

TOP 10 CONTRACT TIPS

Eliminating the Surprise Factor from Your Construction Contracts:
Tips for Owners and Developers



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INTRODUCTION

An effective and comprehensive contract is the foundation of any successful construction project. Zetlin & De Chiara is one of the largest practices in the country devoted to construction law and has long been a recognized leader in the area of drafting and negotiating sophisticated agreements on behalf of owners and developers as well as design professionals.

Owners and developers are often familiar with “standard” construction contract language and provisions, but the industry is continually evolving. Changes in building methodologies impact the way contract provisions must be drafted. Zetlin & De Chiara is immersed in the industry and so understands the impact of new construction trends and technologies and is familiar with all construction delivery methods, including design–bid–build, design–build, construction management and integrated project delivery.

We know it is crucial to review all provisions with a critical and knowledgeable eye to ensure that a contract allocates risks and responsibilities, anticipates and prevents ambiguities and provides mechanisms to avoid disputes arising from contract performance. The time spent at the beginning of the contract process identifying potential problems and negotiating solutions yields dividends and can produce significant cost savings over the life of a project.

Based on its years of extensive experience, Zetlin & De Chiara has identified 10 key contract provisions and outlined tips to help owners and developers avoid pitfalls and make sound, well-informed business decisions.

1 SCOPE OF WORK

The starting point for any construction contract is the project. Whether it is new office headquarters, a mixed-use residential building or new hospital wing, the contract must fully define the scope of the project and obligate the contractors to deliver it. Otherwise, the owner will face a series of unexpected additional costs. The starting point for scope definition are the plans and specifications prepared by the design team. However, the technical documents do not cover all of the contractor's obligations, and owners must identify all of the key issues that need to be addressed in the contract.

At the outset, the ownership team must select the appropriate project delivery system, whether it is the retention of a general contractor, a construction manager as agent or a construction manager at risk. The contract must obligate the contractor to confirm its familiarity with the project site and that its observations of the site correlate with the contents of the documents. The contractor must also affirm that it has carefully reviewed the contract documents and that these documents provide all of the required information for construction. The contract must establish a mechanism for identifying and resolving "gaps" in the documents and mandate the appropriate performance standards for the project.

A comprehensive agreement that protects an owner's interests must identify the external requirements that may affect the project, beginning with obtaining all required public approvals for construction. Many projects also involve specific conditions that must be addressed, such as accommodating a major utility installation or transit facilities or remediating hazardous materials. The contract must specify the contractor's role in addressing these types of issues. If the project is slated for LEED certification, the contractor's responsibility for satisfying this requirement must also be outlined. Additionally, the agreement must delineate third party requirements such as the terms of a zoning lot development agreement, protections for adjacent properties and the requirements of lenders providing project financing. It must also address any critical points raised by the project's insurers.

2 COMPLIANCE WITH SCHEDULE

One of the most critical elements in any owner's construction project is the timeline. In order to protect the owner, any well-crafted construction contract should have several provisions that deal directly with the time allocated to the construction manager (typically at risk) or the general contractor to get the job done. Typically, a well-constructed contract will have an initial project schedule along with all the necessary milestone dates needed to finish the project.

The construction contract must provide numerous clauses obligating the contractors (or the construction manager) to establish and commit to an agreed-upon project schedule. It must also include clauses which allow the owner to properly gauge how well the project is moving towards completion. In this regard, a construction agreement should address scheduling dates that are significant to the owner and the consequences if those dates are not met. Conversely, the contract may also include incentives to motivate the construction manager or general contractor to meet or beat the agreed-upon schedule or target dates for the project.

Topics such as delays and extensions of time, excusable delays, delay deadbands, acceleration, no-damage for owner-generated delays and similar items need to be considered. If appropriate, these items should be included in the contract to establish the owner's expectations as well as the construction manager/general contractor's requirements and obligations regarding schedule. The precise wording of these clauses will depend upon the particular project, but these provisions must be carefully considered and properly drafted to protect the owner's interests.

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3 MEETING OWNER'S TARGET FOR BUDGET

Another key component of an owner's construction project is the budget. It seems obvious that the budget would be of paramount importance, but without proper contractual provisions establishing the primacy of the budget and serious repercussions for over-spending, it can easily become a fading goal as opposed to a rigid requirement. That often spells disaster for the ultimate success of a project.

