

Workshop M4

Monday, October 29, 9:00 a.m.–noon and 1:30–4:30 p.m.

CONTRACT RISK ALLOCATION

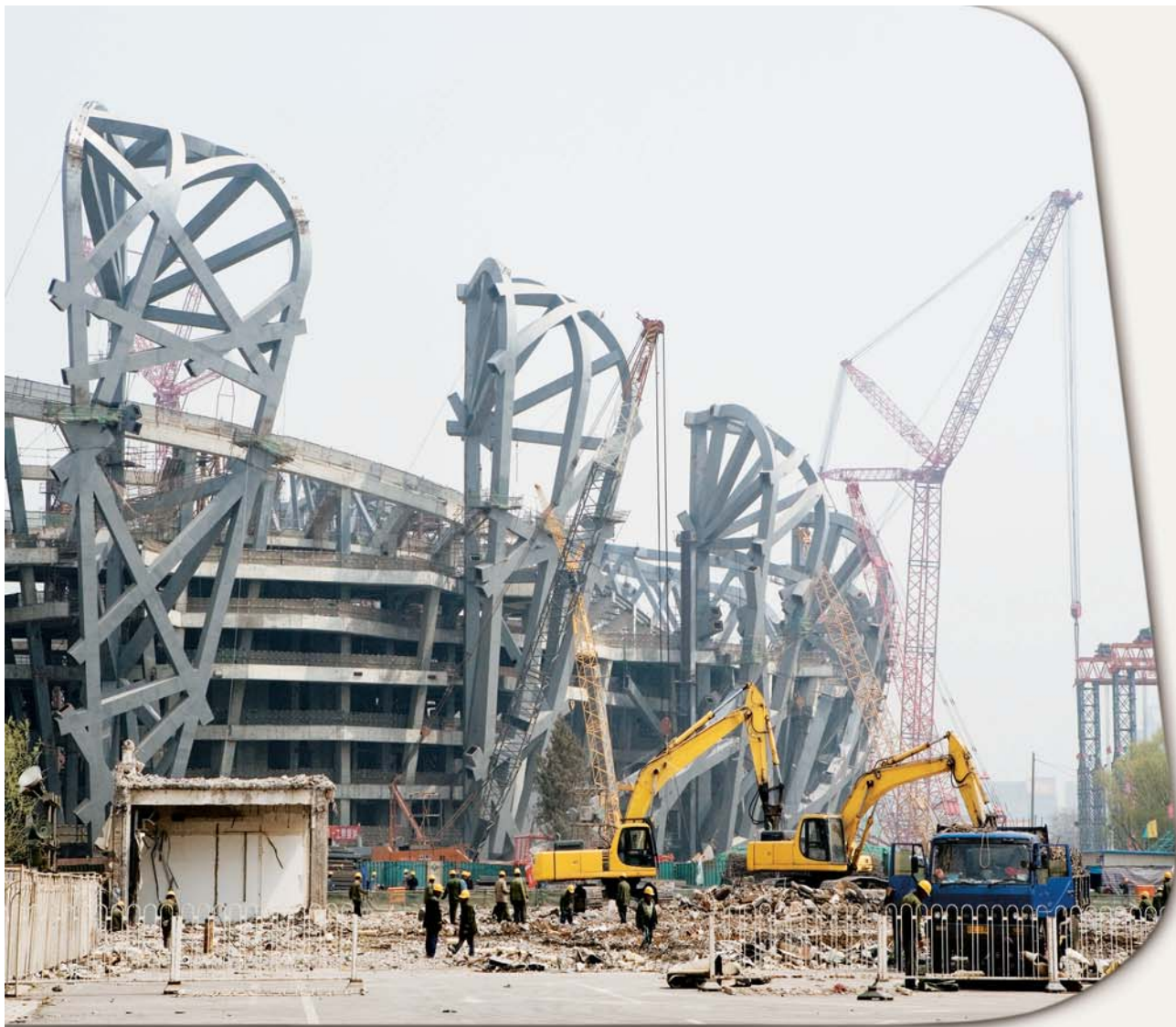
Presented by



Timothy L. Pierce
Partner
K&L Gates

One of our most popular topics, this workshop provides a practical approach to managing risk through the review and negotiation of construction contracts. Find out how to protect your organization, or your client, from problematic language in key provisions such as changes, unforeseen conditions, delays and schedule, payment, termination, dispute resolution, indemnity, limitations of liability, and insurance. Aimed at those new to construction risk allocation, but with an eye on current developments, this session is also a good refresher for veterans.

- Explores key risk allocation mechanisms and draws on real-life examples to demonstrate negotiation strategies.
- Describes typical approaches for insuring construction risks, as well as market and statutory limitations on insuring contractually assumed risks.
- Identifies common problems that can be avoided by involving knowledgeable insurance professionals in the drafting of insurance requirements.



The architect gets the glory.
The city gets the landmark.
The construction company gets to take on all the risk?

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Partner
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Mr. Pierce is copresenting Workshop M4, "Contract Risk Allocation," on Monday. His practice almost exclusively involves legal matters in the construction industry. He works with construction industry clients from the inception of a project and the formation of contracts to the resolution of claims in litigation. An experienced litigator, Mr. Pierce looks for unique solutions to construction disputes to achieve solutions that are efficient and cost-effective for his clients. Mr. Pierce has had extensive trial experience in construction matters, most recently as trial counsel in five jury trials, each ranging from 5 to 10 weeks in length. In 2005, Mr. Pierce obtained a \$37 million judgment on behalf of a contractor on a power plant project after a 10-week jury trial. The judgment was one of the top 10 California jury trial verdicts in 2005. In 2006, Mr. Pierce successfully defended a contractor in a false