AVOIDING KILLER CLAUSES IN DRAFTING CONTRACTS

1. Introduction

a. Constructing a difficult project is not enough these days

b. Contractors must deal with risks over which they have no control

i. Risks assigned to the contractor by contract

2. Contract definition

a. Contract is a binding agreement between 2 or more parties where consideration, usually cost plus a fee or lump sum bid amount, is given in exchange for certain performance guarantees.

b. In theory, a contract = a meeting of the minds.

i. Each party is in agreement as to their own and the other party's rights and responsibilities.

ii. Each party is in agreement as to all of the risks which the party has assumed.

3. Traditionally, contractual risk has been allocated to the party that has control over the risk.

a. E.g., the contractor has control over safety conditions and accepts responsibility for worker safety risks.

b. Today, the equitable approach to risk allocation has been ignored.

c. The contractor is contractually responsible for many risks over which it has little or no control.

d. Not unusual for a contract to unfairly allocate risk to the contractor for differing site conditions, delay, design deficiencies, and timely payment.

4. Inequitable Allocation of Risk

a. Contractor has no control over site conditions

i. Owner usually selects the site

b. Contracts usually contain a "no damage for delay" clause

i. Waives the contractor's rights to compensation regardless of the cause of delay.

ii. Owner can suspend work with the only adjustment to the contract being an extension of time.

c. Pay when paid clauses shift the risk of payment away from the owner or general contractor and down to the party performing the work.

5. Minimizing exposure to inequitable risk

a. Negotiate out killer contract clauses during contract review

i. Not possible for public works contract

(1) Some killer clauses are not enforceable as a matter of law or public policy

(a) Notice of claim period shorter than 90 days

6. Killer Contract Clauses

a. Notice requirements

i. Notices required for added work, delay or differing site conditions

(1) No notice, no valid claim

ii. Typical notice of claim requirement

(1) No claim is valid unless presented to the Contractor or Owner within 14 seconds or hours, or 2 days, etc., of the facts giving rise to the claim.

iii. University of Texas Systems

(1) For all claims, Contractor must submit a legal brief and gather all evidence

for the System's review within 10 days of the occurrence of facts giving rise to the claim or the claim is barred.

iv. Texas Civil Practice & Remedies Code

(1) Section 16.071

> (a) A contract stipulation that requires a claimant to give notice of a claim for damages as a condition precedent to the right to sue on the contract is not valid unless the stipulation is reasonable. A stipulation that requires notification within less than 90 days is void.
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> * * *
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> (d) This section applies to a contract between a federal prime contractor and a subcontractor, except that the notice period stipulated in the subcontract may be for a period not less than the period stipulated in the prime contract, minus seven days.

b. Differing site conditions

i. Differing site conditions are essentially conditions which differ in some degree from that which the parties expected.

(1) Parties expected sand and found rock

(2) Contractors have to add contingencies to bid to cover unexpected

(3) May be managed with a differing site conditions clause

(a) Contractor may delete the contingency amounts

(b) Contractor is only paid extra when unusual conditions are actually encountered.

(c) Good reasons for owner not to have DSC clause

(i) Owner does not build often enough to generate sufficient savings on a number of projects to offset

(ii) Owner who rarely constructs may be more concerned with increased cost of this project

(iii) Owner may have limited funds

(iv) Placing the risk of DSC on contractor provides incentive for contractor to minimize the financial effect of the discovered conditions

1) Contractor may see DSC as an opportunity to rape and pillage

(v) In a competitive market, empirical evidence indicates that contractors do not quantify the risk of DSC and may undervalue the risk

1) Eliminating the DSC may cost the owner little or nothing.

ii. Federal Government contracts contain standard DSC clause

(1) Takes precedence over conflicting language in contract

(2) Often included in federally funded contracts

iii. 2 types of DSC

(1) Type I

(a) Conditions differ materially from those indicated in the contract

(i) Representation of conditions need not be explicit

(ii) Contract documents must provide sufficient grounds to justify a bidder's expectation of latent conditions materially different from those actually encountered.

(2) Type II

(a) Unusual physical conditions differing materially from those ordinarily encountered in the work of the character at issue in the contract.

iv. With DSC clause, contractor still required to make at least a minimal investigation of the site

(1) Today's contracts require contractors to investigate site conditions, labor and utility availability, normal weather conditions, and type of equipment and facilities to perform the work.