It is imperative that a project agreement includes sufficient clauses that protect the owner's economic interests and the monetary limits allocated for construction. While the entire contract is basically in place to state the financials of the deal and to set the performance standards to be achieved, there are specific clauses which must be included to protect the owner's budgetary interests. These clauses cover topics such as compensation, the overall cost of the work, the specific costs of certain physical elements of the project, labor and material costs, issues such as shared savings, responsibility for cost overruns, methods of procurement, timing of payments, change orders, retentions, subcontracting, fees, general conditions, insurance and other "soft costs," among others.

Setting the initial budget is critical, but equally important is having the proper mechanisms in place to monitor costs as construction proceeds and budget updates throughout the project so that the owner can assess how the actual costs are comparing with projected budget. With these and other provisions to protect the owner, a budget becomes a living, breathing indicator of ultimate success for the construction of any project.

4 CONTINGENCY

A construction contingency is a valuable tool if properly envisioned, structured and managed. Such a contingency must first be distinguished from a project's design contingency, which an owner will use in the event of design errors or omissions that need to be rectified, or if design changes are made during the course of the project.

The construction contingency is often established as a percentage of the budgeted cost of the construction work, perhaps subject to enhancement through savings on trade buys. It essentially provides a financial cushion to deal with errors or miscalculations in the construction manager's estimates of time or cost. For instance, if an unforeseen issue leads to unanticipated overtime or if resequencing arises, it can be addressed through the contingency. Owners must consider how much leeway to allow in contractually describing the circumstances in which contingency may be utilized. They also need to consider whether to require advance permission for utilization of contingency (perhaps above a negotiated threshold) or simply to require prior notice of utilization and subsequent documentation.

The construction contingency is a source of shared savings in the event that its prudent management leaves a balance at the end of the project. Negotiation of the division and distribution of those savings may be key to incentivizing the construction manager to be a careful steward of project resources. An innovative approach might be to establish separate contingencies for discrete categories of potential difficulties and to calculate the division of the savings balance separately as to the respective earmarked contingencies.

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5 CHANGES IN THE WORK

While they may not have the same certainty as death and taxes, changes on construction projects of any significance are undeniably ubiquitous. Changes come in various forms, shapes and sizes. The most common way to resolve the impact of a mutually agreed to change is through a change order for contractors or an additional service for design professionals. Like nearly every issue that arises in connection with a construction project, the best advice is to address the issue directly in construction contracts with design professionals, construction managers, trade contractors and vendors.

Regardless of the change itself, it is imperative that contracts include sufficient notice provisions. The onus is properly placed on the party seeking the change. They should be required to provide prompt, written notice so as not to otherwise delay the project. Prompt notification of a potential claim based upon a change permits owners (1) to review the applicable project records and speak with the pertinent parties before memories invariably begin to fade; (2) to document contemporaneously the costs of the work involved in the claim; (3) to explore other less costly solutions for performing the work; and (4) to negotiate a prompt resolution of the claim. For all of these reasons, there should be real consequences if proper notice is not furnished.

Notice is the first step towards resolution of a claim based upon a change in services or work. Approval of a change should be contingent upon the justification and substantiation of the change itself. The ultimate approval should also be conclusive rather than simply authorizing the work to proceed and kicking the proverbial can down the road. In other words, all direct and indirect costs and schedule impacts should be addressed in the change order. Not all changes can be, nor should be, treated equally. Many contracts will use terminology that triggers a change if the change is “minor,” “substantial” or “material.” Of course that begs the question what substantial or material mean. Better results will likely be achieved if the contract language provides some frame of reference for the context of the changes to the specific project.

Arguably the most difficult situation to address comes about in the event of a failure to agree whether something qualifies as a change or the cost/schedule impacts as a result of the change. Without adequate contract language to unequivocally bind the design and construction team members to continue performing the work, a project could be at serious risk. Proper and fair contract language negotiated upfront will help mitigate the consequences of changes.