claims case by the City of Los Angeles in which a unanimous jury found in favor of his client. The client also recovered its attorneys' fees under the California False Claims Act. His construction experience includes prosecuting and defending construction contract, construction defect, and design defect claims on behalf of owners, contractors, and design professionals on both private and public projects. Mr. Pierce also has assisted contractors with bid protests and MBE and DBE matters.

In addition to his construction law practice, Mr. Pierce also focuses on insurance and risk management issues in the construction industry, with an emphasis on representing insureds to maximize coverage for construction claims. Mr. Pierce also has substantial experience in the defense of ADA Title III public access claims and was trial counsel in one of the few Title III cases to go to trial in California. Mr. Pierce was named a Southern California "Super Lawyer" by *Los Angeles Magazine* in 2006.

Before joining K&L Gates, Mr. Pierce was a partner in the Los Angeles office of an international law firm. His professional and civic activities include American Bar Association, Association of General Contractors of California—Insurance and Bond Committee, and California Bar Association.

Mr. Pierce speaks regularly on construction and construction risk management issues, including presentations at conferences and seminars by International Risk Management Institute (IRMI), Western Conference of Construction Consumers, Lorman, California Bar CEB, and the Construction Super Conference. Mr. Pierce has published articles in various publications on construction law matters and is the author of the chapter on Insurance and Indemnity in *California Construction Contracts and Disputes* (3rd ed.), published by California Continuing Education of the Bar.

His court admissions include United States District Court for the Northern, Central, Eastern, and Southern Districts of California. He is admitted to the Bar of California. He holds a J.D., Santa Clara University School of Law (1988) (with honors); an M.S., Virginia Polytechnic Institute and State University (1982) (Mechanical Engineering); and a B.S., Virginia Polytechnic Institute and State University (1980) (Mechanical Engineering; *cum laude*).

Recent representative matters include *City of Los Angeles v. Chicago Bridge & Iron* (2006), where he successfully defended a contractor against a claim by the City of Los Angeles under the California False Claims Act, with a 12-0 verdict in favor of the client after a 5-week jury trial (the client was also awarded its attorneys' fees); and *Modern Continental v. Alstom Power* (2005), where he represented a contractor in claims against an EPC (Engineer/Procure/Construct) contractor on the La Paloma Power Plant Project in Bakersfield, California, obtaining a \$37.1 million judgment after a 10-week jury trial, which was fully secured by bonds. His lengthy list of representative projects includes schools, condominiums, municipal development, hotels, and hospitals.

CONTRACT RISK ALLOCATION

Timothy L. Pierce
K&L Gates

- I. Session Purpose
 - A. How to Avoid The Unexpected From Your Construction Contracts
 - 1. Contract terms are only relevant if a controversy arises. Draft and review contracts with that in mind.
 - 2. Do not leave points unaddressed or ambiguous just to get the contract completed.
 - 3. Try to anticipate the worse case scenario and draft the contract accordingly.
- II. Introduction
 - A. Focusing on General Contracts and Subcontracts
 - B. Construction Contracts Generally Consist of:
 - 1. The Contract with the essential elements such as price, scope of work, schedule, and Appendices.
 - 2. General Provisions or General Conditions which contain the bulk of the contract provisions.
 - 3. Standard and/or Project Specific Specifications, drawings and miscellaneous exhibits.
 - C. Rules for Interpreting Contracts.
 - 1. Courts generally try to apply the agreement as intended by the parties. Ideally, that intent is determined from the plain language of the contract. If the contract is ambiguous, the court can consider extrinsic evidence to help determine the intended meaning of the contract. If that fails, ambiguities in the contract language are construed against the drafter of the contract.
 - D. Integration Clauses – An integrated document is one where the entire agreement is set forth in the writing. This eliminates evidence of side agreements and extrinsic evidence except to address ambiguities.
 - 1. Most contracts have an integration clause thereby nullifying any side deals at the time the agreement is executed.

III. Payment Provisions

A. Payment Schemes

1. Fixed Price (Lump Sum)
2. Time and Material (Cost Reimbursable)
3. Unit Prices
4. Time and material with a guaranteed maximum price

Usually involves a sharing plan for cost savings and contingency for unexpected costs overruns.

B. Pay If Paid vs. Pay When Paid Clauses

1. Pay if Pay Clauses are Invalid in Certain Jurisdictions;

California

- 1) *Clarke v. Safeco* (1997) 15 Cal.4th 882 – Pay if Paid provisions are unconstitutional and unenforceable in California on private works of improvement.
- 2) *Capitol Steel Fabricators, Inc. v. Mega Const. Co., Inc.* (1997) 58 Cal.App.4th 1049. Pay if Paid provisions are unconstitutional and unenforceable on public works of improvement.
- 3) Both *Clarke* and *Mega* are based on the protection of mechanic's lien and payment bond rights. Neither case precludes Pay if Paid clauses on a pure contractual claim. In that instance, the constitutional concerns that dedicated the results do not exist. Query whether the result would be the same if no payment bond or lien rights are involved?

New York, North Carolina and Wisconsin are examples of jurisdictions that void Pay if Paid clauses.

2. Pay if Paid clauses are still valid in the majority of jurisdictions. For example:

Florida, Georgia, Louisiana, Maryland, Ohio, Tennessee, West Virginia.

Important that a Pay if Paid clause be expressly written to establish that the clause is a true condition precedent to payment and not just a Pay when Paid clause. Courts will strictly construe a Pay if Paid clause to be a Pay when Paid clause unless the clause is unambiguous.

Although the clause may protect the general contractor, it may not be a valid defense on a payment bond claim. *Everett Painting Co., Incl. v. Padula & Wadsworth Const. Inc.* (Fla. App. Dist. 2003) 856 So.2d 1059.