(2) AIA A201 directs contractor to verify field conditions and measurements before commencing construction.

(3) If contract has a site inspection clause, and contractor unreasonably fails to inspect the site, contractor may be foreclosed from invoking the DSC

(a) If contractor makes a reasonable inspection of the site, yet fails to discover the DSC, the 2 clauses may conflict.

(4) Courts have resolved the conflict by applying a standard of reasonableness

(a) Contractor is not required to discover hidden conditions, which do not surface through a reasonable investigation.

(b) Contractor is not required to perform burdensome, extensive, or detailed tests or analyses.

(c) If the investigation is constrained by weather conditions, site conditions, or time, the contractor will be only required to perform an investigation that is reasonable

under the circumstances.

v. Disclaimers to DSC

(1) Typically state that info provided by the owner is provided solely for informational purposes and is not warranted or guaranteed by the owner.

(a) Purpose is to render unreasonable any reliance by contractor on owner-provided info which characterizes the condition of the property

(2) Courts have reached a variety of results on the effect of disclaimers

(a) Disclaimer effectively precluded contractor from arguing that reliance on owner provided info was reasonable.

(i) To be effective, disclaimer should provide that info was not warranted, and that contractor has not relied on the info

(ii) Combine with site inspection clause

(b) Brown-McKee, Inc. v. Western Beep, Inc., 538 SW2d 840 (TexCivApp — Amarillo 1976, writ ref'd nre): contractor had no notice of hard rock formation immediately below ground surface. Contractor's DSC claim denied due to broad disclaimer of subsurface conditions in contract. Court held that with disclaimer, contractor would have to prove deception or bad faith on part of owner, or show that owner had withheld material info that it had a duty to disclose.

(c) Millgard Corp. v. McKee/Mays, 49 F.3d 1070 (5th Cir. 1995): contract disclaimed particular soil borings report. Altho contract had DSC clause, court held that subcontractor could not rely on soil borings report to support DSC claim since the report was

specifically disclaimed.

(3) Courts overlooking disclaimers — 3 categories

(a) Reliance was permissible because contractor performed reasonable investigation that confirmed or supported info received from owner.

(b) Reliance was justified because owner intended that contractor rely on info in preparing a bid.

(c) Reliance was justified because circumstances did not allow sufficient time for contractor to conduct an adequate independent investigation.

c. No damages for delay

i. Ordinarily, owner is responsible for delays owner causes to contractor.

(1) E.g., owner may be responsible for obtaining rights of way on project

(a) If owner does not obtain r/w timely and delays work, owner can be liable for contractor's extra costs.

(2) **Anderson Development Corp. v. Coastal States Gathering Co.,** 543 SW2d 402 (TexCivApp — Houston [14th Dist.] 1976, writ ref'd nre): Owner was to obtain r/w. Parties had planned to do the work in the dry summer months. Because owner failed to obtain r/w before summer, contractor had to perform work in fall in between rain storms. As result, the work was performed sporadically as weather permitted and cost significantly more. Contractor did not complete work until three months after the scheduled completion date. Contractor successfully sued to recover its extra costs.

(3) **Board of Regents of the University of Texas v. S&G Construction Co.,**

529 SW2d 90 (TexCivApp — Austin 1975, writ ref'd nre): Owner failed to provide proper plans and specs. Work was delayed while the job was redesigned on a daily basis. Contractor incurred almost $900,000 in extra costs as result of massive number of changes. Contractor successfully sued to recover the extra money. Court reasoned that owner had caused the delays and increased the costs, and should pay for them.

ii. With no damages for delay clause, owner would not be responsible

(1) E.g., "Owner shall not be liable to Contractor for delays of any kind or nature in the progress or completion of the work on the Project. Contractor's remedy for any delay whatsoever shall be an equitable adjustment of contract time."

