

# Identifying and Mitigating the Risks Created by Problematic Clauses in Construction Contracts

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**Abstract:** When it comes to identifying language which is likely to be problematic in construction contracts, even seasoned construction professionals can sometimes overlook a problematic clause, sentence, or word. Moreover, problematic contract clauses are frequently overlooked, or outright ignored, by contractors and owners eager to win the contract and get to work. At the same time, the failure to identify problematic contract clauses can put the financial well-being of the entire company at risk. To mitigate against this risk, companies need to establish effective processes and procedures which require a thorough review of the contract before they bind the company. These procedures should include (1) preparing a set of guidelines which reflects the company's policies toward language commonly found in construction contracts, (2) designating and training a reviewer responsible for identifying problematic language and bringing it to the attention of the decision makers at the company, (3) developing a list of *red flag* and *must-have* clauses which must be avoided, or included, in every contract, and (4) identifying and compiling the lessons learned by the company to learn and improve from its mistakes. This article includes a discussion of certain *red flag* and *must-have* clauses which are frequently encountered in construction contracts, from the perspective of both the owner and the contractor. DOI: [10.1061/\(ASCE\)LA.1943-4170.0000225](https://doi.org/10.1061/(ASCE)LA.1943-4170.0000225). © 2017 American Society of Civil Engineers.

## Introduction

Most construction professionals already know that contract drafting is important. They have heard the old adages from lawyers that words matter, especially when it comes to issues such as payment, scope of work, changes, and time for performance. However, when it comes to identifying language which is likely to be problematic in a draft construction contract, even seasoned construction professionals can sometimes overlook a problematic provision, sentence, or word.

In unique circumstances, the interpretation of a contract can even hinge on the punctuation used. In the case of a Canadian communications company, one errant comma in the contract caused the company to lose Can\$2.13 million.<sup>1</sup> More specifically, the utility company with which the communications company had contracted elected to cancel the contract (as permitted by virtue of the errant comma) and thereafter increased the price terms in a newly proposed contract to the communications company. Because the communication company had already completed extensive infrastructure investment and installation that could only be utilized by contracting with that utility company, it was forced to accept the increased price of the new contract.

As this example illustrates, no company (big or small) can afford to overlook the importance of performing a careful and thorough review of each contract, subcontract, and purchase order to which it agrees. The goal of this paper is to ensure that the only contractual risks a construction company agrees to assume are known, calculated risks. To achieve this goal, this paper offers recommendations, beyond the usual suggestions of careful proofreading and proper punctuation, for avoiding or mitigating pitfalls in construction contracting. This paper examines the best practices for developing and

implementing a proper contract review procedure. This paper also identifies a sampling of particularly problematic clauses, as well as some particularly desirable clauses, of which both contractors and owners should be aware. Unfortunately, a discussion of all important provisions for all types of projects is well beyond the scope of a single paper; that is why contractors and owners are encouraged to learn from their own experiences and use internal processes to track the contract clauses important to them.

## Contract Review and Negotiations

During the bidding and contract-negotiation phases of a construction project, there often exist powerful motivations behind shirking a detailed and thorough review of the contract before signing. From the contractor's perspective, a detailed contract review is often overlooked or ignored in an eagerness to win the contract. Those responsible for procuring business may be (understandably) apprehensive about negotiating difficult terms prior to the award of a contract because they fear it will prevent the company from being awarded the work. From the owner's perspective, the terms of the construction contract are sometimes given insufficient attention due to the sheer volume of other issues that have to be resolved before ground is finally broken on the project (e.g., the design, the government approvals, the financing, and the property rights). Both the contractor and owner tend to rely upon standard language in form contracts without tailoring such language to the specific needs of the project.

And then there is, of course, human nature. As people collaborate to achieve a common goal, such as contractors and owners trying to *seal the deal* on a construction project, they tend to avoid conflict and confrontation with each other. Instead, they tend to focus on the best means and methods, pricing, and schedule for completing the proposed project. In addition, the negotiating teams may be under pressure to meet the business-generation expectations of supervisors and managers at their respective companies. In this context, few employees want to report back to their boss that the deal fell through because they could not agree on the particular language of the contract.

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Yet there is another issue that construction professionals confront in the contract-negotiating process which needs to be openly acknowledged: reviewing and revising construction contracts is difficult. It requires an understanding of legal terms and concepts (which even most lawyers do not fully grasp), it requires careful attention to detail, it is tedious and time-intensive, and, for some, it is boring and monotonous. Making things more difficult, there is rarely, if ever, a one-size-fits-all approach to construction contract drafting because every company and every project is different. Especially for a company without legal resources, the notion of undertaking a comprehensive and thorough review of a construction contract can be intimidating and overwhelming.

Although these human tendencies, idiosyncrasies, and challenges are certainly recurring themes in the contract-negotiation process, they should not be taken for granted. A reasonably prudent contractor or owner cannot afford to leave the contract-negotiating process to the winds of fate; the contracts these negotiations produce are legally binding and have serious, real-world consequences. After all, it is difficult to overstate the downside risk of a poorly drafted contract when a construction dispute ensues. Among other things, such disputes are likely to embroil the company in legal proceedings for years, result in significant attorneys' fees and expert costs, result in decreased productivity for employees, and cause immeasurable aggravation for management. In the event of litigation over a *company killer* clause, the financial well-being of the company may be a going concern. Therefore it behooves contractors and owners alike to implement a comprehensive procedure for reviewing and approving contracts.

### **Lawyers Are Not a Necessary Component of a Contract Review Process**

Before turning to the best practices, there is a common misperception that a lawyer, or a team of lawyers, must be involved in the contract-review process in order for it to be effective. This is neither accurate nor practical in most instances. Very few construction companies enjoy the luxury of an in-house legal department with adequate resources to review and revise every potential construction contract. Even those companies with an in-house legal team typically find that the attention of their lawyers is thinly spread across multiple issues; rarely can they dedicate a single lawyer solely to contract review. For those companies without an in-house legal team, which is by far the majority, the contract-review process generally proceeds without the involvement of a lawyer. Although experienced construction lawyers can provide valuable input (including by identifying problematic contract language, developing the company's policies with respect to such language, and resolving specific contract questions), the absence of a lawyer does not excuse or prevent a company from implementing an effective contract-review process.

