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Common Construction Contract Provisions

Clause for Concern

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In the early stages of a project, the participants pay little (if any) attention to the particulars of their contracts. The focus is on obtaining the work and then completing the job within the allotted time and budget. If all goes smoothly, the project may be completed without anyone ever pulling their contract from the pile gathering dust atop the file cabinet. When the project goes awry, however, the contract becomes the focus. Great attention is paid to the "fine print," often for the first time and often to the great surprise of one or both contracting parties.

Contracts by their nature allocate risks between the parties, and particular clauses can pose traps for the unwary. Some clauses can be particularly troublesome.

Incorporation by Reference

Contracts frequently contain provisions that identify and incorporate by reference other documents, for example:

The Contract Documents consist of the Agreement between Owner and Contractor (hereinafter the Agreement), Conditions of the Contract (General, Supplementary and other Conditions), Drawings, Specifications, Addenda issued prior to execution of the Contract, other documents listed in the Agreement and Modifications issued after execution of the Contract. [1]

Such provisions serve two purposes. First, they identify the documents that are part of the parties' contract but not attached to it. The second and lesser noticed effect, however, is to "flow down" contractual obligations of one party, such as a contractor, to other parties, such as his subcontractors or suppliers. A subcontractor who agrees to "perform all the Work required by the Contract Documents for the construction of the Project," binds himself to comply with *all* the "Contract Documents," even if they are not physically attached to his subcontract. For example, if the term "Contract Documents" is defined as including project specifications and those specifications, in turn, incorporate by reference codes and standards, then those codes and standards will be deemed a part of the contract.

Particularly nettlesome is incorporation by reference through multiple layers of contracting parties. An extreme example can be found in the case of *Russellville Steel Co., Inc. v. A&R Excavating, Inc.* [2] There, an owner entered into a contract with Landis for construction of a research facility, which contract provided for the arbitration of disputes. Landis subcontracted certain steel installations to Russellville Steel, which were to be performed "strictly in accordance with the Contract Documents, listed in Schedule B and incorporated herein by reference." Russellville Steel, in turn, subcontracted some of its work to A&R Excavating through a purchase order.

The purchase order required A&R "to perform the erection work as called for in the attached subcontract." A dispute arose between Russellville Steel and A&R, and A&R filed a demand for arbitration. Russellville Steel denied the existence of an agreement to arbitrate.

The court held that the attachment of the Russellville Steel/Landis subcontract to the purchase order, which subcontract incorporated by reference the owner/Landis agreement, was sufficient to "flow down" the arbitration agreement of the top tier contract to the purchase order.

The inclusion of an incorporation by reference provision in a proposed contract counsels diligent research and understanding of the obligations imposed by the incorporated documents before the contract is signed. A failure to do so

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will not excuse non-performance of obligations imposed by incorporated documents. [3]

Contingent Payment Clauses ("Pay When/If Paid")

In the traditional construction paradigm, an owner contracts with a design professional, usually an architect, to furnish plans and specification for the project. The owner thereafter contracts with a general contractor to build the work according to the design. In each instance, the party contracting with the owner typically subcontracts out portions of the work due the owner. An architect, for example, may hire a mechanical design engineer to do the HVAC design; the contractor may hire a mechanical subcontractor to perform the HVAC installation. In each instance, the party contracting with the owner is potentially between a rock and a hard place: he owes his subcontractor for the services performed, but is at risk that the owner cannot (or will not) pay for that work.

Contingent payment clauses, commonly called "Pay When Paid" or "Pay if Paid" clauses, are used to shift this risk of nonpayment or late payment to the subcontractor. These clauses generally provide that a subcontractor is not entitled to payment until the party with whom he contracted receives payment from the owner, for example:

Contractor shall have no obligation, legal, equitable, or otherwise, to pay Subcontractor for Work performed by Subcontractor unless and until Contractor is paid by the Owner for the Work performed by Subcontractor. Furthermore, in the event Contractor is never paid by Owner for Subcontractor's Work, then Subcontractor shall forever be barred from making, and hereby waives, in perpetuity, any claim against Contractor therefor.