(a) Clause need not be conspicuous to be valid

(2) **City of Houston v. RF Ball Construction Co.,** 570 SW2d 75 (TexCivApp — Houston [14th Dist.] 1978, writ ref'd nre): Contractor received several hundred change orders and almost 900 design clarifications radically altering the plans and specs for a project. The large number of changes was later held not to be within the contemplation of the parties when the project began. As result of all the changes, contractor incurred $3 million in extra cost not including the direct cost of performing all the extra work. Contractor sued to recover the indirect costs of delay, disruption, general hindrance, and inefficiency. Contract contained a variation of the no damages for delay clause, which the court held to bar recovery for indirect costs for changes and modifications.

iii. Exceptions:

(1) Will not be enforced if the delays that occurred were not contemplated

when the contract was signed.

(2) Will not be enforced if delays were caused by owner's active interference, bad faith, or intentional misconduct.

(3) If the delay has extended for such an unreasonable length of time that the party delayed would have been justified in abandoning the contract.

(4) If the owner materially misrepresents site conditions or conceals material site conditions info, the owner may be liable for delays the contractor sustains.

(a) Whether an exception exists is a jury question

iv. If the contract contains a "no damage for delay" clause, then the contractor should focus its claim on the costs resulting from the added time required to accomplish a change.

v. The changes clause can be a contractor's best friend.

vi. The delay clause should only be invoked for non-compensable delays, such as strikes.

vii. The contractor should try not to use the word "delay" — use changes instead.

viii. Job costs segregated by account coding for the specific charge casing extra time are indispensable to proving actual damage.

d. Pay when paid vs. Pay if paid

i. Pay when paid

(1) Contractor will pay the subcontractor within 10 days from the date that contractor is paid by the owner.

(a) Does not pass risk of non-payment

(b) Only delays payment for a reasonable time

ii. Pay if paid

(1) Contractor will pay the subcontractor if and only if the contractor is paid first by the owner for subcontractor's work, payment by the owner being an express condition precedent to contractor's obligation to pay subcontractor. Subcontractor assumes the risk that of non-payment by the owner, and looks to the owner for the source of funds for the project.

(a) Passes the risk of non-payment on to the subcontractor

e. Changes Clause

i. To determine if there is a change, parties must determine the scope of work

(1) Scope of work should be set out in P&S, contract or attachment to contract

(2) Defining scope of work properly means listing what contractor is to do and what contractor is not to do

(a) If contractor is to install a dishwasher, is contractor also to furnish the dishwasher?

(3) Problems arise when contract defines the work as not only the work apparent on the P&S, but also what is reasonably implied for the work.

(a) If plans show that contractor is to install a dishwasher, owner can argue that it may be reasonably implied that contractor is also to furnish the dishwasher

(b) If plans show that contractor is to install dishwasher, is contractor also required to plumb and electrify the dishwasher in a place where there was no plumbing or electricity?

ii. Requests for clarification or requests for information

(1) Pre bid and during contract to resolve questions of scope

iii. Constructive changes

(1) "Constructive" is a legal word of art

(2) "Constructive" means that you must get ready to pretend that something is when it really isn't.

(3) Constructive change to contract is a change that only one side recognizes

(a) E.g., owner delays progress by not obtaining r/w. W/o r/w, contractor cannot work on a particular site. Unless owner extends contract time, contractor will face doing same amount of work but in less actual working days. If owner denies contractor's requests for time extension, owner has constructively shortened the contract time. Contractor would argue that owner has constructively accelerated the contractor.

iv. Pricing of changes

(1) Owner may limit changes to actual cost, or actual cost plus 10%

v. Early resolution of problems is ultimately the most cost-effective approach to contractual risk management.

vi. The best way to resolve issues early is to maintain good site records such as daily logs, time sheets, cost reports, schedules, etc., and to keep lines of communication open between the parties and internal management.

vii. Contractor needs to train its personnel to observe and collect data to track changes.

viii. Contractor needs to track the costs by cost code for changes.

f. Indemnity

i. Indemnity for one's own negligence must be expressly stated in the contract

(1) **Ethyl Corp. v. Daniel Construction Co.,** 725 SW2d 705 (Tex. 1987): Unless owner writes the indemnity provision in clear black and white language, contractor will not have to indemnify the owner for the owner's own negligence.

(2) Standard AIA language like ¶ 3.18 in A201 General Conditions is not sufficient to satisfy express negligence doctrine

ii. **AIA A201 GENERAL CONDITIONS INDEMNITY (1987)**

> 3.18.1 To the fullest extent permitted by law, the Contractor shall indemnify and hold harmless the Owner, Architect, Architect's consultants, and agents and employees of any of them, from and against claims, damages, losses and expenses, including but not limited to attorneys' fees, arising out of or resulting from performance of the Work, provided that such claim, damage, loss or expense is attributable to bodily injury, sickness, disease or death, or to injury to or destruction of tangible property (other than the Work itself) including loss of use resulting therefrom, but only to the extent caused in whole or in part by negligent acts or omissions of the Contractor, a Subcontractor, anyone directly or indirectly employed by them or anyone for whose acts they may be liable, regardless of whether or not such claim, damage, loss or expense is caused in part by a party indemnified hereunder. Such obligation shall not be construed to negate, abridge, or reduce other rights or obligations of indemnity which would otherwise exist as to a party or person described in this Paragraph 3.18.

iii. In ***Atlantic Richfield Co. v. Petroleum Personnel, Inc.***, 768 S.W.2d 724 (Tex. 1989), the Texas Supreme Court upheld the following language as satisfying the express negligence doctrine:

> Contractor [PPI] agrees to hold harmless and unconditionally indemnify COMPANY [ARCO] against and for all liability, cost, expenses, claims and damages which [ARCO] may at any time suffer or sustain or become liable for any reason of any accidents, damages or injuries either to the persons or property or both, of [PPI], or

> of the workmen of either party, or of any other parties, or to the property of [ARCO], in any matter arising from the work performed hereunder, including but not limited to any negligent act or omission of [ARCO], its officers, agents or employees.

iv. ***Dresser Industries v. Page Petroleum Co.*****,** 853 S.W.2d 505 (Tex. 1993), the Supreme Court stressed that an indemnity agreement must be conspicuous enough to provide "fair notice" of its term. To provide "fair notice," an indemnity provision must be apparent to a reasonable person. A notation on the face of the contract which draws attention to the provision, such as all capital letters or contrasting type or color is sufficient.

v. ***Fisk Electric Co. v. Constructors & Associates*****,** 888 S.W.2d 813 (Tex. 1994), the court held that if an indemnity provision does not initially satisfy the express negligence doctrine, an indemnitor has no duty to indemnify another for their attorney's fees even if the other were later found not to be negligent.

vi. Texas Civil Practice & Remedies Code §130.002 invalidates a provision which attempts to have a contractor indemnify an architect or engineer for liability and damage for personal injury, property damage, and expenses arising from the design professional's negligence in preparing plans or specifications or in contract administration.

vii. If the owner has required the contractor to indemnify the owner for the owner's own negligence, the contractor should secure sufficient liability insurance to cover the risk. If the contractor cannot obtain such insurance, the contractor should seriously consider qualifying its bid or not bidding at all. A Texas court has held that an agreement to cover a party's negligence also covers the party's gross negligence, which could result in punitive damage award in millions of dollars.

g. Disclaimers of Liability

i. Disclaimer for defects in P&S

ii. Disclaimer for availability of materials

iii. Disclaimer for extra costs that contractor may incur due to variety of reasons

(1) E.g., contractor responsible for any changes in regulatory requirements for project during the construction of the project.

iv. Disclaimer for responsibility for special, incidental, indirect and consequential damages arising from breach of contract

(1) E.g., owner agrees to pay contractor $1 million for project. Contractor then buys an expensive machine for the project. Owner does not pay on schedule. W/o payment, contractor cannot make payment on machine and bank repossess it. Loss of machine is a special or consequential damage. With disclaimer, owner not responsible.

h. Limitations of liability

i. Assumption of risk should have a value

(1) To limit risk, party may buy insurance, cost of insurance = value of risk

ii. Liability limited to amount of compensation

(1) Cap liability to set amount or a percentage of some amount.

(a) E.g., liability limited to contractor's fee for project

(b) Allows contractor to quantify risk of liability to owner and to remove a contingency for the liability from its price.

(c) In theory, owner receives benefit of lower price in return for a

definable value of liability for contractor.

iii. Liability limited to insurance proceeds

(1) Risk has a cost

(2) Purchasing insurance allocates cost and defines amount of risk.

(3) Owner may receive a lower price as contractor deletes a contingency for risk now covered by insurance.

(a) Owner may request more insurance

iv. Liability limited to a set amount

(1) