

Workshop W2

Wednesday, October 11, 9 a.m.–noon

CONSTRUCTION CONTRACT NEGOTIATION

Panelists



David B. Dolnick
Risk Manager
The Brady Companies



W. Scott Trethewey
Senior Vice President,
Risk Management
Moss & Associates, LLC



Thomas Weise
Director, Construction
Materials and Services
Intel Corporation

Moderated by



J. William Ernstrom
General Counsel
Alberici Group, Inc.

The terms of the construction contract dictate the allocation of risks between the contracting parties. This session examines key risk allocation and insurance provisions, including indemnity provisions, insurance requirements, and waivers of damages, with emphasis on the negotiation process. Hear construction company, project owner, and subcontractor representatives discuss their positions with respect to these contract provisions, their arguments supporting their preferred position, where they are willing to bend, what they expect in return, and what constitutes a deal breaker.

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**David B. Dolnick
Risk Manager
The Brady Companies**

Mr. Dolnick, one of the panelists for Wednesday morning's Workshop W2, "Construction Contract Negotiation," is risk manager for The Brady Companies, a multifaceted construction firm headquartered in La Mesa, California. He has been involved in the risk management field for more than 18 years, prior to which he served in underwriting, loss control, and marketing capacities with several insurers. Mr. Dolnick is a deputy member of the Risk and Insurance Management Society. He was honored as that organization's "Heart of RIMS" in 1998 and as the San Diego Chapter's "Risk Manager of the Year" for 1997. He served as president of the San Diego Chapter for 2001 and again for 2002, and he also served as a mentor to various RIMS Chapters across the country. He is a member of the Society's Nominating Committee and he serves on the Member & Chapter Services committee and on the Steering Committee for the RIMS Western Regional Conference. He was chair of the 2004 RIMS Western Regional Conference in Newport Beach.

Mr. Dolnick is also a member of the Risk Management Committee of the Associated General Contractors of America and was active with its Mold Litigation Taskforce, helping the AGC to write a widely recognized and nationally honored document on mold in construction. He currently chairs the AGC's Gap Task Force, which is helping to develop risk management solutions for small and mid-sized contractors and the insurance brokers and agents who serve them.

Mr. Dolnick is a professional member of the American Society of Safety Engineers, and served as president of the San Diego Chapter of ASSE in 1985-86. He also served on the Board of Directors of the Pacific Safety Council from 1984 through 1987. He has been a frequent speaker at national, regional, and local seminars, including the IRMI Construction Risk Conference in 2003 and the 2002 and 2003 RIMS Annual Conference and Exhibition. He has also served as the moderator and coordinator for the Construction Industry Session at the RIMS Annual Conference and Exhibition since 2003.

**J. William Ernstrom
General Counsel
Alberici Group, Inc.**

Mr. Ernstrom is moderator for Wednesday morning's Workshop W2, "Construction Contract Negotiation." He is General Counsel of Alberici Group, Inc. He is a founding partner of the law firm of Ernstrom & Drete, LLP. For over 25 years, he has focused his practice on the construction industry. Mr. Ernstrom is also Counsel to the Contract Documents Program for the Associated General Contractors of America.

In 1998, Mr. Ernstrom was selected by the AGC as "Chairman of the Year" for his work in representing contractors' interests in contract documents. He has been awarded the AGC President's Coin for exemplifying skill, responsibility, and integrity as well as unlimited motivation on behalf of the Association. At IRMI's 2003 Construction Risk Conference in Chicago, Mr. Ernstrom was presented with the Words of Wisdom (WOW) award.

Mr. Ernstrom coedited the *AGC Contractor Documents Handbook*, Aspen Publishers, Inc., 2003, and contributed a chapter to that book on AGC Document No. 200. He has authored numerous articles on surety and construction law topics. In particular, he has written about construction management and the American Institute of Architects A201 General Conditions for the *Wiley Construction Law Update*, as

well as on the topic of design-build for the *Aspen Construction Law Update*. He frequently lectures throughout the country for the Associated General Contractors, the National Association of Surety Bond Producers, the American Arbitration Association, the Design Build Institute of America and the Construction Financial Management Association. Mr. Ernstrom is a member of the ABA Fidelity & Surety Committee, the Surety Claims Institute, and the National Bond Claims Association. He has spoken at the Fidelity & Surety Law Committee Mid-Winter Meeting and the ABA's Forum on the Construction Industry.

W. Scott Trethewey
Senior Vice President, Risk Management
Moss & Associates, LLC

Mr. Trethewey is a panelist for Workshop W2, "Construction Contract Negotiation," on Wednesday morning. As Senior Vice President of Risk Management at Moss & Associates, he has overall responsibility for Moss' risk management, surety, and insurance programs. He draws upon the relationships and knowledge gained during his 18 years of experience in the construction and risk management communities.