### **Best Practices for Instituting a Contract-Review Procedure**

There are two key roles that are needed for a contract-review process: (1) a competent reviewer, and (2) a rational decision maker. A properly structured contract-review system enables the reviewer to identify problematic language in the draft construction contract, and bring it to the attention of the decision maker at the company. Turning first to the decision maker, depending on the company the decision maker may be a single person (e.g., the president or CEO), a core group of executives or vice presidents, or a number of decision makers spanning different business divisions. However the company is structured, the decision maker should be someone who

is authorized to enter into contracts on behalf of the company and who is familiar with the financial health, objectives, and risk-tolerance of the company.

Once the problematic language is before the decision maker, he or she is responsible for deciding what to approve, revise, or delete, as necessary, based upon a set of comprehensive policies that the company has previously considered and approved for such contracts. The company's policy on contracts should be a living document which not only reflects sound business practices and strong legal positions but also changes over time based upon the experiences of the company, good or bad, in its everyday operations. Thus there should be a procedure in place at the company to funnel the lessons learned by the company (such as by reporting them to the reviewers) so that these lessons can be considered and included within future contract-drafting policies. Although a lawyer is not needed as part of the contract-review process for every contract, the input of a lawyer is advisable when developing the company's policies toward certain language which is likely to be encountered in construction contracts.

Under certain circumstances, the decision maker will come across a construction contract containing provisions which are presumptively prohibited by the company's policies, but the project has a considerable upside for the company (e.g., high profits or a highly desirable business partner). To account for these high-risk/high-reward scenarios, the company should adopt a written policy which requires the decision maker to consult with others who have an ownership interest in the company before entering into a high-risk contract. A single decision maker should not be empowered to *bet the company* on one contract, no matter how high the potential profits or returns. In the case of a partnership, a single partner should consult with his or her partners before entering into any contract which has an increased risk profile because every partner has an interest in the gains and losses of the partnership. As with big companies, no single partner should be permitted to *bet the company* on a single construction contract without first informing and obtaining approval from the other partners.

Finally, if the contracting party ultimately will not agree to the revisions or deletions approved by the decision maker, then the issue should again be brought to the attention of the decision makers at the company. The decision makers must then determine whether the risk posed by this language is acceptable given the financial well-being of the company and the company's objectives and strategies in the market.

### **Selecting the Reviewer**

Selecting the person<sup>2</sup> (or group of people) who will serve as the reviewer is arguably the most important decision the company will make when implementing a contract-review system. The ability to identify problematic contract language is a skill that takes practice because every contract and every project is different. Companies that invest the time to properly train a competent and trustworthy reviewer will be rewarded over time because that person will develop a specialization which improves the company's ability to recognize and avoid risk.

The reviewer is being entrusted to identify the existence, or the absence, of certain contract language which can significantly affect the risk-profile assumed by the company, both at a project level and as a whole. Therefore the individual selected by the company must be detail-oriented, trustworthy, and a critical thinker. He or she must not be intimidated or bored by the dense, complex contracts which are common in the construction industry. He or she will need to generally know the construction industry—but, more specifically, know the company's position in the market, how the company

makes money and what kinds of jobs are most profitable, the activities the company is licensed to perform (i.e., design services), the company's compliance with certain state and federal regulations, and the company's prior history with certain contracting partners.

Ideally, the designated reviewer should be someone who is not a member of the contract-negotiating team. After all, people on the contract-negotiating team are typically under pressure to close the deal, and may be unable to honestly evaluate the contract and identify problematic language. Moreover, because their focus is on *sealing the deal*, the business team may be unable or unwilling to walk away from a particularly risky contract even when walking away is in the best interests of the company. Instead, the reviewer should have a single end goal: a well-drafted contract conforming to the company's policies. The reviewer must also be publically supported by the company so that he or she can make the necessary changes to the contract without concern over how he or she will be perceived by the contract-negotiating team. Finally, the reviewer should be compensated independently for his or her review services; not based upon whether the company gets the deal or the project. By alleviating these pressures, the reviewer can maintain an objective perspective in the contract-review process.

### Review Process

Once the reviewer has been designated, that individual should have a consistent approach to parsing the contract for specific clauses or areas of concern. The review process can generally be broken down into two main types of clauses: (1) those that are presumptively going to be rejected by the company (i.e., *red flags*), and (2) those that are presumptively required in every contract the company signs (i.e., *must haves*). With respect to these *red flags* and *must haves*, the company's policies on contract drafting can include stock language representing preapproved changes that the reviewer can comfortably make to the contract language. Using this stock language ensures that the problematic contract language is not only recognized by the reviewer, but is addressed in a manner which is consistent with the company policy. By relegating these types of revisions to an administrative level, the stock language also reduces the workload on the decision maker, who can then simply verify and accept the revisions. Of course, all revisions by the reviewer should be tracked in redline for approval by the decision makers.

However, the reviewer should not merely review a contract to identify the *red flags* and the *must have* language. The reviewer must also carefully review every contract for language which could present a risk for the company. It is by searching for the unexpected risks in a contract where the reviewers' knowledge of the industry and competency in reading contracts becomes most valuable. Whenever he or she is in doubt, the reviewer should flag any *unknown risks* for further review by the decision makers.

Finally, depending on the company's available time and resources for contract review, as well as on the importance or dollar amount of any given contract, a redundant or iterative review should be performed after the initial review has been made. Iterative review processes have been shown to increase accuracy and reduce errors in various applications across multiple industries.<sup>3</sup> Here, such an iterative review process could be accomplished either by (1) sending the contract to two or more reviewers, or (2) having the same reviewer perform a review of the same contract two or more times. In either instance, the iterative review is likely to result in stronger, less risky, and more-consistent construction contracts.