Note: subcontract adopting Florida law for a project in New York may provide for a valid Pay if Paid clause in a jurisdiction that otherwise invalids Pay if Paid provisions. *Welsbach Elec. Corp. v. MasTec N. Am., Inc.* (N.Y. Ct. App. Nov. 20, 2006) 2006 N.Y. LEXIS 3565 (and cases discussed therein).

3. Pay when Paid Clauses are valid clauses determining the time for payment, but do not create a condition of payment.

Prompt Payment Statutes may specify the time for payment.

General contractor may be able to specify a different payment time if in writing.

4. When does a Pay when Paid clause become a Pay if Paid clause?

Usually payment must be made in a reasonable time. Address what is a reasonable time in the contract.

Critical that general contractor's include subcontract provisions that:

- 1) Tie the subcontractor into the dispute resolution process with the owner when any portion of a claim is a pass-through claim.
- 2) Limit the subcontractor's remedy to that obtained through the owner dispute resolution process and bind the subcontractor to the outcome with the owner.
- 3) Require the subcontractor to exhaust all remedies available against the owner before it can pursue a claim against the general contractor.
- 4) Require the subcontractor to participate jointly with the general contractor to prosecute fully any claims against the owner.
- 5) Require the subcontractor to stay any action that it must file prior to resolution of the owner dispute process to enforce mechanic's lien and payment bond rights.
- 6) Do not rely on a general incorporation clause to accomplish the above items.

IV. Changes To The Work

A. Owner Requested Change Orders

1. Generally the owner has the right to make changes to the work that come within the general purpose of the project and that do not fundamentally change the character of the work.

2. Contracts contain different procedures, but generally provide that:

Change orders must be in writing and contractor will not be paid unless the change is in writing, except, the owner can also issue a change directive that the contractor must perform even if there is no agreement on the price or whether the work is extra to the contract.

Contractors should be cautious not to perform work unless there is a written change order or written work directive. Most contracts specifically state that any work performed without a written change order or directive is performed voluntarily.

Avoid the scenario where the actual change order work gets ahead of the change order paper work. In most instances the contractors are performing without an ability to bill for the work and the owner will be confronted with a claim at the end of the project.

3. Owner generally wants the option to issue unilateral change orders (construction change directives in the AIA A201), but in practice the pricing on unilateral changes can lead to a dispute.

B. Changed Conditions and Design Revisions

1. Generally the contractor is entitled to additional compensation for work that was not contemplated in the original scope of work because of unknown conditions. Unknown conditions can be either:

physical conditions that differ from that shown in the contract documents; or

conditions that were unusual and differing from that ordinarily encountered or inherent in the work to be performed.

2. The Spearin Doctrine (*United States v. Spearin* (1918) 248 U.S. 132) – owner impliedly warrants that the plans and specifications issued for a project are free from defects and that project can be constructed from the plans and specifications.

3. Errors in the plans and specifications. As a general rule, contractors are entitled to compensation for latent errors in the design documents, but not patent (obvious) errors in the contract documents.

Another common clause states that the contractor is responsible for latent discrepancies unless the owner is notified of the problem promptly after it is discovered by the contractor.

4. Owner can shift the burden of unknown conditions to the contractor.

For example, see: *Wunderlich v. State of California* (1967) 65 Cal.2d 777; *Interstate Contracting Corp. v. City of Dallas* (2005) 407 F.3d 708.

Contract should use explicit language given the general rule that contractors are entitled to additional compensation. Contractor needs to have had a fair opportunity to include the cost of contingent events in its bid or GMP price.

Does shifting the costs for unknown conditions help or hurt the owner? Will increase bid amounts, but may be useful on a project with a tight budget.

Statutes may limit an owner's ability to transfer this risk. See for example California Public Contract Code section 7104 which states that contracts that involve digging trenches or excavation deeper than four feet shall include a clause providing for a change order when unknown conditions are encountered. Can such provisions be waived?

5. Be mindful of contract provisions that advise of potential differing site conditions which may shift the risk of such conditions to the contractor:

Appeal of Mass Constr. Group, Inc. (Oct. 30, 2006) ASBCA No. 55440, 2006 ASBCA LEXIS 96 [contractor that failed to review site condition date assumed risk of differing site conditions].

Universal Constr., Inc. v. United States (U.S. Court of Federal Claims Apr. 18, 2006) No. 03-1502C [sufficient disclosures in the contract documents transferred risk of unforeseen conditions to the contractor].

Appeal of Billington Contracting, Inc. (Feb. 28, 2005) ASBCA No. 54147 [The Armed Services Board rejected a differing site conditions claim because the contractor failed to examine documents referenced in the bid solicitation located 750 miles from the job site.]

C. Notice Provisions

1. Contracts usually contain a notice provision to give the owner fair warning of potential extra work claims. The law interpreting such provisions varies by jurisdiction, but contractors should comply with such notice provisions to avoid prejudice to the owner and its claim rights. The consequence of not providing notice varies by jurisdiction. Examples of potential pitfalls of not providing timely notice:

Grantech Co. Ltd. v. N.D. Dept. of Trans. (N.D. 2004) 676 N.W.2d 781 [failure to give contractually required notice of differing site conditions bars claim in arbitration].

Rissler & McMurry v. Sheridan Area Water (Wyo. 1996) 929 P.2d 1228 [failure to follow written claims procedure was a basis to deny claim for extra compensation].

Galín Corp. v. MCI Telecommunications Corp. (1994 5th Cir.) 12 F.3d 465. [claim barred for failure to give timely notice].

Heckler Elec. Co. Inc. v. City of New York (2000) 715 NY S.2d 619. [Delay claim dismissed because contractor's delay notice did not include detailed statement of delay damages as required by contract].

D. Change Order Pricing

1. Change order work can be priced on (1) a time and material basis (2) unit price basis or (3) a fixed price basis. Each change order is an amendment to the contract. Contracts frequently specify the percentage of profits and overhead that will be paid on change order work.
2. Watch for contracts that set a fixed amount for extended general conditions on a daily or monthly basis.

Need to distinguish between extended general conditions costs and additional administrative costs to address change orders.

V. Schedule and Time Related Clauses

A. No Damage For Delay Clauses

1. As a general rule, such clauses are strictly construed against owners, but if unambiguous will be enforceable.

2. The courts have developed many exceptions to no damage for delay clauses. Some of the more common exceptions or reasons a court will not enforce a no damage for delay clause are:

The delay was beyond the contemplation of the parties.

The length of the delay was unreasonable such that it amounts to an abandonment of the contract.

The delay was caused by acts of bad faith or fraud.

The delay was caused by the active interference by the owner or prime contractor.

The delay was caused by the gross negligence of the owner or prime contractor.

3. Some states have placed legislative limitations on no damage for delay clauses.

California Public Contract Code Section 7102 states that no damage for delay clauses are unenforceable if the delay was unreasonable and not within the contemplation of the parties.

Washington State: such clauses are against public policy in Washington State (RCW B4.24.360; *Scoccolo Const. Inc. v. City of Renton* (Wash.Ct.App.2000) 9 P.3d 886).

Virginia: *Blake Const. Co./Poole & Kent v. Upper Occoquan Sewage Authority* (Va. 2003) 587 S.E. 2d 711. No damage for delay clause violates state statute prohibiting public agency from disclaiming financial responsibility for their own acts or omissions.

Such statutory prohibitions raise several questions:

- 1) What constitutes an unreasonable delay?
- 2) When is a delay within the contemplation of the parties?
- 3) Does a particular delay have to be spelled out in the contract to be contemplated? This is a good practice for owners that want to avoid the consequences of Public Contract Code section 7102 or similar limitations in other jurisdictions.

