included in this Manual as Appendix 1.

Where you anticipate that the other party will insist on using its standard form subcontract agreement, your negotiating position is the strongest when you submit at bid time a pre-printed form entitled "Standard Bid Terms and Conditions," to be included as part of your bid. Your terms will serve to modify the other party's form, where there is a conflict between your terms and the other party's terms.

The standard procedure when using Bid Terms and Conditions is to send a copy of your terms to your prospective customer by fax at the same time you submit your bid. A sample Standard Form Bid Terms and Conditions for use by subcontractors is included in this Manual as Appendix 2.

If you have not submitted either your own Proposal or your proposed terms at bid time, an alternative way of modifying a general contractor's subcontract agreement is to use an Addendum, which sets forth your terms.

A sample Addendum is included as Appendix 3. When an Addendum is used, it should to be stapled to the back of your customer's contract, with a notation immediately above the signature block that the contract is amended by the attached Addendum.