### Tools to Facilitate Contract Review

Several tools are available to assist construction professionals and companies to disseminate the task of contract review among the contract reviewers and decision makers at the company. One of the most basic tools which has proven to decrease errors is the systematic use of checklists.<sup>4</sup> Both the *red flags* and *must haves* can be reflected on a comprehensive checklist which the reviewer can use to spot clauses of known concern, and ensure that no key clause is left out. When the contract is sent from the reviewer to the decision maker, the checklist can be affixed to the contract, thereby demonstrating to the decision maker that the *red flags* and *must haves* clauses have been systematically addressed. Although a checklist is a useful tool for identifying potential contract hazards and eliminating them, the reviewer must be alert to novel features of any contract and not rely solely on the items in the checklist.

Instead of, or in addition to, the use of checklists, some companies use a contract coversheet. The coversheet contains a description of the project, the expected fee, the scope, the location, the duration, the client, highlighted contract terms, and anything else the company considers important. The coversheet is useful for providing basic information about the contract to a busy decision maker, especially when such information is buried within dozens of pages of the contract. The coversheet can also note the progression of the review from one individual to the next, when such review was conducted, who the decision maker is, and the decision maker's recommendations. Tracking who has reviewed the contract, how many times, and what changes have been made is very useful where iterative reviews are being performed.

Aside from checklists and coversheets, there are more sophisticated tools available for larger companies. For example, some companies use a *stoplight chart* (a sample of which is included in the Supplemental Data) to communicate the process for sending contracts through multiple levels of review. Using the stoplight chart, those contracts which fall within the green range do not require further review, those within the yellow range may require further review, and those within the red range absolutely require further review. What separates the green, yellow, and red ranges may depend upon several different factors unique to the company, but a sampling of these variations is as follows:

- The type of work (e.g., a purchase order is green, a construction-services agreement is yellow, and a design-build agreement is red);
- The dollar amount (e.g., contracts under \$10,000 are green, between \$10,000 and \$100,000 are yellow, and over \$100,000 are red);
- The form of the contract (e.g., contracts on the company's standard form are green, but those drafted using a different form are automatically red); and
- Particular contract terms (e.g., a *waiver of consequential damages* is green, but the absence of such a waiver is automatically red).

The advantage of a tool like a stoplight chart is that it is flexible and customizable. The example provided assumes that the highest level of review is from the legal department, but that need not always be the case. Companies without a legal department may specify an executive as the highest-level reviewer or may designate certain types of contracts that must be submitted to outside counsel for review. Following review by legal counsel, if any, the decision makers still have the ultimate responsibility of deciding whether to agree to the contract as revised, based upon calculations of risk and reward.

Although contract-review tools are valuable from an efficiency and administration standpoint, care should be taken not to

overcomplicate them to the point where employees have trouble following them. At the same time, contract-review tools should also not be oversimplified. For example, it is too simplistic to assume that contracts with relatively low dollar amounts do not require serious scrutiny from the decision makers; they may contain problematic clauses which, if left unaddressed, expose the company to significant risk. With that in mind, construction companies that implement contract-review tools should fairly expect that those tools will need routine tweaking in order to serve their intended purpose.

### Problematic (*Red Flag*) Clauses

Certain clauses are virtually always unacceptable due to the significant risk they create for at least one party. These clauses should be stricken or neutralized, and if neither option is acceptable, the company needs to be prepared to respectfully walk away.

Of course, what is considered a *red flag* clause will depend on each individual company, including its particular area of expertise; the experiences that the company has had over the years with various projects; and its level of risk aversion at the time the contract is being considered. Sometimes such clauses may be acceptable if other areas of the contract are modified to the point that the risk:reward ratio balances out. The best practice, however, is to regularly and consistently remove or neutralize the *red flag* clauses in every contract that company enters into. Some examples of *red flag* clauses, based upon the experiences of construction professional clients, follow.

#### *No-Damage-for-Delay*

A *no-damage-for-delay* clause typically allows a contractor to obtain an extension of time for an excusable delay on the project (i.e., a delay not caused by the contractor), but precludes the contractor from obtaining an increase in the contract price due to such delay.

Owners will occasionally insert a *no-damage-for-delay* clause as a means of controlling costs and avoiding liability in the event of a delay. Owners are legitimately concerned that an unknown or unforeseen condition on the site could cause a prolonged delay which, even though not caused by the contractor, could drastically increase the costs of construction. In this event, the contingency set aside for unanticipated events on the project can quickly evaporate. The owner may then be faced with a difficult decision: on the one hand, cut its losses by value-engineering, mothballing, or terminating the project; or on the other hand, ask for an infusion of additional funds from the parent company, lenders, or other investors. When a project is already facing prolonged delays and increased costs, the prospect of convincing the financiers to contribute even more money can be a daunting, if not impossible, task.

Although the motivation for inserting a *no-damage-for-delay* clause is understandable from the owner's perspective, owners may nevertheless underestimate the impact such a clause can have on a contractor. Taken to its logical limit, this clause could require a contractor to maintain its crews, equipment, labor, and other assets on a project for an indefinite period of time, without pay, due to a delay caused by another party (e.g., the owner or architect) or due to an event over which the contractor has no control (e.g., force majeure). The result could be financially ruinous for the contractor, which continues to incur costs for these crews, equipment, labor, and other assets but is unable to recover such costs from the owner. Worse still, the contractor may be unable to shift any assets away from the delayed project until it is finished, which means that the contractor cannot pursue any more profitable work during the delay.

Furthermore, although a *no-damage-for-delay* clause may initially seem to protect the owner's financial interests, there has been litigation over the enforceability of such clauses, including when the contractor asserts that the delay was (1) of a type not contemplated by the parties, (2) caused by the active interference of the owner or a party controlled by the owner, (3) unreasonable or unexpected in terms of the length of delay, or (4) resulted from the fraud or bad faith of one of the parties.<sup>3</sup> Thus an owner may actually be inviting litigation by inserting a strict *no-damage-for-delay* clause, especially where the contractor subsequently incurs significant costs resulting from a delay for which the contractor is not responsible.