4. Should an owner include a no damage for delay clause in its contract or a general contractor in its subcontracts? Note they are not in the typical form contracts like the AIA forms. Even if allowed, still be mindful that:

The court will strictly construe the clause.

The contract price may go up in anticipation of delays that never happen.

Will the clause eliminate inefficiency claims.

If a subcontract contains a no damage for delay clause, but the prime contract does not, the subcontractor may still be entitled to recover for owner caused delays.

B. Liquidated Damages Provisions

1. Common provision to protect owners from delays on a project. Basic elements are:

Contemplated that the owner will incur damages for delay, but the actual damages caused by delay are hard to ascertain at the time the contract is signed.

Amount of damages must represent damages and not a penalty.

Owner does not need to demonstrate actual damages to invoke a liquidated damages provision.

2. Liquidated damage provisions can also apply to damages for delays to the contractor.
3. Make sure the amount of liquidated damages are commensurate with the potential damages the contractor may causes.
4. Is the owner better off without a liquidated damages provision? Without such a clause, owner is entitled to its actual damages.

C. Suspension Provisions

1. Owner usually has the right to suspend the work for cause and for convenience.

Suspensions for convenience provide for compensation to the contractor if the project is delayed by the suspension. Contractor is generally required to take various steps to protect the work and to minimize impact to the project because of the suspension.

Suspensions for cause are by definition necessary because of an event or situation created by the contractor (such as an unsafe condition) and thus the contractor is not entitled to compensation for extra expenses caused by the suspension.

2. Usually the contractor does not have a right to suspend the work. Contractor may want to add a provision that if the work is suspended for an extended period of time, the contract will be considered terminated or the contractor will have the right to terminate.

Contractor may also want to state that if the work is suspended and the parties cannot agree on how time and compensation are to be adjusted, then the contract can be terminated.

VI. Termination Provisions

A. Two types of termination:

1. Termination for cause
2. Termination for convenience

B. Termination for Cause by Owner

1. Is this clause even needed? Normally a party to a contract can terminate if the other party has materially breached the contract. In either instance (with or without the clause), the contractor shall be given an opportunity to cure before it is terminated.
2. Clause could allow termination for an immaterial breach which is normally not the basis for termination under general contract law.
3. Owners typically include a clause stating that should owner's termination for cause subsequently be determined to be improper, the termination is deemed a termination for convenience. Query whether this clause is enforceable since a party breaching a contract may be precluded from relying on the contract it has breached.

Standard clause under the FAR and enforceable under contracts with the Federal Government.

C. Termination for Convenience by Owner

1. Standard clause in general contract. Allows owner to terminate for any reason. The clause typically requires the contractor to take various steps to preserve and protect the work, to terminate subcontractors, to assign subcontracts and purchase orders, and/or to transfer title to all work and material to the owner. A clause that every owner needs in its prime contract and every general contractor wants in its subcontract.
2. Contractor is compensated for all work to date including materials purchased. Typically, contractor is not entitled to loss profits for work not performed. Outstanding claims and change orders have to be resolved between the owner and contractor.

AIA A201 contract allows for recovery of unearned profit. Typically owners revise this provision.

D. Termination by the Contractor

1. Some contracts give the contractor a limited right if the owner fails to make payment. Those options can be:

Stop work, but no right to terminate the contract.

Terminate the contract after proper notice to give the owner a chance to cure the default.
2. Since many contracts require the contractor to continue working even if there is a dispute, a limited termination clause is desirable by the contractor. However, query whether the owner can materially breach the contract and still require the contractor to continue working without timely payment. In some instances, it may not be feasible for the contractor to continue working if they are not receiving sufficient funding to satisfy the cost of the work.
3. In reaction to the invalidation of pay if paid clauses, California adopted Civil Code 3260.2 which gives contractors rights to stop work on private works of improvement when the owner is behind in making progress payments.

VII. Dispute Resolution

A. Arbitration

1. Should the contract contain an arbitration clause? Arbitration is becoming less favored because the decision is generally made by one arbitrator, there are no rights of appeal and arbitrations are just as costly as litigation in court.