Such clauses have been the subject of considerable dispute, with virtually identical language being held enforceable in one court, but not another. In a small number of states, legislatures have enacted statutes prohibiting the enforcement of such clauses. [4] In another small group of states, courts have found such provisions void as against public policy. In yet a third group of states, such clauses have been held enforceable if they clearly and unequivocally state that payment to the general contractor is a "condition precedent" to the general contractor's obligation to pay his subcontractor.

The majority of state courts enforce such clauses, but refuse to regard them as a complete bar to payment of subcontractors. The underlying reasoning varies greatly from court opinion to court opinion, and is sometimes disingenuous. For example, in *Southern States Masonry, Inc. v. J.A. Jones Construction Company*,[5] the Louisiana Supreme Court held that rather explicit clauses failed to make the owner's payments to the general contractor a condition precedent to the general contractor's obligation to pay his subcontractors. Other courts have focused on whether owner insolvency was considered or contemplated at the time the subcontract was executed:

In our opinion, [the provision was] designed to postpone payment for a reasonable period of time after work was completed, during which the general contractor would be afforded the opportunity of procuring from the owner the funds necessary to pay the subcontractor. To construe it as requiring the subcontractor to wait to be paid by the owner, which may never occur, is to give it an unreasonable construction which the parties did not intend at the time the subcontract was entered into. [6]

In these "majority rule" states, contingent payment clauses are interpreted as requiring payment to subcontractors within a reasonable time.

In states where such clauses are enforceable, the extent of enforcement often turns on the intent of the parties at the time of contract formation, or a court's parsing of contract language to determine if it makes owner payment a condition precedent to subcontractor payment. Accordingly, careful attention must be paid to contingent payment language to understand whether it raises a complete bar to subcontractor payment, or merely affects the timing of payment.

Indemnification

In an indemnity provision, the risk of loss from enumerated events is shifted from one party (the "indemnitee") to another (the "indemnitor"), with the latter agreeing to "hold harmless" (i.e., reimburse) the indemnitee for costs and expenses arising out of those events. These provisions typically take one of three forms. First, a "broad form" indemnity provision holds the indemnitee harmless from any and all claims, even if they arise from the *indemnitee's* own negligence. Second, "comparative fault" indemnity clauses make the indemnitor responsible only for the losses he causes, either in whole or in part. Finally, an "intermediate form" provision protects an indemnitee from all losses except those arising from the sole fault of the indemnitee.

The enforceability of a particular indemnity provision can vary from state to state. The majority of courts view with disfavor clauses that indemnify the indemnitee against losses arising from his own negligence. In these jurisdictions, "broad form" indemnity clauses will be strictly and narrowly construed. Indemnification against one's own negligence will not be allowed unless that intent was expressed in "unequivocal terms." While the intent to indemnify must be expressed unequivocally, there are no "magic words" that achieve that result. Language that is acceptable in one jurisdiction may be found unacceptable in another.

In addition, courts may look beyond the language of the indemnity clause to other provisions of the contract, such as the insurance clauses, for guidance on the scope of indemnity intended by the parties. Finally, courts may look at the sophistication of the parties and their relative bargaining positions. Sophisticated parties of equal bargaining strength are in a bet-

ter position to write contracts that exclude indemnification for the indemnitee's negligence.

Even in states permitting "broad form" indemnity, there are limits. Generally, such clauses will not operate to relieve a party from their "gross negligence" or intentional acts. Parties negotiating a contract should know and understand the extent of their indemnification obligations before signing on the dotted line.

No Damage for Delay

Construction contracts typically provide a time extension for completion of the work in the event of an excusable delay:

If the Contractor is delayed at any time in progress of the Work by an act or neglect of the Owner or Architect, or of an employee of either, or of a separate contractor employed by the Owner, or by changes ordered in the Work, or by labor disputes, fire, unusual delay in deliveries, unavoidable casualties or other causes beyond the Contractor's control, or by delay authorized by the Owner pending arbitration, or by other causes which the Architect determines may justify delay, then the Contract Time shall be extended by Change Order for such reasonable time as the Architect may determine. [7]

Some contracts will be silent on the issue of whether an excusable delay event also entitles a contractor to compensation. Other contracts may provide that an excusable delay event "does not preclude recovery of damages for delay."[8] Some contracts, however, may expressly bar the recovery of compensation in the event of excusable delay.

As a general rule, "no damages for delay" provisions are valid and enforceable. As with most general rules, there are exceptions. Courts will refuse to enforce a "no damages for delay" clause if the delay (1) was caused by an owner's active interference, gross negligence, or breach of contract; (2) is unreasonably long and effectively constitutes an abandonment of the project; or, (3) was not contemplated by either party.

Waiver of Consequential/Incidental Damages

When a contract is breached, both direct and indirect (aka "consequential") damages can result. Direct damages are the costs and expenses incurred directly as a result of the breach of contract. For example, few would argue with the proposition that costs and expenses incurred by a hotel owner to investigate and remediate a mold problem caused by defective design or construction constitute damages directly flowing from breach. Consequential damages, which are generally defined as damages that are indirectly caused by the breach of contract, are more controversial. Using the example above, lost revenue suffered by the hotel owner while rooms are undergoing remediation would be considered by some a consequential damage flowing from the breach. Others would strenuously argue that such damages are direct, rather than consequential, because they are a foreseeable result of the breach.

It is not at all unusual for one or both of the parties to a contract to seek to limit their exposure for consequential damages.[9] The reason for such waivers is understandable. In many instances, exposure for consequential damages can substantially exceed the face amount of the contract at issue.[10] Moreover, the evidence of such damages, particularly in the area of future damages, lost profits — can be speculative at best. The enforceability of consequential damage waivers can vary. In some states, such waivers are prohibited in all construction contracts, and in others prohibited only in certain types of contracts. As alluded to earlier, there is considerable debate in legal circles as to which damages are direct and which are consequential. Parties who contemplate such waivers must carefully evaluate the potential damage claims being waived and assess the risk of doing so.

Dispute Resolution

Contract clauses providing for the arbitration of disputes are now the rule rather than the exception in construction industry contracts. For example, the widely used AIA General Conditions of the Contract for Construction, AIA Document A201, provides that "[a]ny Claim arising out of or related to the Contract …shall …be subject to arbitration" in accordance with the Construction Industry Arbitration Rules of the American Arbitration Association ("AAA") currently in effect.[11] As arbitration provisions have become increasingly more commonplace in contracts, so too have arbitration laws become the norm: in addition to the Federal Arbitration Act, all 50 states, the District of Columbia, and Puerto Rico have enacted arbitration laws. Under these laws, arbitration provisions are valid and enforceable. In fact, public policy favors arbitration, and doubts regarding the existence of an agreement to arbitrate generally are resolved in favor of arbitration.

Because of the strong public policy favoring arbitration, arbitration awards are presumed to be valid. Accordingly, the award of an arbitrator may be vacated, modified, or corrected only if one of the grounds enumerated in the applicable arbitration law is present. These statutory grounds typically are: (1) the award was procured by corruption or fraud; (2) there was evident partiality or corruption on the part of the arbitrator; (3) the arbitrator was guilty of extreme misconduct (e.g., refused to hear evidence material to the controversy); or (4) the arbitrator exceeded the powers granted him by the arbitration clause of the contract. An award may not be appealed merely for errors of fact or law by the arbitrator.