In order to find contractual language upon which both parties can agree, and which is most likely to be enforceable in court, the following steps are recommended. First, the parties should lay bare the concerns which are motivating their respective positions, and appropriately support those positions with facts and figures. The owner should explain its concerns over financing, revenue, or schedule, and the contractor should explain its concerns over idle assets or opportunity costs. The parties should also identify the specific events which could cause delay on this particular project (e.g., weather, submittal review, availability of labor or materials, or government oversight) and determine the relative likelihood of those events affecting the project.

Second, once the specific concerns of the parties are exposed, the clause should be tailored in such a way that balances those concerns in a mutually agreeable way. For example, the *no-damages-for-delay* clause could provide as follows:

The contractor shall not be entitled to any damages for delay; provided, however, that if the [consecutive or cumulative] number of Non-Contractor-Caused-Delays exceeds [X] days, then contractor shall be entitled to compensation beginning on the [X + 1] day, and each [consecutive or cumulative] day thereafter, at a daily rate of [Y], provided further that the total amount for all Non-Contractor-Caused-Delays on the project cannot exceed [Z].

Each of these items is subject to further negotiation. For example:

- The definition of *Non-Contractor-Caused-Delays* can be modified to identify specific types of delays which are compensable (e.g., force majeure, weather, or actions caused by the owner's forces) and those which are not (e.g., labor strikes, material fabrication, or differing site conditions);
- The length of delay [X] can be consecutive or cumulative delays, and can be adjusted to consider relevant time concerns (e.g., contractor idle time, expected weather conditions, or the owner's obligations to begin repaying the loan);
- The daily rate [Y] can be adjusted to include certain costs (i.e., idle equipment or labor, and extended general conditions) while excluding others (home-office overhead, and lost profit on other projects); and
- The total amount of damages [Z] can be adjusted to limit the owner's total exposure for Non-Contractor-Caused-Delays, and could be based upon the contingency in the budget, or a consideration of the owner's overall financial strength.

Somewhere between the balancing of all of these factors there is almost always common ground where both parties feel adequately protected and therefore comfortable entering into a contract.

#### *Design Liability*

Under the *Spearin* doctrine, an owner which provides plans and specifications to a contractor impliedly warrants that such plans

and specifications are accurate and suitable for their intended use. As a result, a contractor will not be held liable for the consequences of defects in the plans and specifications, provided that the contractor has constructed the project in accordance with those plans and specifications.<sup>6</sup> This is the default allocation of liability for federal government projects and for projects in states which have adopted the *Spearin* doctrine. However, the default allocation can be altered by the agreement of the parties.

In particular, owners often insert language into a construction contract requiring the contractor to “study,” “analyze,” or “examine” the contract documents before beginning work and to notify the owner in writing of any defects, inconsistencies, or omissions in the plans and specifications. Alternatively, owners insert language pursuant to which contractors warrant that “all materials supplied and installed by the contractor will be fit for their intended purposes,” or that “all design documents comply with applicable building codes.” These clauses effectively shift liability for improper design from the owner (more specifically, the owner’s design professional) to the contractor. Owners are frequently motivated to insert these clauses for one of two reasons: either (1) they believe it serves as an extra form insurance to hold both the design professional and the contractor responsible for deficiencies in the design, or (2) they do not want the contractor to escape liability for constructing the project in a manner which the contractor knew, or should have known, was contrary to applicable law.

Although the latter of these two reasons is legitimate, the first is problematic for a number of reasons. First, most contractors (unless they are design-builders) do not have the training, experience, or licensure to perform what amounts to a peer review of the design documents. Just like practicing law or medicine without a license, the performance of professional design services without a license is illegal in most, if not all, jurisdictions. Second, the contractor’s proposal and fee is generally based upon the means, methods, sequences, techniques, and schedule necessary to construct the work shown in the design documents. The contractor’s bid generally does not include design services or peer reviewing the design documents, and the contractor is not being compensated for these services. Third, contractors do not generally carry professional liability insurance. Consequently, if the owner seeks damages from the contractor due to improper design, there likely will not be any insurance proceeds to cover the owner’s loss.

When it comes to drafting this clause in a contract, it is generally not unreasonable for owners to require the contractor to represent that it has reviewed and become familiar with the contract documents as well as the project site. Indeed, doing so is often necessary in order for the contractor to submit a bid based upon reasonable assumptions or for a contractor to issue a final guaranteed maximum price (FGMP). It is also generally reasonable for owners to require the contractor to notify the owner if the contractor discovers any defects, inconsistencies, or omissions in the design during the course of the contractor’s review. However, contractors have a sound basis for asserting that their review of the contract documents is expressly not for purposes of identifying defects, inconsistencies, or omissions in the design, nor for purposes of identifying conflicts between the contract documents and applicable building codes, both of which could amount to a peer review. Contractors should be aware, however, that their failure to build the project in accordance with applicable building codes, even at the behest of the owner, can still result in liability for the contractor.<sup>7</sup> Therefore if contractors come across a design which they know, or should know, to be contrary to applicable law, then it is best practice to raise this concern with the owner in writing, such as by submitting a Request for Information.

## Broad-Form Indemnity

Indemnity clauses are present in nearly every construction contract. The indemnity obligation may be mutual (each party owes a duty to indemnify the other party) or one-sided (only one party has a duty to indemnify the other party). One-sided clauses are not *per se* unreasonable; there are several circumstances in which the indemnification obligation only flows one way (e.g., the contractor’s obligation to indemnify the owner for liens filed by the contractor or its subcontractors). However, so-called *broad-form indemnity* clauses are generally unreasonable. Broad-form indemnity requires the first party (typically the contractor) to indemnify the second party (typically the owner) for *all* damages or losses, regardless of which party is at fault for such damages or losses.<sup>8</sup> Under this type of provision, the first party is obligated to indemnify the second party (usually by providing a defense to and paying for the liability incurred by the second party), even if the liability alleged is a result of the negligent actions or omissions of the second party. Given the inherent unfairness in such an arrangement, many states have adopted anti-indemnity statutes which nullify these types of clauses. Nevertheless, a surprising number of construction contracts continue to include broad-form indemnity provisions to this date, including in states that have banned the use of such clauses.<sup>9</sup>