6 INDEMNIFICATION – Allocation of Risk

Owners face enormous risk of liability for work performed by the construction team on a project. A critical purpose of a construction contract is to appropriately address risk allocation, and indemnification is one of the most effective tools for accomplishing this. A priority for owners is obtaining appropriate indemnification protection from the construction manager and general contractor and confirming that this obligation is also embraced by the subcontractors. While some contractors will seek to limit their indemnity obligation to claims for personal injury and property damage, such a limited indemnity leaves the owner exposed to substantial risk. Some indemnity clauses exclude protection for property damage to the work itself, assuming that such damage is covered by insurance. These limited indemnity provisions ignore the fact that the contractor's breach of its agreement may cause substantial damages that are not covered by insurance, but will cause the owner to sustain substantial out of pocket losses. If the contractor's indemnity extends to damages incurred by the owner as a result of its breach of contract, the contractor is responsible for those damages and it must defend the owner against additional claims which are likely to arise.

Often the owner needs to obtain indemnity protection that includes third parties, such as investors, affiliated companies, lenders and, in some cases, other parties with properties in the vicinity of the project site. A construction contract must also provide appropriate protection for the owner against statutory liabilities, such as the duties imposed on owners and contractors for state and federally mandated site safety procedures. Since an owner or developer cannot control site safety, it must obligate its construction team to implement an effective safety program and assume full responsibility for job site accidents and injuries. Indemnification is a key part of this protection. Contractors often benefit from statutory limits on liability to their own employees who are injured on the job, so it is especially important that they be obligated to indemnify the owner against potential worker claims.

Contractors often seek limitation of their total liability and their obligations to provide indemnity protection to the owner. These limitations can take the form of exclusions from the indemnity itself, waivers of consequential damages and specific dollar amounts. Owners need to avoid pitfalls in connection with these terms so they get the full protection they bargained for.





7 INSURANCE

When considering insurance for a construction project, first and foremost, it is important to work with a broker who is intimately familiar with the construction industry. Construction projects are fraught with perils for the unwary, and an experienced broker will appreciate the coverage issues that will be needed for proper protection. From a legal and practical perspective, owners should consider different insurance options and should be scrupulously mindful of rights they want to include in their construction agreements.

On larger projects, typically over \$100 Million, an owner will want to consider an Owner Controlled Insurance Program (“OCIP”) or a Contractor Controlled Insurance Program (“CCIP”). While a CCIP may at first seem less costly, an OCIP offers more control over the quality of insurers and the terms of insurance. It remains intact even if the General Contractor or Construction Manager is terminated, and the savings are returned to the owner. With a CCIP, any savings will need to be negotiated as part of the upfront deal. If a CCIP is selected, it is imperative that the owner define carefully the fees to be charged for the CCIP. For example, if a particular trade is excluded from the CCIP, is the general contractor or construction manager still entitled to use the cost of the trade in calculating its fee? A number of these issues arise in the drafting of the general contractor/construction manager agreement along with an OCIP or CCIP. Some additional points to consider for insurance policies:

Ensure that additional insureds are included in policies as needed. Include the right to review actual policies, not just certificates.

Confirm that the general contractor/construction manager’s insurance and the policies of the trades, are primary and non-contributory so a dispute about coverage between or among carriers is avoided.

When considering performance and payment bonds for a project, review the language of the bonds. Confirm that ownership is identified as a co-obligee providing direct rights vis-a-vis the bonding company in the event of a contractor default. A product like Subguard, issued by Zurich Insurance Company to replace the individual payment and performance bonds of subcontractors, is also worthy of consideration when exploring insurance for a project.

8 DISPUTE RESOLUTION

Given the cost of litigation, particularly in document intensive construction disputes, alternative dispute resolution (“ADR”) can often be an economical option to consider. While not a complete panacea, an ADR can be either a full substitute (binding arbitration) or an interim step (mediation) that may obviate litigation. The analysis of whether to utilize ADR needs to occur during contractual negotiation, not when a dispute occurs. Numerous factors impact the determination whether ADR is appropriate on any given project. For example, the project may be within a state or municipality with local courts that have a bias against out-of-state entities. Alternatively, the law in the project state may be disadvantageous to owners, developers, and/or design professionals. Drafting of tailored contractual provisions will ensure the application of laws from jurisdictions favorable to the interests involved.

In utilizing ADR for a construction dispute, particular care must be employed to ensure that the procedure encompasses all relevant parties. Uniformity in the drafting of various construction contracts will bind all parties to the ADR process. At a minimum, provisions allowing for the unfettered consolidation or joinder of parties to the ADR will prevent the process from being unduly limited. Consideration must also be given to whether the prevailing party will recover all attorneys’ fees, which can be extensive given the complexity of construction disputes. Finally, if binding arbitration is impractical for multiple parties, careful consideration must be given to utilizing non-binding mediation as an interim method of resolving disputes with the aid of an experienced mediator.

