5

AVOIDING PAYMENT DISPUTES

Introduction

The ultimate challenge for any construction contractor is to get paid in full for properly and timely performing the work encompassed in its bid price. Yet complete and timely performance is, in today's marketplace, unfortunately not enough. All too often, owners strain to find creative reasons to hold back payments due to general contractors and construction managers. Indeed, when losses occur on a project, there is a tendency for the owner and contractors at all levels to attempt to shift such losses to the party below them in the chain of contracts. The purpose of this chapter is to explore methods by which contractors can gain leverage in their contract negotiations in order to get paid in full.

There are essentially three challenges which contractors must meet in negotiating payment clauses: (1) avoiding shifting down to you the risk of non-payment by your customer's customer; (2) maximizing your leverage against unfair backcharges; and (3) maximizing your leverage in the event of non-payment by your immediate customer.

Challenge # 1: Limiting the Scope of "Pay-When-Paid" Clauses

For lower-tier contractors, one risk that is commonly shfited to them is non-payment by the owner. There are two main types of contingent payment clauses:

1. The standard clause, which only governs the *timing* of payment.

2. The "condition precedent" clause, which shifts credit risk downstream, and which governs whether you get paid at all.

The first type of clause is fair and reasonable; the second is not.

An example of a fair clause governing progress payments is found in Section 14.2.7 of the standard form subcontract issued jointly by the Associated General Contractors and the American Subcontractors Association, which provides as follows:

> **TIME OF PAYMENT.** Payments to the Subcontractor for satisfactory performance of the Subcontract Work shall be made no later than seven (7) calendar days after receipt by the Contractor of payment from the Owner for the Subcontract Work. If payment from the Owner for such Subcontract Work is not received by the Contractor, through no fault of the Subcontractor, the Contractor will make payment to the Subcontractor within a reasonable time for the Subcontract Work satisfactorily performed.

By contrast, an example of a wholly unfair payment clause is as follows:

> **PAYMENT.** Payments to the Subcontractor for satisfactory performance of the Subcontract Work shall be made no later than seven days after receipt by the Contractor of payment from the Owner, such payment from the Owner being a condition precedent to Contractor's obligation to pay Subcontractor.

Under the first example, the credit risk of default by the Owner stays with the Contractor, and the Contractor must eventually pay you regardless of whether the Owner ever pays the Contractor. This is as it should be, since the Contractor is in the best position to evaluate the credit worthiness of the Owner. Your legal remedies may be limited by a condition precedent clause.

The second type of clause can result in wholly unfair situations. For example, if the Contractor itself defaults in its own performance, and the Owner holds back money due to the Contractor's default, the Contractor should not be able to benefit from its own default by being relieved of its obligation to pay its subcontractors and suppliers. Further, some other subcontractor may default, causing offsetting claims against the Contractor. Why should you have to pay for someone else's default? Isn't that what performance bonds are for?

Subtle changes in language can alter an otherwise acceptable "timing of payment" clause into a credit-risk shifting clause. Rather than having to spend your time and energy analyzing the payment provisions of your customer's contracts, I recommend simply including in your standard form bid terms and conditions, and in your standard form Addendum, a payment clause modeled after the "fair" clause used in the first example above.

Challenge # 2: Maximizing Leverage Against Unfair Backcharges

A common problem which exists throughout the entire construction industry is the use of unwarranted and unfair backcharges as a means of reducing a downstream contractor's payments at the end of a job. Owners do it to general contractors, general contractors do it to subcontractors, and subcontractors do it to sub-subcontractors. Some industry participants rationalize their conduct with the justification that it is necessary to offset the filing against them of what they perceive as unwarranted, unfair extra work and delay claims.

The time to establish your leverage against unjustified backcharges is at the contract negotiation stage of the job -- by the use of a "backcharge bond-off" clause. A backcharge bond-off clause gives the downstream contractor the option of posting a surety bond to assure payment of a claim against it if a challenged backcharge is determined to be valid, and requires payment of the disputed funds pending resolution of the dispute.

The reason behind the use of such a clause is as follows: in a typical example, let's say a general contractor owes a subcontractor for the last progress payment on a job, and during the course of the job a letter has been sent to the sub claiming delays in completing its work which were actually caused by delays on the part of a predecessor subcontractor in getting the job ready for the sub's work to be installed. The GC has advised that your entire final payment is going to be held up until you consent to a $5,000 backcharge as your contribution to the delay. You believe that the entire backcharge is unjustified, but on the other hand, you need your money now. You feel you can negotiate the backcharge down to $2,500, but don't believe you should have to pay anything for delays caused by others. What do you do?