A similar danger exists where the construction contract requires one party (typically the contractor) to name the other party (typically the owner) as an *additional insured* under the commercial general liability or other insurance policy. Once a party names another as an additional insured on its policy, unless limited contractually, the insurance company becomes obligated to defend the additional insured as it would defend the policy holder. Where there is no contractual limitation on damages resulting from the additional insured’s own negligence, this simply represents a broad-form indemnity clause in disguise. Although many states have invalidated broad-form indemnity clauses, such as the one referenced at Endnote 9, the additional-insured clause has not yet received the same degree of scrutiny by most states.<sup>10</sup>

The additional insured need only go to the insurance company and file a claim to seek coverage, just as if the insured was obligated to indemnify the additional insured.<sup>11</sup> If the contractor named the owner as an additional insured, then the contractor (1) would be paying the premium for both parties to be insured, (2) would have to pay the deductible for any claims made by the owner, and (3) would risk its insurance company either raising its premiums or canceling the policy following claims by the owner on the policy, affecting the contractor’s overall ability to secure and maintain insurance for future work.<sup>12</sup>

Obviously, this is a great deal for the owner who stands to benefit from all of the protections of insurance with none of the costs. Nevertheless, it is to the owner’s benefit to ensure that the contractor’s insurance policy does not contain any limitations or exclusions for co-insureds. Similarly, contractors should have appropriate conversations with their insurance brokers and carriers concerning the implications of such a provision. If, for example, the insurance policy contains a cross-liability exclusion (which bars coverage for claims between two or more insureds), then neither the owner nor contractor would be insured in a lawsuit against the other—information which would be useful at the time of contracting. Moreover, the contractor should determine whether it will incur increased costs because of the *additional insured* provision in terms of its premiums and deductibles. The contractor may determine that there is a price for the inclusion of such a provision which causes the contractor to increase its bid accordingly.

## Unilateral Assignment

A unilateral assignment clause allows one of the contracting parties to assign the contract to a third party at its sole direction. In essence, this clause allows a complete stranger to step into the shoes of the contracting party. Most sophisticated parties would not be comfortable having their accounts payable transferred to someone with whom they have no prior relationship and whose ability and willingness to pay under the contract is in doubt. Moreover, there is a history of assignments being used for nefarious purposes.<sup>13</sup> Although assignments are sometimes necessary for a variety of legal and practical reasons, best practice is to stipulate that any assignment requires the prior written approval of the other party.

It should be recognized that owners often must borrow money from lenders in order to finance their construction projects. Lenders will typically require that the construction contract contain a clause that allows that contract to be assigned from the owner to the lender. If such a clause is included in the construction contract, then one of two approaches is typically taken: (1) the contract stipulates that the assignor (i.e., the owner) remains liable for any of the liabilities or debts incurred by the assignor prior to assignment (First Approach), or (2) the contract stipulates that the assignee (i.e., the lender) expressly assumes any and all liabilities or debts incurred by the assignor prior to assignment (Second Approach).<sup>14</sup>

From the contractor's perspective, the First Approach may seem to provide the most assurance that the contractor will be paid because the owner, whom the contractor presumably vetted prior to undertaking the job, will remain financially responsible for the debts. However, if the owner is an assetless, single-purpose entity (SPE), then the First Approach could leave the contractor without a solvent entity from which to be paid. In that circumstance, the contractor may be forced to pursue other, more expensive avenues to recover payment (such as suing the lender or recording a mechanic's lien on the property).

At first blush, the Second Approach appears to give the contractor a financially solvent entity from which to receive payment (i.e., the lender). However, it should not be forgotten that the lender is a new contracting partner and therefore may dispute actions previously taken by the owner, such as the commitment to pay for outstanding change orders or change directives. Therefore, in deciding how best to protect itself in the contract for purposes of an owner-lender assignment provision, the contractor should conduct due diligence on the lender, including its construction lending experience, reputation, and litigiousness, and also ascertain the most likely source for recovering unpaid amounts in the event of assignment (i.e., the owner or the lender). Where acceptable, the best approach for the contractor is to insist on the right to approve any assignment in advance so that it can evaluate at that time how much risk the assignment entails.

From the owner's perspective, the First Approach can likewise be problematic for several reasons. For instance, the owner's cash flow may be limited to disbursements from the lender to finance the project. If there has been a default on the loan terms, then the owner may hold the contractual responsibility to pay the contractor but not the means by which to effect payment, because the lender will not disburse the funds. Although the Second Approach is more attractive for the owner, it can be difficult to convince the lender to accept an arrangement whereby it will be legally responsible to the contractor for the debts accumulated by the owner. To compensate for such risk, the lender may require increased involvement in the construction of the project, including on-site representatives, the right to review and approve pay applications, and heightened loan-disbursement requirements. Therefore, just like the contractor, the owner needs to conduct due diligence regarding the lender's

financial obligations and legal rights in the event of assignment as a part of determining how best to draft the owner-lender assignment provision.

## Must-Have Clauses

*Must-have* clauses are typically a matter of subjective preference derived from a combination of best practices and prior experiences. Because of this, not every company will always perceive the same clauses as truly *must-haves*. Obviously, this section does not provide an all-inclusive list of *must-have* clauses; basic standard terms, such as scope, price, and schedule, should always be included in every contract. For purposes of this paper, however, the focus is placed on clauses that tend to receive less attention but should nevertheless be presumptively included in every contract as a matter of company policy.

## Differing Site Conditions

For both contractors and owners, surprises may lurk below the undisturbed project site. Often these surprises are hindrances to the performance of the work; only very rarely is the surprise a happy one.<sup>15</sup> Sometimes the nature of the condition unearthed is truly remarkable, but devastating to the progress of work. For instances, across the western United States, woolly mammoth remains have a habit of appearing on construction sites, requiring shutdowns of operations and extensive archaeological recovery efforts.<sup>16</sup> As another example, contractors not familiar with the history of Chicago may fail to realize that certain highly desirable, downtown properties are actually contaminated by radioactive soil.<sup>17</sup>

No matter what the unexpected subsurface conditions may be, contractors and owners should protect themselves by including a *differing site conditions* clause. The differing site conditions clause allocates the risk between the owner and the contractor if the actual conditions on site (1) materially differ from those indicated in the contract documents, or (2) materially differ from those that one would normally expect to encounter in the area of the project. Contractors who agree to perform work without an appropriate differing site conditions clause may find themselves unable to seek relief from the owner for delays or increased costs due to such conditions. Owners who did not insist upon a differing site conditions clause are putting themselves at risk because there will not be a process for recognizing such conditions, timely notifying the owner, reviewing the conditions, determining how to resolve the problem, and processing a claim by a contractor. In other words, without a differing site conditions clause there is likely to be a long and protracted dispute in the event that unforeseen conditions significantly increase the cost or time for performing the work.

## Waiver of Consequential Damages

Consequential damages can be defined as those damages which are not a direct result of the action which caused harm (e.g., breach of contract or tort) but instead are a consequence of that action. Typical examples of consequential damages include lost profits, lost rents, loss of use, interest and finance charges, additional labor costs, damage to reputation, down or idle time, material escalation costs, loss of productivity and efficiency, and additional home office costs. Consequential damages are generally only recoverable in tort actions, and are generally not recoverable in contract disputes, unless such damages were reasonably foreseeable at the time the contract was made.

The ability to seek consequential damages from a party can turn a relatively small-dollar dispute into a potential *company killer*.

In a now-infamous construction case in New Jersey, a construction manager entered into a \$600,000 contract for renovations at the Sands casino in Atlantic City. The contract did not include a waiver of consequential damages provision. The project was completed several months later than anticipated. The casino sued the construction manager for approximately \$14 million in damages for lost profits. An arbitration panel awarded damages of \$14 million against the construction manager, more than 24 times the amount of the manager's contract, and the award was upheld in court.<sup>18</sup>

As a result of this and other cases, it is now common practice for contracting parties to insist on a mutual waiver of the right to seek consequential damages against each other. Contractors should be highly cautious of contracts which do not require the owner to waive consequential damages. Although owners sometimes refuse to waive consequential damages in order to preserve their ability to recover lost profits, this approach is likely to discourage high-quality construction companies from bidding on the work because it represents an immeasurable risk at the time of contracting. Owners concerned with protecting their lost profits would be better advised to use liquidated damages as a means of estimating the damages to be incurred in the event of a delay. Liquidated damages are far more agreeable to contractors because the risk of failing to complete on time is quantifiable. The liquidated damages clause is more likely to be enforced in court if it is based upon the owner's best efforts to quantify actual impacts anticipated by the delay, a process which the owner should carefully and purposefully document.

As a drafting tip, the construction contract should not only contain a blanket waiver of consequential damages but should also include a nonexhaustive listing of the particular consequential damages being waived, which can be changed depending the nature of the project being constructed (e.g., lost profits should be listed for a hotel project, whereas lost sales should be listed for a condominium project).

### Flow-Down

Both the contractor and owner have an interest in ensuring the performance of the subcontractors. A *flow-down* clause<sup>19</sup> incorporates certain obligations under the prime contract into the subcontracts. An owner will typically require such a clause in the prime contract and the contractor is then obligated to place language to the same effect in all subcontracts that it executes for the project. Even if the prime contract does not require the contractor to flow down its responsibilities in its subcontracts, the contractor may include a flow-down clause in the subcontracts by incorporating the prime contract by reference in such subcontracts. The contractor should also provide in its subcontracts that, to the extent of any conflict between the subcontractor's obligations under the subcontract or the prime contract, the subcontract governs. In this way, the contractor gets the best of both worlds: the obligations in the prime contract shift to the subcontractors, and, in the event of any discrepancy, the strict clauses in the subcontracts are upheld.

Flow-down clauses also have the effect of helping to streamline dispute proceedings. All disputes between the owner, the contractor, and the subcontractors should be subject to the same dispute-resolution proceedings (e.g., arbitration or litigation), in the same forum, and applying the same substantive law. This allows all potentially liable parties to have their claims adjudicated at one time, in one place, and according to the same standards. Where the owner and contractor's claims are subject to a different dispute resolution than the contractor and subcontractors' claims, or a different substantive law is applied by different forums, the result is likely to be expensive and complicated.

As a drafting tip, flow-down clauses should be specific about what they do or do not include, and which contract terms govern in the case of inconsistencies.<sup>20</sup> Additionally, contractors should be careful to avoid flowing down provisions that should not apply to the subcontractors. For example, if a broad flow-down clause is used in a subcontract, then a subcontractor may argue that payments should be received by the subcontractor under the payment schedule of the prime contract rather than under the subcontract, which contains a pay-if-paid provision. To avoid this problem, the payment provisions of the prime contract should be expressly excluded from the flow-down clause in the subcontract.

### Mediation

Mediation is a nonbinding dispute resolution procedure in which a trained conflict-resolution professional (the mediator) facilitates the resolution of a dispute between feuding parties. The mediator may be appointed by a court or may be selected by a dispute-resolution services provider, such as the American Arbitration Association (AAA). Most frequently, however, the parties mutually agree upon the mediator after a dispute has arisen, based upon the mediator's background, qualifications, and experience as it relates to the parties' dispute.

There are many mediators nationwide who claim to specialize in facilitating the resolution of construction disputes. However, not all of the professed construction mediators possess the skill and acumen necessary to resolve construction disputes. Before agreeing upon the mediator, the parties should carefully vet the proposed mediator's reputation for resolving construction disputes and should keep in mind that the most reputable mediators tend to be booked several months in advance.

When the parties to a construction contract select the appropriate mediator for their dispute, and approach mediation with a good-faith desire to resolve the dispute, mediation has a high success rate.<sup>21</sup> In most instances, mediation represents the optimal economic opportunity to settle the dispute before the parties incur significant attorneys' fees, expert witness fees, and other costs related to the proceedings.<sup>22</sup> Additionally, a successfully mediated dispute may preserve the relationship between the parties.<sup>23</sup> As a result, mediation has established itself as the primary method of resolving formal disputes in the construction industry. However, the only way to ensure that any dispute between the contracting parties will be referred to mediation is to include a provision in the contract making mediation a *condition-precedent* to other forms of dispute resolution (i.e., litigation or arbitration).