Prior to joining Moss, Mr. Trethewey spent 5 years with Centex Construction Group where he had overall responsibility for the company's initiatives in risk management and insurance. Before joining Centex, he spent 11 years with Willis where he held the title of senior vice president and ran the Risk Management Practice Group in the Washington, D.C., region. Mr. Trethewey began his career in public accounting with the firm of Johnson, Lambert & Company.

Mr. Trethewey earned a B.B.A. in Accounting from the College of William and Mary. He is a member of the AGC Surety Bonding Committee, AGC Risk Management Committee, and the Design Build Institute of America's Risk Management, Insurance, and Safety Committee.

Thomas Weise
Director
Intel Corporation

Mr. Weise is a panelist for Workshop W2, "Construction Contract Negotiation," on Wednesday morning. Located at Intel Arizona's Ocotillo site, he joined Intel in 1984. He is currently responsible for the acquisition and supplier management of Intel's global construction business. Intel currently has 47 million square feet in 45 countries worldwide.

Mr. Weise's previous responsibilities at Intel include: Supplier Quality Engineering Manager, Systems Commodities Materials Manager, and Manager of Corporate Capital, Assembly/Test Equipment Group.

Mr. Weise has received numerous Intel Recognitions such as "Contribution to Materials Training and Career Development," "Development of Intel's Supplier Continuous Quality Improvement Process," "Development of the Intel Advanced Total Cost Method," and development of "One Construction Management Process@Intel." Mr. Weise is a member of the Association of General Contractors and Private Industry Advisory Council, and he is President of the Construction Users Round Table, Advisor to The Alliance for Construction Excellence, Del Web School of Construction, and sits on the Board of Trustees for the National Center for Construction Education and Research.

CONSTRUCTION CONTRACT NEGOTIATION

The terms of the construction contract dictate the allocation of risks between the contracting parties. Even when standard form construction contracts are used, modifications are virtually always made to various contract provisions. This session examines key risk allocation and insurance provisions, including indemnity provisions, insurance requirements, and waivers of damages, with an emphasis on the negotiation process.

In this session, a distinguished panel representing a cross-section of the construction insurance industry will discuss a variety of current issues, some of which are controversial, with the goal of increasing awareness, opening dialogues, and improving cooperation among project participants, such as the owner, contractor, and subcontractor.

In Their Words ...

In preparation for this discussion, we asked each of our panelists to summarize, from their unique perspective, the key areas they look for, or are concerned about, when negotiating construction contracts.

Construction Contracts: An Owners Perspective of Risk

Thomas Weise
Director, Construction Materials and Services
Intel Corporation

Let's peel all the mumbo jumbo off and really look at what drives a contractual arrangement between two parties in the construction business world. First there are Terms and Conditions that have to be applied according to law in each state or place of business; you can't get out of these and the fact of the matter is you don't want to. Then there are the other conditions of business, those terms that are job specific, location specific, etc. etc.

It is a falsehood to claim that a contract is a license to marry two parties or, more commonly stated, to build a partnership; it is in reality pre-divorce papers that you are signing. The owner will allocate risk in the specific contractual terms that they deem necessary to protect them from a divorce; those terms are insurance that is passed down the food chain that starts from the end customer to the beginning of the owners supply chain—it cannot be broken! The best way to avoid exercising the terms of your pre-divorce package is to: (1.) Make sure you understand why the owner is at risk and what impact you or your service may have on that risk. (2.) Develop a mutual understanding on performance that is separate from the specific legal terms and conditions while keeping the legal terms in place. (3.) If your relationship with an owner is contractually based, it is not a relationship. Understand the risks associated with your relationship however it is defined between the two parties.

With that said, what you need to do differently is to build a noncontractual relationship that builds on mutual performance expectations that both parties agree with. If an event during a

construction project results in a legal representative of either party to pull out the contract and waive it in the face to the other party you can bet you will never get to a performance-based relationship.

There are several groups in the industry trying to work toward standard contractual templates that will reduce the amount of pre-positioning in allocation of risk so common in the first stages of any construction project. More importantly, standard contract templates move the industry toward what was stated earlier—manage the exceptions via project specifics versus the entire contract. While the standard contract templates are an excellent start for the industry the real focus should be on job performance. The objective is to avoid contractual arguments.

At Intel Corporation we have used the model of separating the contractual terms and conditions from the performance expectations, which we call the Division 1 supplement. In order for a contractor to play in our business we establish the contractual terms and conditions that remain evergreen at the onset of our business relationship. We then release each contract by job and location via the Division 1 supplement, which in essence is the specific job expectations. This allows us as owner to communicate specifics versus the terms and conditions generalities and saves both parties numerous headaches. Shame on us if we ever have to pull the terms and conditions out and begin litigation—we did not do our job—and shame on the contractor entity for waiving the terms and conditions in our face—they haven't done their job. The expectation is we manage the job-specific requirements and not the contractual terms and conditions unless forced to.