Under the circumstances where withholding of payment is used as leverage to force consent to a backcharge, the party holding the money has all the leverage. If you have to sue for your money, that is just going to cost you more money for legal fees. Whatever you decide to do you are in a lose-lose situation.

The backcharge bond-off clause is designed to shift the leverage back to your favor, by requiring the contractor to pay you now, with your obligation -- backed by a surety bond -- to repay the contractor if the dispute is resolved in its favor. The following is an example of a backcharge bond-off clause:

> If Contractor believes in good faith that it has a claim against Subcontractor, Contractor shall promptly notify Subcontractor in writing of the full details of such claim, including a detailed statement of the amount claimed. Subcontractor shall have the option of posting a surety bond in the amount of such claim, in which case Contractor shall have no right to withhold any payments otherwise due to Subcontractor. In the event it is subsequently determined that the claim in question is valid, Subcontractor and its

surety shall be liable to make prompt payment of the amount due. If it is determined that the claim lacks merit, Contractor shall reimburse Subcontractor for the costs of such bond. Further, if Contractor fails to honor its obligation to make full payment upon the posting of a bond, Contractor shall be responsible for any attorneys' fees incurred by Subcontractor in seeking to enforce this provision.

The advantage of this clause is that it alters the balance of power between the parties, and it takes away the Contractor's leverage to use the withholding of progress payments and/or retainage to force unfair settlements on you.

Not all backcharges, of course, are unwarranted. Where a subcontractor fails to perform its work properly, thereby requiring the general contractor to perform the work itself or sub the work out to another contractor, the general contractor has a right under the law to withhold payment as an offset. No contract clause permitting an offset is required. It is also permissible, under most subcontracts, to withhold payments from a subcontractor in amounts necessary to satisfy claims against the general contractor made by a subcontractor's unpaid downstream subs and suppliers -- particularly where the claimants have live mechanics' lien or bond rights.

Challenge # 3: Maximizing Leverage to Get Paid

The vast majority of disputes that arise out of construction projects are settled through negotiation. The outcome of negotiations tends to be determined in large part by the amount of leverage each party has. Your leverage to obtain payments through negotiation can be increased by including three clauses in your contract terms:

* An interest clause

* An attorneys' fees clause

* An arbitration clause

Interest and Attorneys' Fees

Your objective in insisting on including provisions in your contracts which provide for payment to you of interest and attorneys' fees in the event you are forced to engage in either litigation or arbitration to get paid, is not actually to obtain such recovery. I have very rarely seen interest and attorneys' fees actually collected, since the vast majority of cases are settled. What I have seen *routinely* is the negotiation of settlements which provide for giving up interest and attorneys' fees in exchange for full payment of the balance owed. Your objective should be to maximize your leverage in the event a dispute over payment arises.

If your customer has the choice of payment between two parties -- one of whom is claiming interest and attorneys' fees and the other not -- the party whose contract provides for interest and attorneys' fees nearly always gets paid first.

Arbitration

If you operate your business in a jurisdiction where the court system is so backlogged that it takes years to get to trial, you will not have much leverage in threatening to take your customer to court in the event of nonpayment. After all, you need your money now, not in two or three years.

There are two distinct advantages to the use of arbitration clauses in your subcontracts. First, you can resolve disputes quickly -- for matters under $50,000, in only a few months. Further, arbitrators knowledgeable in the construction industry are not as likely as jurors to be fooled by trumped up defenses.

Summary of Chapter

Payment disputes can be avoided by limiting the scope of "pay-when-paid" clauses in subcontracts; using a backcharge bond-off clause in your terms and conditions to avoid unfair use of the leverage that comes from an ability to withhold payment; including clauses in your terms and conditions which require payment of interest and attorneys' fees on past due accounts; and including an arbitration clause in your contracts.

6

AVOIDING SCOPE OF WORK DISPUTES

Introduction

Of all the various types of disputes which arise between participants in a construction project, the most avoidable, by good management practices, involve scope of work issues. It takes, no doubt, a certain amount of diligence to make sure that the scope of work description in your contract is clear, and that your contract includes only work included in your bid price. That effort, however, is well rewarded.