As a contract drafting tip, the mediation provision should include the identity of the mediator or the procedure by which the mediator will be selected, the location of the mediation, the timeframe in which the mediation is to be conducted, the rules applicable to the mediation (e.g., the AAA's Construction Industry Arbitration Rules and Mediation Procedures), and the parties' intentions with respect to paying for the mediator and the mediation provider fees.

### Conclusion

Reviewing and revising construction contracts is hard and difficult work—but so is erecting buildings, building bridges, and paving roads. There is no reason why construction professionals, and the companies they employ, cannot apply their well-deserved reputation for efficiency, hard work, and problem solving to implementing an effective contract-review process. Such a review process will ultimately make the company stronger, more decisive, and less susceptible to unknown risks. If the only risks that the company

assumes are known, calculated risks, then it is more likely to be successful and profitable over the long term.

## Acknowledgments

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## Supplemental Data

A sample contracting stoplight tool is available online in the ASCE Library ([www.ascelibrary.org](http://www.ascelibrary.org)).

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De Silva Moore v. Publicis Groupe, 287 F.R.D. 182, 200 (S.D.N.Y. 2012).  
United States v. Spearin, 248 U.S. 132, 136 (1918).  
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Shell Oil Co. v. Nat'l Fire Ins. Co. of Pittsburgh, Penn., 52 Cal. Rptr. 2d 580 (Cal. Ct. App. 1996).  
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### List of Statutes

- CFR 52.236-2(a)-(b) (2016).  
American Institute of Architects, A201-2007 § 13.2.2.  
ConsensusDOCS 200, ¶ 5.3.

## Endnotes

<sup>1</sup>Abigail A. Patthoff, "This Is Your Brain on Law School: The Impact of Fear-Based Narratives on Law," 2015 *Utah L. Rev.* 391, 397; Peter Bowal & Johnathon Layton, "Comma Law," *LawNow Magazine* (Mar. 6, 2014), available: <http://www.lawnow.org/comma-law/#1>. The clause in question read as follows:

This Agreement shall be effective from the date it is made and shall continue in force for a period of five (5) years from the date it is made, and thereafter for successive five (5) year terms, unless and until terminated by one year prior notice in writing by either party.

Whereas the utility company argued that the clause provided the right to terminate the five-year-term at any time (with one year's notice), the communication company argued that the clause only allowed the contract to be cancelled at the end of the five-year term (as long as one-year's notice was provided before the end of such term). The commission deciding the dispute determined that the placement of the comma before the word "unless" signified that termination could be invoked at any time, provided that one year's prior written notice was given. Although the reviewing court ultimately determined that a French language counterpart controlled, the damage was already done, and the communication company was subject to the increased rates.

<sup>2</sup>The person selected could be an office manager, a project manager, an administrative assistant, or a secretary, as long as he or she meets the criteria discussed herein.

<sup>3</sup>See Major Edward L. Westfall, Book Review, "How Will You Measure Your Life?" 2015 *Army Law*. 40 42 (considering an iterative review process for proficient marksmanship); *In re Black Farmers Discrimination Litig.*, 856 F.Supp.2d 1, 35 (D.D.C. 2011) (for arbiters assessing merits of class action member claims, an "iterative review process will reduce errors in claim determinations and subject each claim to thorough examination."); *De Silva Moore v. Publicis Groupe*, 287 F.R.D. 182, 200 (S.D.N.Y. 2012) (explaining how predictive coding programs used to assist in litigation discovery efforts rely on iterative review of results to ensure accuracy and reliability).

<sup>4</sup>See e.g., "Prevention of Surgical Malpractice Claims by Use of a Surgical Safety Checklist," *Ann Surg.*, (de Vries EN, Mar. 2011) (the implementation of a surgical safety checklist would have intercepted 1/3 of all contributing factors in surgical malpractice claims, including 40% of deaths and 29% of incidents leading to permanent damage); see also Defense Federal Acquisition Regulation Supplement: Proposal Adequacy Checklist (DFARS Case 2011-D042), Federal Register, March 28, 2013 (amending the Defense Federal Acquisition Regulation Supplement to incorporate a checklist for proposals in response to solicitations that require submission of certified cost or pricing data); see also *The Checklist Manifesto: How to Get Things Right*, by Atul Gawande (2009) (following the *checklist revolution* into fields well beyond medicine, from homeland security to investment banking, skyscraper construction, and businesses of all kinds).

<sup>5</sup>For a discussion of these factors, see "No-Damage-for-Delay Contract Clauses," Kraftson Caudle, Daniel J. Kraftson, Esquire, available: <http://www.kraftsoncaudle.com/cutsheets/nodamagefordelaycontractclauses.pdf>.

<sup>6</sup>*United States v. Spearin*, 248 U.S. 132, 136 (1918); *BRW, Inc. v. Dufficy & Sons, Inc.*, 99 P.3d 66, 73 (Colo. 2004) (citing *Spearin* for the propositions that (1) a developer impliedly warrants the adequacy of the plans and specifications it provides to a contractor, and (2) a contractor can sue a developer for economic losses that result from defects in the plans and specifications).

<sup>7</sup>Although the contractor is not required to review the design for errors, the contractor's failure to build the project in accordance with applicable building codes can still result in liability for the contractor. Indeed, the Massachusetts Court of Appeals recently held that a contractor was liable for knowingly building the roof of a home in violation of the applicable building code, even though the owner purportedly instructed the contractor to build the home in that manner. See *Downey, et al. v. Chutehall Construction Co., Ltd.*, 88 Mass. App. Ct. (2016).

<sup>8</sup>An example of a broad-form indemnity clause is as follows: "Contractor shall indemnify and hold harmless Owner from and against all claims, damages, losses and expenses, regardless of whether they were caused in whole or in part by the negligent acts or omissions of Owner, another contractor of Owner's, anyone directly or indirectly employed by them or anyone for whose acts they may be liable."