There are advantages and disadvantages to arbitration. Advocates of the process argue that it results in quicker, more economical dispute resolution. Generally, there is no discovery unless permitted by the arbitrator, or agreed to by the parties. Proponents also argue that the award is more likely to be technically correct due to the relative informality of the proceeding, and the presence of a decision-maker that is experi-

enced in the field. Critics dispute that arbitration is less expensive (particularly in complex cases), and point to the hidden costs, such as arbitrator fees, that are not incurred in a lawsuit. Critics decry the lack of discovery, which, in their view, leads to "trial by ambush." Detractors also argue that arbitrators are more likely to reach an equitable result, known as "splitting the baby," rather than do what the law or the contract requires, with the outcome not being subject to appeal.

Beyond weighing the advantages and disadvantages of arbitration, contract negotiators must assess the process and procedures proposed for arbitration. Are the rules acceptable? Is the method for selecting arbitrators acceptable? These are just a few of the questions that should be addressed before contract signing.

Choice of Law/Forum

A "choice of law" or "governing law" provision identifies the law under which the contract is to be interpreted (e.g., "This Agreement shall be governed by and construed according to the Laws of the State of New York."). A "choice of forum" provision identifies the location where the parties have agreed that any disputes should be litigated or arbitrated (e.g., "Any and all disputes arising out of this Agreement and/or the Project shall be decided by a state or federal court of competent jurisdiction in Suffolk County, New York.").

As a general rule, both choice of law and choice of forum provisions are valid and enforceable. In some jurisdictions, however, the parties' freedom to contract in this area is limited by statute.[12]

Attorney's Fees

Attorney's fees generally are not recoverable in a lawsuit in the absence of a statute or contract provision authorizing their recovery. In some instances, a contract will contain a provision awarding attorney's fees to the prevailing party in any dispute arising out of the contract. Here, the language used becomes important: "shall award" indicates that an award of attorney's fees is mandatory; "may award" indicates that an award is discretionary. Use of discretionary language begs the question of what criteria are to guide the exercise of that discretion. In both instances, the identification of the "prevailing party" can be problematic. If both parties make claims and win on some issues but lose on others, which party is the "prevailing party?" Finally, attention should be paid for hidden attorney's fee provisions. For example, one court found that an indemnity provision obligating the indemnitor "to bear the expense of the investigations and defenses of all claims or demands or causes of action" required the indemnitor to pay the indemnitee's attorney's fees as an "expense of . . . defenses."

Notes

1. American Institute of Architects (AIA) Document A201 (1997), 1.1.1.
2. 624 So. 2d 11, 13 (La. App. 5 Cir. 1993).
3. *Allen v. Royale "16," Inc.*, 449 So.2d 1365, 1368 (La. App. 4th Cir. 1984). ("One who signs a contract is presumed to know its terms and cannot avoid its provisions, absent fraud or error, simply because he fails to read or understand it.")
4. e.g., N.C. Gen. Stat. 22C-2. ("Payment by the owner to contractor is not a condition precedent for payment to a subcontractor . . . and an agreement to the contrary is unenforceable.")
5. 507 So.2d 198 (La. 1987).
6. *Thomas J. Dyer Co. v. Bishop Int'l Engineering Co.*, 303 F.2d 655 (6th Cir. 1962).
7. AIA Document A201 (1997), 8.3.1.
8. AIA Document A201 (1997), 8.3.3.
9. The 1997 edition of AIA Document A 201 contains a mutual waiver of consequential damages by the owner and general contractor. See AIA Document A201, 4.3.10.
10. For example, in the indoor air quality lawsuit involving the Polk County (Fla.) courthouse, consequential damages made the county's total damage claim nearly twice the original construction cost. It is not merely contractors who are at risk for such claims. Owners can be sued for consequential damages arising out of, among other things, excusable delay events.
11. AIA Document A201 (1997), 4.6.1 and 4.6.2. In the absence of a contractual agreement providing otherwise, contractual disputes are resolved in the court system.
12. e.g., La. Rev. Stat. 9:2779; N.C. Gen. Stat. 22B-3; Ohio Rev. Code 4113.62.