

The Importance of Construction Contracts and Items to Consider When Preparing Construction Contracts

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It's important for parties entering into any significant economic transaction to have written contracts. This is especially true for construction projects which are, by their nature, complicated. A contract on a construction project sets forth the parties' obligations to each other and determines how risks will be shared or divided on the project.

The Value of Having a *Written* Construction Contract

A construction contract does not have to be reduced to written form for it to exist or operate. Once two parties agree to have construction work performed and the builder commences the work, there is a construction contract that exists, regardless of whether the agreement has been reduced to writing and signed by both parties.

The key distinction between a contract that is in writing and one that is not is what terms control or define the parties' agreement. In the case of a well-written contract, the written terms carefully and clearly define the parties' agreement, their expectations, and their respective risks and obligations. With a mere oral contract, there are no written terms and the terms that control are defined by the parties' oral discussions or negotiation correspondence (and, in the case of a dispute, the parties will invariably not agree on what those discussions were), the course of performance of the contract (i.e., how have the parties performed the project work prior to a dispute), and the limited default rights applicable by operation of law.

One of the biggest problems encountered with non-written contracts is that each party's respective memory of the agreement changes over time, especially if a dispute arises. Similarly, people are sometimes simply dishonest about the terms of the agreement when a dispute arises, large sums of money are at stake, and a recollection different from (or not entirely consistent with) "the truth" will improve their position. These problems can be mostly avoided with a written contract.

There are many additional benefits to having a written contract for a construction project. Even if the parties "trust" each other, a written contract provides a clear road map at the onset of the project of how the parties will proceed to carry out the work. This helps to ensure that the project will run smoothly and diminishes the risk of potentially fatal problems. Absent this written road map, each party may have certain assumptions about what the agreement is or how the other will behave in a certain situation. Those assumptions are often incorrect and can prove fatal to a project.

Written contracts also help to guide—or even force—the parties to comply with reasonable business procedures since those procedures will be specifically spelled out in a well-written contract and become requirements of each party. This is referred to as the "channeling function."

Another application of the channeling function is that a well-written construction contract forces the parties to consider and

agree on issues that they otherwise might not even contemplate at the beginning of a project but that are commonly encountered in the particular type of project and could very well become major issues during the course of performance.

Finally, if the parties do have a dispute, particularly if that dispute ends up in litigation, the more terms that have been reduced to a clear written statement the fewer terms will be genuinely in dispute. This leads to a more efficient, or at least less costly, resolution of the dispute since there will be fewer issues to legitimately fight over.

Default Provisions in the Law

If a term is not reduced to writing (if the contract, whether written or oral, is silent on the issue) the law may supply a default term if an issue arises. By reducing such terms to writing, the parties can control how that issue will be handled and avoid having a default term imposed upon them that is not favorable to their position.

Even if the law supplies a default term, in many cases (but not all) that term or requirement can be modified by the parties in their written contract. In many cases modification must be in writing and must be signed by both parties. In some limited cases the law requires not only that the modification be in writing, but also that particular (sometimes referred to as "magic") words be used. A well-written contract will include these "magic" words.

However, some legal requirements cannot be modified by contract, even a written one. An example of this is the statute of limitations which governs the amount of time that a party has after a dispute arises to initiate a claim in court. As a very general rule, the parties to a contract can shorten this time period (down to a minimum, typically never less than one-year), but the parties cannot extend the period.

Risk Shifting

The economic effect of a contract is to shift or allocate risks. By way of example, a builder who enters into a contract with a building materials supplier to purchase two-by-fours at a set price on a future date is shifting the risk onto the supplier-seller that the price of two-by-fours will increase between the present day and the future date set for the purchase. Similarly, the builder-buyer assumes the risk that the price of two-by-fours will decrease.

Every provision in a construction contract can be considered a mechanism to shift or allocate some identifiable risk. If the construction contract contemplates the construction of a structure for a fixed fee, then the builder assumes the risk that forces beyond the builder's control may cause the actual cost of construction to exceed that fixed fee, cutting into the builder's expected profit, maybe even resulting in a loss. At the same time, the owner assumes the risk that forces beyond the owner's control will cause the actual cost of construction to be significantly less than what was contemplated or expected by the parties at the time the contract was entered into, resulting in a bonus profit to the builder.

There are numerous other risk issues, other than price, that can be allocated by a written construction contract. It is important to understand that a risk does not have to be fully allocated to one party or the other. Commonly in a construction contract, a risk is split such that it is either shared or allocated to one party only up to a certain point, after which the risk is either shared or allocated back to the other party.

A cost-plus contract with a guaranteed maximum price is an example of this. The owner is allocated the risk of cost overruns up to the guaranteed maximum price. If the guaranteed maximum price is exceeded, the risk or burden of cost overruns is shifted back to the contractor-builder for each dollar that exceeds the guaranteed maximum price.

Other risks that can be allocated by a well-written construction contract and examples of how they address such allocation are as follows:

- Time. If project completion is delayed, which party will incur the attendant loss, to what extent, and how will the loss be measured.
- Design Issues. In the case of a defect in the design, which party will be responsible for correcting the defect and to

what extent.

- Acts of God / Damage to the Work / Effects of Weather . In the case of an "act of God," such as a severe storm, that delays or damages the work, which party will be responsible for the attendant loss.
- Funding. If there is a disruption in the flow of funds to construct the project, such as a delay of disbursements from a lender, which party will be responsible.
- Regulatory Risk / Approvals. If the government fails to provide necessary approvals or issues regulations that require a change in the design or performance of the project, which party will be responsible for the resulting costs.
- Concealed or Unexpected Conditions. If there are conditions encountered on the project that are unexpected such as bad soil that will not support the construction without considerable, and expensive, additional work, which party will be responsible for addressing and overcoming the problem and to what extent.
- Damage to Third Parties / Indemnity. Which party will be responsible for damage or injury caused to third parties (i.e., those that are not a party to any contract for the project at issue) and to what extent.

This list is not exhaustive, and in the section below discussing key elements in construction contracts there are other terms commonly found in construction contracts where risk allocation is also appropriate.

Parties to a Construction Contract

For a complex project, there could be, and usually are, multiple contracts at any one time. The most obvious and common is the contract between the owner (or developer) and the general contractor (or builder). Additionally, if a design professional is involved, there will be a contract between that party and the owner (or, as is increasingly common, between the design professional and the builder in the case of design-build contracts). If the builder hires subcontractors rather than self-performing everything (the former being much more common) there will be subcontracts between the builder and its subcontractors (called "first-tier subcontractors"), and there are often additional contracts between the first-tier subcontractors and their second-tier subcontractors, and so down the line.

Suppliers sit in the position of subcontractors in this scheme and there will likely be a supply subcontract (sometimes nothing more than a purchase order) between the supplier and the contractor or subcontractor with whom the supplier deals. If a party is required to obtain or carry insurance, then the insurance is another form of contract that applies to the project. Similarly, any performance and payment bonds obtained by a contractor or subcontractors are also contracts that apply to the project. So clearly, even a moderately sized construction project can involve numerous sets of construction contracts.

Key Elements of a Construction Contract

It is not possible to enumerate each and every item that should be present in a written construction contract in all situations. However, every construction contract should generally address the following items:

- Price, including whether it will be calculated as a fixed fee, cost plus, or cost plus with a guaranteed maximum price;
- How changes in the character of the work, contract time, or contract price will be handled (change orders);
- The order of performance and triggering of events;
- The time of performance of each step in the contract;
- Whether delay damages will be assessed for delayed completion and, if they are assessed, whether they will be assessed as actual damages or liquidated (an agreed-upon amount) damages;
- Sureties, including whether performance and payment bonds will be required;
- The terms and conditions of any performance and payment bonds;
- Warranty obligations;
- How notices between the parties will be handled;
- How disputes between the parties will be handled or conducted;
- How liens on the project will be handled or waived;
- How interim progress payments will be requested and disbursed, including what conditions must be met to trigger a

disbursement;

- Insurance, including what parties will be required to carry insurance, what occurrences must be covered by insurance, and what are the parties' rights to make a claim on the other party's insurance policies;
- How the project will proceed in the event of a serious dispute arising during the project;
- Firing and termination provisions that govern how situations of default will be handled; and,
- Whether certain items in the contract will be considered allowances (items that the owner is allowed to select within a specified budget) and how allowances will be handled.

Even this extensive list is not exhaustive.

Consistency, Flow Down, and Tiers

An important concern on construction projects with numerous parties and contracts is ensuring that the different contracts are consistent with each other including provisions that flow down from upper-tier contracts. For instance, a general contractor-subcontractor contract will frequently have provisions that "flow down"— meaning the provisions of the prime contract between the owner and the general contractor will apply to the subcontract. Such provisions should be carefully drafted, and if a party is subject to such provisions, it should make sure it has a copy of the upper-tier contract being flowed down or applied; otherwise, the party is agreeing to a set of contract terms to which it has not seen.

Similarly, a contracting party should consider how claims involving other parties will be handled when there is no direct contract between that party and the other party. For example, what will happen between the builder and the owner when the owner's neighbor claims that the builder has damaged the neighbor's property while working on the owner's property? For this reason, there frequently are provisions in construction contracts dealing with indemnity and defense.

Industry Forms

Standard industry forms are commonly used in the drafting and preparation of construction contracts, especially for large projects. The most commonly used are those prepared by The American Institute of Architects ("AIA") and ConsensusDocs. At one time the Associated General Contractors of America maintained its own set of forms; however these have been merged into ConsensusDocs.

When using industry forms, it is important to understand that the different forms for different contracts interact and work together. For example, the AIA form for an owner-architect contract assumes the use of the AIA form for the owner-contractor contract. Thus, if you use one type of standard owner-contractor contract you should be careful to make certain that a standard contract from the same source is also used for the owner-architect contract. Similarly, any modifications to a standard owner-contractor should be considered when preparing the owner-architect contract and vice versa. The same consideration applies to modifications of contractor-subcontractor subcontracts, subcontractor-subcontractor subcontracts, and supplier purchase orders.

Conclusion

Any construction project of any size should involve a written contract or contracts. You should consult a legal professional in the event you are entering into or considering entering into a contract for a construction project. Ward and Smith, P.A. has a large group of experienced professionals with extensive knowledge of construction contracts who are ready to assist you in drafting and analyzing such contracts and their necessary terms and conditions.

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