<sup>9</sup>Trisha Strobe, "Comment: From the Bottom of the Food Chain Looking Up: Subcontractors Are Finding That Additional Insured Endorsements Are Giving Them Much More Than They Bargained For," 23 *St. Louis U. Pub. L. Rev.* 697, 706-07 (2004); Samir B. Mehta, "Commentary: Additional Insured Status in Construction Contracts and Moral Hazard," 3 *Conn. Ins. L. J.* 169, 181 (1996).

<sup>10</sup>E.g., *Chevron U.S.A. v. Bragg Crane & Rigging Co.*, 180 Cal. App. 3d 639 (1986) (holding that state law outlawing broad-form indemnity did not preclude an additional insured from receiving coverage under the insurance policy for its sole negligence); *Shell Oil Co. v. Nat'l Fire Ins. Co. of Pittsburgh, Penn.*, 52 Cal. Rptr. 2d 580 (Cal. Ct. App. 1996) (holding the same).

<sup>11</sup>Strobe, *supra* note 11, at 707.

<sup>12</sup>See *id.*

<sup>13</sup>E.g., *Matter of Brion*, 964 N.Y.S.2d 57 (N.Y. Sup. Ct. 2012) (granting injunctive relief to prevent the son of a recently deceased construction company owner from assigning all of the company's contracts to the



son's separate construction company, which would have deprived the son's siblings any share in the profit from those contracts).

<sup>14</sup>For example, AIA Form 201 provides in part that the "Owner may, without consent of the Contractor, assign the Contract to a lender providing construction financing for the Project, if the lender assumes the Owner's rights and obligations under the Contract Documents." AIA A201-2007 § 13.2.2. The contractor should seek to further clarify this clause by adding language ensuring that preassignment and postassignment owner liabilities and obligations are assumed by the assignee.

<sup>15</sup>In New Orleans, a backhoe unearthed two boxes of silver and gold coins (approximately one thousand coins total) from the Civil War era. Associated Press, "Workers Unearth Old Coins," *The New York Times* (Oct. 31, 1982), <http://www.nytimes.com/1982/10/31/us/workers-unearth-old-coins.html>.

<sup>16</sup>See "Significant Fossil Find Unearthed in Colorado by Gould Construction," University of Colorado Boulder (2011), <http://www.colorado.edu/engineering/profile/significant-fossil-find-unearthed-colorado-gould-construction>; Phil Diehl, "Construction Reveals Trove of Fossils in Carlsbad," *The San Diego Union-Tribune* (Sep. 3, 2015), <http://www.sandiegouniontribune.com/news/science/sdut-treasure-trove-of-fossils-found-at-carlsbad-2015sep03-story.html>; Liz Fields, "Construction Workers Unearth Ice Age Mammoth Tusk in Seattle," *ABC News* (Feb. 12, 2014), <http://abcnews.go.com/blogs/headlines/2014/02/construction-workers-unearth-ice-age-mammoth-tuskin-seattle/>.

<sup>17</sup>See "Gaslight Era Left Radioactive Legacy in Chicago," *Chicago Tribune*, Michael Hawthorne (Apr. 17, 2014), [http://articles.chicagotribune.com/2014-04-17/news/ct-thorium-radioactive-cleanup-20140417\\_1\\_chicago-river-west-chicago-radioactive-waste](http://articles.chicagotribune.com/2014-04-17/news/ct-thorium-radioactive-cleanup-20140417_1_chicago-river-west-chicago-radioactive-waste).

<sup>18</sup>E.g., *Perini Corp. v. Grete Bay Hotel & Casino, Inc.*, 610 A.2d 364 (N.J. 1992) (upholding an award of \$14,000,000 in lost profit damages to a casino against the construction manager whose contract was for \$600,000).

<sup>19</sup>Sometimes referred to as a *conduit*, *flow-through*, or *incorporation by reference* clause.

<sup>20</sup>E.g., *McAnulla Elec. Constr., Inc. v. Radius Techs., LLC*, No. N10C-03-076 PLA, Del. Super. LEXIS 407 (Sep. 24, 2010) (determining that

summary judgment was not proper because the poorly drafted flow-down clause created ambiguity about what *flowed down* or not).

<sup>21</sup>Richard Fullerton, "Searching for Balance in Conflict Management: The Contractor's Perspective," 60 *Constr.* 48 (2005) (stating that at least one large construction company reports a 100% success rate for mediations, with the national average being as high as 85%); John P. Madden, "Recipe for Success in Construction Mediation," 56 *Disp. Resol. J.* 16, 16 (2001) (reporting average success rate of 85%); Penny Brooker & Anthony Lavers, "Mediation Outcomes: Lawyers' Experience with Commercial and Construction Mediation in the United Kingdom," 5 *Pepp. Disp. Resol. L.J.* 161, 188 (2005) (indicating that, in the United Kingdom, approximately 70% of construction mediations result in full settlement); Douglas A. Henderson, "Mediation Success: An Empirical Analysis," 11 *Ohio St. J. on Disp. Res.* 105 (1996) (suggesting that construction industry mediations are likely more effective than mediation in other realms because builders require prompt resolution to disputes that arise during project construction).

<sup>22</sup>Although there is much debate about whether the empirical data exists to support the notion that mediation always saves companies money, it seems clear that successful mediation does. Don Peters, "It Takes Two to Tango, and to Mediate: Legal Cultural and Other Factors Influencing United States and Latin American Lawyers' Resistance to Mediating Commercial Disputes," 9 *Rich. J. Global L. & Bus.* 381, 390-91 (2010) (recognizing that the majority of business men and women in the United States report cost savings with mediation over arbitration or litigation) (citations omitted). Discontent with the cost-saving claim of mediation arises when mediations were either unsuccessful, poorly executed, or both, resulting in litigation, which statistically will occur more often as use of mediation becomes more widespread. Kenneth F. Dunham, "Is Mediation the New Equity?" 31 *Am. J. Trial Advoc.* 87, 89-90 (2007) (noting that in the 1970s mediation was a rarity, but that its benefits have led to its ever-increasing use).

<sup>23</sup>Lisa Brennan, "What Lawyers Like: Mediation," *Nat'l L. J.*, Nov. 9 1999, at 4 (indicating that at least 50% of outside counsel and in-house counsel find that mediation better preserves relationships).