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9 GENERAL CONDITIONS

The General Conditions category encompasses a wide range of services and materials necessary to make a project run smoothly but outside the scope of any particular trade and therefore furnished directly by the construction manager or general contractor. These items range from sidewalk sheds and hoists to bottled water and sanitary facilities. It is important to know at the outset what items are included in General Conditions, for which a detailed matrix is often prepared as an exhibit to the contract documents. Project management, information technology and site labor generally fall within General Conditions. Legal services (compensated under the fee) are generally not included, while project accounting services may be the subject of negotiation. Insurance is often compensated separately from General Conditions.

Once the components of the General Conditions are known, it is critical to specify the basis on which they will be paid. Actual, demonstrated cost is the most transparent basis, although General Conditions are sometimes calculated as an agreed-upon percentage of the trade cost of the work or pursuant to agreed-upon rates. Thus, straight-time and overtime labor rates can be negotiated, although owners may be apprehensive that some profit may be calculated into those rates. Project administration personnel may be compensated at a rate based on their salary with a negotiated multiplier to account for such things as taxes and paid-time-off including vacation, sick days and holidays. In such instances, owners should be vigilant that they are not asked to fund paid-time-off separately during the course of the project.

Owners will endeavor to secure a cap on General Conditions at the outset of a project with respect to the entire scope of the work. That cap may be increased only in limited circumstances. For example, in the event of an excusable delay, actual increases in General Conditions costs demonstrably attributable to the delay may be compensated, sometimes after a threshold period of 30 days or longer. In that case, the increased General Conditions should serve as the sole remedy for such delay. General Conditions costs may also be increased due to changes in the scope of the work. If General Conditions are charged as a percentage of the trade cost of changed work, then owners may consider negotiating a threshold dollar amount of changes below which additional General Conditions will not be charged – a so-called “deadband.”

10 SUBCONTRACT ISSUES

Owners often rely blindly on general contractors or construction managers to enter into subcontracts with the trades, unaware of the particular provisions in the subcontracts. While ownership may believe it is protected by the contract with the general contractor or construction manager, it will be much better served by reviewing and verifying the subcontractor agreement and often by adding specific provisions. For example, an owner will want to verify subcontractors’ insurance limits and indemnity obligations, assuring that it is named an additional insured on the policy and the indemnity obligation, an obligation that needs to be broadly worded. The owner should confirm that in the event of termination of the general contractor or construction manager, the contract with the trade is assignable to the owner or the owner’s new general contractor or construction manager. In jurisdictions such as New York where it might be difficult (or impossible) for an owner to commence an action directly against the general contractor’s or construction manager’s subcontractor, a provision might be considered pursuant to which an owner may be a third-party beneficiary of the general contractor/construction manager – subcontractor agreement, thereby enabling the owner to bring an action directly against the subcontractor in the event of a default or breach by that subcontractor. Careful consideration of the general contractor/construction manager – subcontractor agreement can only benefit an owner. It is a prudent exercise best undertaken prior to finalizing the contract with the general contractor or construction manager.

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ABOUT ZETLIN & DE CHIARA LLP

Zetlin & De Chiara LLP provides sophisticated, innovative legal representation and business counsel to real estate owners, commercial and residential developers, architects and engineers on all aspects of complex construction projects and disputes. The firm's attorneys bring a rare blend of expertise to their work including in-house construction counsel experience, LEED accreditation, and education in architecture and engineering. Zetlin & De Chiara has been involved with many iconic projects in the education, healthcare, hospitality, infrastructure, transportation, cultural, environmental and energy sectors.

Zetlin & De Chiara provides counsel throughout the construction planning, design and building process, from drafting and negotiating contracts to developing risk management strategies. Well-known for its courtroom prowess, the firm also represents clients in mediation and alternative dispute resolution. Zetlin & De Chiara represents domestic and international clients in high-stakes, bet-the-company matters. Many of the lawsuits in which the firm has been involved have concerned projects outside of the United States.

Zetlin & De Chiara also assists clients with business formation, licensing and corporate issues. Clients also seek the firm's guidance on the benefits and challenges of new technologies, innovative methodologies, alternative construction delivery methods and industry trends. Zetlin & De Chiara serves as general counsel to numerous design, construction and real estate professional associations.

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