Should the arbitration be governed by the Federal Arbitration Act or the applicable State Arbitration Act. To fall within the FAA, the dispute must involve interstate commerce or the transport of goods or services across interstate lines.
2. Considerations for an arbitration provision:

Adopt the rules from the American Arbitration Association for Construction Industry arbitrations?

Establish a custom procedure. The possible advantage is the arbitration can be simplified and made more cost effective. This is accomplished by limiting discovery and/or the length of the arbitration. The downside is one must arbitrate somewhat in the dark as to the other side's case. This may be a worthwhile tradeoff when the amount in controversy is small.

How many arbitrators will hear the case? Is a panel of three arbitrators consisting of one neutral of any value?

Who pays for the costs of the arbitrators? Does the arbitrator have the right to shift such allocation?

What rights of appeal will the parties have? Generally, Courts have placed strict limits on what is appealable from an arbitration award. Do the parties want to expand on these limited grounds? This tends to defeat one of the objectives of arbitration, but may also make it more palatable. In California, the courts have rejected contractual provisions providing full appellate rights from a private arbitration.

Compare judicial reference (California) which is effectively an arbitration with appellate rights.

3. Assure that all potentially related claims are subject to a consolidated proceeding. For example, arbitration clause in design contract but not in the general contract may put the owner in two separate forums.

B. Mediation

1. The AIA contracts now have mandatory mediation clauses. Although mediation is an effective means of resolving construction disputes, is mandatory mediation a contradiction in terms?

C. Dispute Review Boards

1. Common on public works projects. Rulings of the DRB are advisory but can be admissible in subsequent litigation. How effective are DRBs? May be more effective if a penalty is imposed for pursuing a claim in litigation and not achieving a result more favorable than the DRB ruling.

D. Complex Dispute Resolution Procedures

1. Public works contracts can contain complicated procedures that require some or all of the following steps:

Submission of the claim to the project team or architect

An appeal to the owner's representatives not on site

An appeal to the DRB

Mediation

Arbitration or an action in court

2. Contractor needs to be cognizant of time limits to proceed from each step of the dispute resolution process. Missing a time limit can be deemed a waiver of the right to pursue the claim further.
3. Are such procedures of benefit to the owner or the contractor?

E. Attorney's Fees

1. Generally, no right to attorney's fees unless contract provides for such right. Standard clause says that the prevailing party shall be entitled to recover its attorney's fees. Clause must be written broad enough to include expert witness fees (litigation expenses).

Compare rights under prompt payment statutes

2. A clause written in favor of only one party will be interpreted to act bilaterally.
3. California case law has found that a party making a statutory offer of settlement (CCP 998) can become the prevailing party if the other party fails to obtain a more favorable ruling at trial.
4. Larger entities tend to disfavor attorney's fees clauses since they have greater resources and do not want to give smaller plaintiffs an incentive to litigate.

F. Limitation of Liability Clauses

1. Although more common in design contracts, general contracts can contain clauses limiting either party's liability.
2. The 1997 AIA A201 General Conditions provide for a mutual waiver of consequential damages. One major exception is any liquidated damages due owner. The clause contemplates a waiver of:

Owner: rental expenses, losses of use, income, profit, financing, business and reputation and for loss of management or employee productivity.

Contractor: Home office overhead, loss of profit not directly related to the work and losses of financing, business and reputation.
3. Owner would typically not want this clause, but sophisticated contractors may look elsewhere for work rather than assume the extensive liability for consequential damages.
4. Possible compromises: Limit exposure for consequential damages to a fixed sum like the contract fee.
5. Even a broad limitation of liability clause in favor of the owner may not limit liability under a state prompt payment statute. *John B. Conomos, Inc. v. Sun Co., Inc.* (Pa. Super. 2003) 831 A. 2d 696.