Many scope of work disputes can be traced back to an all-too-common problem that exists throughout the construction industry: the preparation of bids under tremendous time pressure, which in turn leads to mistakes. Mistakes in bids then carry over to the contract, and result in disputes over whether particular work is part of the contract. The assumption in the construction industry is that if work is included in the specification for your work, and you submit a price to perform the work contained in that specification without identifying specific exclusions, you must perform all the work described, even if you failed to include some of that work in your take-off.

The most important thing you can learn from this chapter is follows:

> **Make a habit of building into your time schedule, each time you submit a bid or sign a contract, a few minutes for double checking your scope of work description, and for asking yourself whether the work you are committing to perform is spelled out clearly. Taking the time to clarify ambiguities at this early stage can help you avoid expensive problems down the line.**

Ten Rules for Avoiding Scope of Work Disputes

Based on past experience, I have come up with the following ten basic rules designed to help you avoid scope of work issues:

1. Use a Scope of Work Letter. A scope of work letter should accompany each of your bids. The purpose of the letter is in part to force you to review the work you have included within your take-off, and to make sure that there is no work that you have inadvertently left out. Problems can arise, for example, where work which is required of your trade appears on the drawings used by other trades. Problems also arise where instructions in footnotes to plans are overlooked. Your scope of work letter will protect you from having to perform work that you did not include in your bid price. Your scope of work letter should also set forth a list of exclusions, for work that is not within your scope.

2. Incorporate Your Scope of Work Letter Into Your Contract. Your ultimate subcontract or purchase order should incorporate your scope of work letter by reference, so that your contract will contain a precise description of your work.

3. Inquire About Known Ambiguities. Where there is an obvious ambiguity in a bid proposal or a proposed subcontract, you must make an inquiry to clarify the matter. If you fail to inquire, the interpretation given to the matter by your contracting party will be deemed to control.

4. Reject Contractual Liability for Hidden Ambiguities and Defects in Plans. Do not permit your contracting party to pass down to you by contract responsibility for performing work that you did not include in your bid price due to a hidden ambiguity. So-called "latent" ambiguities are those that are hidden and non-obvious, and which you did not discover in the process of formulating your bid. The drafter of the contract should be responsible for all losses resulting from latent ambiguities. Where a contract attempts to transfer to you the risk of ambiguities or defects in plans, add to that provision a limit to only those ambiguities which you have found prior to performing your work.

5. Avoid Vague Terms. Do not accept vague or overly-general descriptions of your work. Particularly avoid provisions which include work not shown on drawings or referenced in specifications, but which can be "inferred" from them.

6. Identify the Documents On Which You Base Your Bid. Identify the drawings used in formulating your bid by number and date, and do the same for the specifications, including addenda, as well. Your standard form terms and conditions should state that additional work set forth in addenda and revisions to drawings which you have not actually received at bid time is not part of your scope of work.

7. Deal In Advance With Unknown Conditions. Where there is a chance that unknown conditions may affect your work, set forth the assumptions on which your bid is based in your proposed bid terms. Take the time to visit and inspect the site to determine whether there are hidden problems on the job.

8. Exclude Performance Descriptions. There are two main types of scope of work descriptions. "Design" specifications describe the work that is to be performed, and the job of the contractor is to perform the work exactly as described. "Performance" specifications describe the result desired, leaving it up to the contractor to determine how to achieve that result. Some specifications contain both types of descriptions. Unless you intend to enter into a performance-type contract, you should attempt to delete from your contract descriptions of work that use performance-type language.

9. Exclude Responsibility for Damage by Others. Once the materials called for in your contract have been properly installed, it should be the responsibility of the general contractor -- not yourself -- to assure that no damage is done to the material after you have left the job. Your scope of work should specifically exclude corrective work for damage to your work after you have left the job.

10. Avoid Oral Modifications. Oral assurances concerning your scope of work requirements are not usually binding. At the very least, when you receive oral assurances concerning your scope of work, write a letter to the other party stating "this will confirm our conversation of [date], in which you advised me ...."

The Five Basic Rules of Contract Interpretation

Many scope of work disputes involve questions of contract interpretation. The basic rules of contract interpretation are as follows:

1. The first and most fundamental rule is that a contract is to be construed as a whole, giving consideration to all its parts, and giving meaning to all of them, rather than taking words, phrases or sentences out of context.

2. Another important rule is that ambiguities are to be construed against the party who was responsible for writing the contract. This principle is particularly applicable where a pre-printed standard form contract is involved, where the other party played no part in preparing the document.

3. Terms of art -- the special language of a trade -- are given their meaning according to the standard usage in that trade.

4. Where plans and specifications are made a part of a contract, their terms will apply with the same force as if they were set out in the body of the contract itself. The same is true for other documents incorporated by reference.

5. Where there is conflict between sections of a contract, the contract itself may contain a "precedence" clause, which spells out which provision will prevail. Such clauses are valid and are honored when there is a conflict between two portions of the Contract Documents.

Summary of Chapter

Scope of work disputes arise due to the failure of company management to take the time to clarify exactly what work is included in a bid.

Scope of work disputes can be avoided by use of a detailed scope of work letter, using a checklist of exclusions, using precise language to describe your work, and avoiding "perform-ance" type specifications. When ambiguities are found in the plans or specifications, they should be called to the attention of your customer immediately. Problems with unknown conditions can often be avoided by visiting the site and recording your observations. Lastly, do not rely on oral assurances concerning your scope of work.

7

CONTRACT CLAUSES DEALING WITH DELAY AND DISRUPTION

Introduction

Nowhere is the aphorism "time is money" more true than in the construction industry. A delayed or disrupted project can mean serious financial impact on a contractor. Another thing that is also certain is that in a delayed or disrupted project, someone is going to end up taking a loss. Owners tend to shift to the maximum extent possible risk of delays onto the prime contractor. Similarly, general contractors and construction managers often take great pains to assure that their subcontracts are heavily stacked in their favor, so that the cost of delay and disruption flows down the chain of contracts to the lower-tier contractors. Further, the written record of project activities and correspondence has a tendency to support those who prepare such records when disputes over delay claims arise, and general contractors are experts at keeping records that support their position.

The first step in dealing with delay and disruption is at the contract negotiation stage. Your task in this regard has two aspects: maximizing your protection against potential delay claims filed against you, and providing the basis for filing your own delay claims in appropriate circumstances.

The Critical Distinction Between "Delay" and "Disruption"

The term "delay" is ambiguous, in that it has two separate meanings when used in the context of a construction project. When speaking of "delay," a distinction must be made between changes in the period of time when an activity (or the project) is scheduled to take place, and time in the sense of *duration,* or how long it takes to perform an activity. Thus it is more accurate to limit the use of the term "delay" to describe changes in the schedule, and to use the term "extended duration" to describe the impact of an event which disrupts the schedule and which results in the activity taking longer to perform than planned.

In negotiating contract terms, these two alternative meanings of "delay" must be kept in mind. Although changes to the time period in which a contractor's work can result in difficult scheduling conflicts with other jobs, in times of low inflation mere delay in starting work on a job usually doesn't result in a serious cost impact.

A contract term limiting the right to obtain extra compensation for mere"delay"-- meaning only a shift in the schedule for starting work, is not normally objectionable. The language used, however, should clearly state that only compensation for time impacts, and not efficiency impacts, is being waived.

Disruption, in contrast to delay, means one or more events which impact on the efficiency of a contractor's performance. Disruption can be dealt with in one of two ways -- more manpower and longer hours (overtime) during the same period of work performance, or extended duration -- the use of the same level of manpower over a longer period of time. Since "delay" in the sense of extended duration is an inevitable result of interference, it is extremely important in negotiations over contract terms to distinguish between assigning liability for delay and assigning liability for disruption.

Maximizing Protection Against Delay Claims

Scheduling Clauses

The most important clause in your subcontract or purchase order concerning scheduling and delay is the clause which sets forth the time frames within which your performance must be completed. After all, in order to establish the existence of delay, there must be a contractual benchmark against which to measure your performance. There are two main things you need to watch out for:

1. Contract clauses which give the right to your customer to set a schedule for your work without input or consent on your part.

2. Contract clauses which require you to abide by the project schedule, but which have no corresponding obligation on the part of the general contractor to hold to that schedule.

The first objective of a fair scheduling clause is to establish a fair and reasonable period of time within which to perform your work, and to permit you to follow an efficient sequence that will minimize your costs. Where a general contractor or construction manager reserves to itself the right to control your schedule -- in what are known as "right-to-schedule" clauses -- you lose control over your schedule and are subject to the whims of your customer.

In a right-to-schedule clause, your customer reserves to itself the right to schedule your work without your input – to alter your planned sequence, to start and stop your work, to move you from area to area without notice, etc. Under these types of clauses, you can find yourself declared to be "late" simply because your customer's schedule says so, even if you are performing exactly as you had planned. Right-to-schedule clauses look quite innocent, but can leave you in a world of trouble. These clauses are wholly unfair, and should not be accepted.

Here is an example of a right-to-schedule clause which caused the subcontractor who permitted it to be included in its contract to suffer massive losses:

> **Contractor's Right to Control Schedule.** The Subcontractor shall be obligated to perform his work when and as directed by Contractor. The Subcontractor shall omit any sections or portions of the work that may be required by Contractor, and fill in such sections or portions when directed, shall stop work and resume later when and as directed by Contractor, and shall perform its work in the sequence directed by Contractor.

Here is an example of a reasonable and fair scheduling clause:

> **Subcontractor's Schedule**. Subcontractor anticipates completing its work, absent unforeseen events beyond its control, and interference by others, in __ work days, with work to commence 48 hours after Notice to Proceed. Contractor agrees to use that time period as the basis for its the project schedule. If, prior to or during performance of the work on the Project, Subcontractor is directed or required, due to no fault of its own, to delay or interrupt its work, Contractor shall extend Subcontractor's schedule to allow for such delays or interruptions.

For subcontractors, another issue which should be dealt with in the contract is the need for your customer to keep you advised as to when your mobilization is needed. Setting up a contractual procedure for advance notification will assist in avoiding scheduling conflicts among jobs. Here is an example of such a clause:

> **Notice to Proceed.** Contractor shall use its best efforts to give Subcontractor approximately one week's advance notice of the date on which the project will be ready for installation of its work. Subcontractor shall commence work on 48 hours' notice to proceed.

Non-Liability for Unforeseen Events

The second most important clause concerning scheduling and delay is that providing for non-liability for unforeseen events beyond your control and without your fault. I recommend the following clause:

> **Unforeseen Delays.** Subcontractor shall have no liability to Contractor for delays in the completion of its work, and shall be entitled to an extension of time but no increase in contract price, for delays resulting from unforeseen causes beyond the control of either party hereto and without fault of either party hereto, including but not restricted to acts

of God, acts of the public enemy, acts of the Government, acts of another subcontractor or supplier which were beyond the control of Contractor, fires, floods, epidemics, quarantine restrictions, strikes, embargoes, and delays caused by Subcontractor's sub-subcontractors or suppliers to the extent such delays arise out of unforeseen events beyond their control and without their fault.

Weather Delays

Claims for delays arising out of "unusually severe" weather are rarely successful, due to difficulties in proof. It is preferable to set forth in your contract the number of days which you have anticipated (and hence included in your estimate) for lost weather days, and which entitles you to an extension of time, but no money, for additional lost weather days beyond those anticipated. The following is a sample clause to be used to govern weather delays:

> **Weather delays.** It is anticipated that __ days per month will be lost due to adverse weather conditions. In the event Subcontractor is unable to work due to adverse weather on more than that number of days in any given month, a corresponding adjustment shall be made to Subcontractor's schedule.

Liquidated Damages

Liquidated damages play a useful role in construction contracts, and in many cases the per diem damages provided for are less than actual damages would have been. Contract clauses dealing with liquidated damages need to limit your liability, however, to only those delays assessed against your customer which were caused solely by your contractual default, and to which your customer in no way contributed.

Where a general contractor is assessed liquidated damages arising out of a subcontractors' delay, and in addition the general contractor suffers actual damages due to the delays, both types of damages can be recovered by the general contractor against the subcontractor, unless there is a clause in the subcontract to the contrary.

This is an example of a fair and reasonable liability-for-delay clause:

> **Liquidated Damages for Project Delay.** In the event of unexcused delay in Subcontractor's performance which results in a delay in the completion of the Project which is caused solely by Subcontractor and to which no other party contributed, Subcontractor shall be liable to Contractor for liquidated damages assessed against it by Owner for such delay.

Protecting Your Right to File Delay Claims

Delay Notice Clauses

The most important thing that you can do to protect your rights to file delay and disruption claims is to immediately send a notice to your customer as soon as you are impacted by any event beyond your control.

Most subcontracts contain clauses that waive your rights to file claims for delay for failure to give notice of a delay within a specified number of days. While I recommend trying to change delay notice clauses to only require notices to be sent within a "reasonable" time, since there are so many other important things to negotiate over, simply staying aware of such notice provisions and complying with them is a more reasonable approach than fighting with your customer over this particular issue.

If you are unable to get such a clause stricken from your contract, one solution is to post a notice in your office or job trailer, as appropriate, as a reminder that on the job in question you are required to give notice upon the occurrence of any delay. It is a good idea in any event to provide your contracting party with immediate notice in the event you are delayed by an event which is not your fault.

The Need to Limit the Scope of No-Damages-for-Delay Clauses

The problem with so-called no-damages-for-delay clauses is that they typically are drafted so that they encompass far more than mere delay. Many contractors include clauses in their contracts under which you waive your rights to file claims for disruption and interference as well as delay. This is wholly unfair, and these types of clauses should be amended before you sign the subcontract. An example of a fair no-damages-for-delay clause is as follows:

> Subcontractor agrees to waive all claims, and shall receive no compensation, for delays in commencement of its work.

An example of a modification to create a wholly unfair clause is as follows:

> Subcontractor agrees to waive all claims, and shall receive no compensation, for delays, hindrances, disruption, and interference with its work.

The original purpose of no-damages-for-delay clauses was to cover the situation in which the time at which a contractor would start a job was uncertain, and the parties were in agreement that the price would be the same regardless of the starting date. In other words, the owner would not be liable for increased costs if, for example, funding problems delayed the start of the job. It was never the

intent of such clauses to cover damages caused by their own breaches of contract, such as interfering or hindering a subcontractor's performance.

By slight changes in wording, however, no-damages-for-delay clauses have been turned into a license for the upstream party to engage in serious breaches of contract with impunity. Where no-damages clauses are written so as to cover anything other than changes in schedule, they should be amended.

Summary of Chapter

There is a major distinction between mere delay -- that is, the time period during which your work is performed, and disruption, interference and hindrance, which causes your costs of performance to increase. Care should be taken to limit no-damages-for-delay clauses to cover delay only, while avoiding waiver of claims for disruption and the like. Avoid clauses which give your contracting party the right to schedule your work without your consent and input. Also, limit your liability for unforeseen delays, and limit your liability for liquidated damages to those delays caused solely by your fault.

8

AVOIDING PAYING FOR OTHER PARTIES' WRONGDOING: CONTRACT CLAUSES FOR INDEMNIFICATION AND INSURANCE

Indemnification Clauses

Absent a limitation under state law, participants in a construction project are free to allocate financial responsibility for the damages flowing from personal injury or property damage among themselves, in their contracts. The general idea, to be blunt about it, seems to be to push as much responsibility onto the other guy as the law will allow. Further, even where agreements extending indemnification for a contracting party's sole negligence have been outlawed, such legal restrictions are often overcome by clauses requiring "named insured" status on the other party's liability policy.

Indemnification clauses have also been used with increasing frequency to shift losses arising from fines for safety violations, as well as other economic losses.

Many subcontractors and suppliers are blissfully unaware of the fact that through harsh indemnification provisions, they can become contractually liable for someone else's negligence, including the negligence of their contracting party. There have been numerous instances where indemnification clauses in subcontracts and purchase orders have resulted in crushing if not ruinous losses suffered by wholly blameless parties. This is an area in which diligence in contract negotiation can truly make the difference between success and bankruptcy.

Indemnification is a contractual method of shifting legal liability from one party to another. Under an indemnification agreement, one party agrees to step into the other party's place, and to accept legal liability for the other party's actions, usually including the other party's negligence and wrongful acts.

In construction contracts, indemnification clauses generally allocate risk of personal injury or property damage arising out of accidents, but some clauses cover performance and business risks as well.

There are three types of indemnification clauses:

* The limited clause, which essentially provides for no more contractual liability than the law of negligence requires anyway.

* The intermediate clause, which requires indemnification and defense where both of you are at fault.

* The broad form clause, which requires that you bear all loss and costs of defense, including losses caused solely by the other party's fault.

In legal language, the party agreeing to indemnify is referred to as the "indemnifier" and the person indemnified as the "indemnitee."

In the limited clause, the indemnifier simply agrees in its contract to accept contractual liability for its own fault -- that is, its own negligence, wrongful acts or failure to act. Since the law requires parties who cause damage due to their own negligent or wrongful conduct to provide compensation for such damage, such clauses are unobjectionable.

There are several ways to write intermediate clauses with respect to "joint" negligence: under one version, where both parties to the contract are negligent, they agree to shift all liability to one of them. Beware, however, that under some clauses, "joint" negligence between the indemnifier and *any third party* is enough to shift liability to the indemnifier. Such clauses should be avoided.

Both intermediate and broad form indemnification clauses can be made acceptable by providing that indemnity is granted "to the extent and only to the extent, loss or damage is caused by Subcontractor."

In Arizona, Alaska, California, Connecticut, Hawaii, Indiana, Maryland, Michigan, South Carolina, South Dakota, Tennessee, Utah, Washington, Virginia, and West Virginia, indemnification is permitted, but only where there is joint negligence.

In Illinois, Louisiana, Minnesota, Mississippi, Ohio and Rhode Island, shifting of liability to a non-negligent party is not permitted even where there is joint negligence.

The following is an example of an unfair indemnification clause:

> Subcontractor agrees to defend and indemnify contractor, and to hold Contractor harmless, for all liability, losses and damages, including consequential damages, for personal injury or death, or property damage arising from or related to Subcontractor's work, including liability, losses and damages caused by Contractor's fault.

By changing a few words, the same clause can be altered into a fair clause:

> Subcontractor agrees to defend and indemnify contractor, and to hold Contractor harmless, for all liability, losses and damages, including consequential damages, for personal injury or death, or property damage arising from or related to Subcontractor's work, to the extent, but only to the extent, of the fault of the Subcontractor.

Insurance Clauses

There are two recurring insurance-related issues which subcontractors must deal with routinely in contract negotiations: being added as an insured on the contractor's Builder's Risk policy, and avoiding adding the contractor and others as additional insureds on your liability policy.

Builder's Risk

As is discussed in further detail in Chapter 15 dealing with insurance, Builder's Risk insurance is designed to cover the risks of damage to a portion of the project while it is under construction. By being included as an insured on the policy, you are assured that if your work is damaged, or if you are charged with damaging another contractor's work, the loss above the policy deductible will be covered by the Builder's Risk policy. Such policies normally include a waiver of the right to recoup the amount paid from the party at fault -- known as a "waiver of subrogation." A standard clause dealing with this issue states:

> **Builder's Risk Insurance**. Contractor shall cause to have Subcontractor added to the Builder's Risk policy as an additional named insured, with a waiver of subrogation endorsement.[1]

The Problems Involved in Adding Your Customer as An Additional Insured

In recent years it has become common for general contractors to seek from their subcontractors what may properly be viewed as a form of "back-door" indemnification, by requesting that subcontractors add both the general contractor and the owner as an "additional insured" on the subcontractor's liability insurance policies. There are some drawbacks to adding additional insureds on your liability policy, since if your insurance is called upon to honor a claim, it is your future premiums which will be affected.

1 "Subrogation" involves the payment to an innocent insured by his insurer, and then the insurance company obtaining reimbursement for the monies paid out from a third party who caused the damage or loss.

I recommend that you soften the effect of adapting additional insureds to your liability insurance by including in your standard form terms and conditions a clause which provides that where both your insurance and your additional insured's insurance would both cover a loss, that your insurance is deemed secondary, rather than primary, to your contracting party's own insurance. As secondary insurance, your policy will not come into effect until the policy limit of your customer's policy is reached.

Another way in which the impact of adding another party as an additional insured to your insurance can be reduced is to include in your terms and conditions a provision to the effect that the coverage of your insurance is limited to that which is covered by the contract's indemnification clause. Another way to provide such a limit is to agree that your policy will provide payment of claims only, and not the provision of a defense.

Summary of Chapter

Indemnification is the contractual shifting of legal liability from one party to the other. There is nothing objectionable about agreeing to accept contractual liability for the negligence and wrongful acts of your employees and agents. You should not, however, accept liability for the negligent or wrongful acts of your contracting party. Indemnification should be limited to the extent, and only to the extent, to which liability arises out of your employees' actions.

As for insurance-related clauses, you should insist on being added to the project's Builder's Risk policy, which covers damage to the project (including your own work), and should contractually limit the impact of adding your contracting party and others as additional insureds on your insurance policies.