Construction Contract Negotiation: A Contractor's Perspective

**W. Scott Trethewey
Senior Vice President, Risk Management
Moss & Associates, LLC**

According to Merriam-Webster's Online Dictionary, the term *contract* is defined as follows:

"con-tract ('kän-"trakt) : noun 1 a : a binding agreement between two or more persons or parties; especially : one legally enforceable b : a business arrangement for the supply of goods or services at a fixed price <make parts on contract> c : the act of marriage or an agreement to marry 2 : a document describing the terms of a contract 3 : the final bid to win a specified number of tricks in bridge 4 : an order or arrangement for a hired assassin to kill someone"

If asked to define the term *contract*, most of us in the construction industry would probably recite some variation of the first two parts of the first definition. However, it is interesting to note that Merriam-Webster also uses the terms "marriage" and "kill" in its definition. Allocation of risk is one of the principal drivers that determine whether a relationship between owner and contractor or contractor and subcontractor results in a beneficial partnership or possible death.

The conventional view of risk allocation focuses primarily on the contract. In the purest sense, the contract attempts to allocate risk to the parties who are in the best position to control the risk and who are compensated accordingly to assume the risk. As evidence of this view, construction industry contract standards have been developed by a number of reputable organizations. The contract standards oftentimes serve as the standard baseline upon which most negotiations commence.

Key areas of risk in the contract between the owner and the general contractor include: Indemnity, Insurance, Limitation of Liability for Performance, Schedule/Delay, Differing Site Conditions, Hazardous Material, Owner Changes, Design Responsibility, Warranty, Force Majeure, Payment, Substantial Completion, Contingency, Default/Termination for Cause/Dispute Resolution, and Owner Financing. Conversely, the key areas of risk in the contract between General Contractor and Subcontractor include: Indemnity, Insurance, Price, Scope, Schedule, Changes to the Work, Performance, Payment, Warranties and Guarantees, and Default/Termination/Dispute Resolution.

Traditionally, the challenge for the General Contractor is to understand risks inherent in both the owner contract and subcontract and how those risks can be properly aligned. Often overlooked, but equally important to the contractual risk allocation process, is the general contractor's ability to understand risk allocation in the context of its own operational drivers and external influences that impact its business. Some of these factors include:

- Resource constraints
- Procurement strategies
- Market choices
- Stage of the construction market cycle
- Key historical risk factors impacting project outcomes
- Quality or lack of relationship with owners and subcontractors
- Availability of meaningful financial protection for low frequency, high severity issues

Each of these factors creates tension on the contracting process and ultimately impacts risk allocation. The general contractor's ability to look inward first and thoroughly understand these drivers enable it to navigate the contract negotiation process. This process of self-understanding ultimately allows the general contractor to make disciplined decisions about risk that hopefully produce beneficial partnerships and positive relationships throughout the construction process.

Negotiating Construction Contracts: A Subcontractor's Risk Management Perspective

**David B. Dolnick
Risk Manager
The Brady Companies**

In its purest, abstract form, a contract is a document that sets forth the identities, obligations, duties, and rights of the parties entering into the agreement. The allocation of the risks between those parties is an inherent part of this process. As the contracts used in construction industry have become increasingly complex, however, many provisions previously viewed as innocuous recitals or as mere formalities now often serve the less obvious purpose of modifying or further defining the allocation of risks between the parties.

I have heard on innumerable occasions that those closest to the work (i.e., the subcontractors or sub-subcontractors) should bear the risk of that work. The phrase has become almost axiomatic, and is, I suspect, often repeated without thought or analysis. Much of the verbiage in the contracts I see is intended to bring this concept to fruition. The idea has become so pervasive and so all-encompassing that few today challenge its veracity. It is, however, far too simplistic a view. I would propose that challenging this oft-proclaimed reality, however, is something that we all must embrace.

First, a truth: despite the view held by many subcontractors, the majority of general contractors do not have the ability to impose their own custom-selected and written contractual terms on their clients, especially not where those clients are the sophisticated owners of larger projects. Most often, however, at the initial bargaining stage of a project there appears to be some effort to balance the risks and the rewards in the prime agreement. Risk, it would appear, rolls down hill, and, like it or not, most subcontractors draft even less of the contractual terms by which they are bound than do their upper-tier clients. Far too frequently, I encounter or hear of a "take it or leave it" approach being adopted by general contractors toward their lower-tier "partners." This approach, despite its obvious appeal to at least one party in the equation, does not properly allocate risk in proportion to fault, but rather forces allocation of risk away from a partially responsible party toward one with lesser negotiating strength. In so doing, it creates inequity, increases the frictional costs of claims, forces litigation where none need exist, and supports a cottage industry of experts, attorneys, and consultants that help their clients prepare for either the prosecution or the defense of construction claims of varying scope and nature. I know of no other industry that routinely feeds on itself in such a manner. The response I typically hear when raising this viewpoint? Simply that we should either not bid the project, price the risks into our bid, or cover those risks with insurance. Often, no real attempt to level the playing field is considered.

Thus, from the subcontractor's perspective, the balance of risk to reward is most often performed by others, others whose agendas and purposes are avowedly divergent from those of the subcontractor community. In a few notable cases, the "risk equation" has become a profit center to the general contractor, and the terms of that transfer and financing of risk are neither negotiable nor open to discussion or question. In a pure world, of course, all subcontractors bidding such a project would recognize that increased risk and would price their work accordingly. In reality, however, the market plays an enormous role in determining the

maximum price that a responsible subcontractor can charge, so the variable in the equation becomes not the price of the bid, but rather the margin a subcontractor makes. One can be the “smart” subcontractor (avoiding excessive risk at too little reward) for only so long if one hopes to remain in business, and from time to time unacceptable contractual risks must be undertaken.

To illustrate my point, please consider that the terms of a contract I hold most likely to lead to a dispute over the disproportionate allocation of risk is not the indemnity provision, but rather the description of the work to be undertaken. The provisions of most indemnity and hold harmless agreements have frequently been disputed, and often litigated. Bushels of scholarly articles and books have discussed the terms and conditions found therein. The language of such clauses and provisions has, most often, assumed a boilerplate if not a routine status. These risks are fairly clear, generally acknowledged, and usually well known to both parties. While court cases still abound on the meaning of this or that phrase in the indemnity provisions, the map is relatively clear absent legislative changes or new caselaw. The same can be said of similar clauses, such as the “pay if paid/pay when paid” provisions, the governing law provisions, and similar terms. There are, however, some portions of the contract that can have a major impact on the risk allocation, and their status is far less clear. Primary among these is the description of the work itself. There are two reasons for this. First, the sheer complexity of that provision is often belied by the scant few lines allocated thereto in the contract per se. Much of the description of work provisions is detailed in the specifications and plans for the project, and is incorporated by reference. Occupying often hundreds if not thousands of pages of specifications, and anywhere from dozens to tens of thousands of drawings, the risks of misinterpretation, misapplication, and misconstruction (pun intended) within this body of information is immense. We have all seen flashings disappear, noted that value engineering can prove costly in the long run, and read field directives that fail to provide much in the way of direction.

What? A tempest in a teapot, you say? Consider, then, an aphorism my attorneys tell me often, “The indemnity provisions in a contract cannot generally reach beyond the “four corners” of the contract!” At least one of those four corners is the description of the work, and it contains, therefore, a far more dangerous balancing of risk than most other provisions within the agreement. In most if not all jurisdictions, I cannot be held to indemnify for work not within my scope, or to indemnify for completely unrelated aspects of the project. When focusing on the indemnity and hold harmless provisions, then, we all too often limit our view to that artificial construct known as “insurable risk.” Some even mislabel insurance policies as a “risk transfer” mechanism, and limit their risk management perspective to a review of those aspects of the contract for which they can purchase a policy of insurance. Parenthetically, an insurance policy is actually a risk financing mechanism, as it only serves to provide the contingent funding for certain events predicated on the triggering of a claim under the policy; it does nothing to allocate the actual risk to another party.

I have seen contractors spend hours poring and debating over the placement of a single comma within the indemnity provisions, blind to the gaping holes in the design of the very work they undertake. Not convinced? Consider, then to whom we assign the responsibility for reviewing the plans, specifications, and other documents describing the work itself. In most organizations that responsibility lies with estimators, bidders, business development personnel, or similar functions. How are those vital members of our team compensated? Most typi-

cally, their pay is largely determined by how much business they successfully negotiate, occasionally modified with some "accuracy" measure of actual versus budgeted performance. Yet the cost of risk of a project will many times not be known until years after its completion, long after we have closed the compensation books for our business development team. I have seen far too many disasters strike in this area years after a project was completed. While many of those claims may have aspects that can be insured, others have large gaps where no insurance funding will ever be available, or for which no thought to the allocation of risk was given. To paraphrase Doug Barlow, an icon of the risk management profession who served as President of the Risk and Insurance Management Society in the early 1970s, "All good management is fundamentally Risk Management." Our industry must begin the application of that principle to all portions of our contracts if we are to thrive into the future. That application begins with a fair, open, and honest allocation of risk within our contracts, an allocation spearheaded by complete and balanced definitions of the work being undertaken, and the risks being born in that work.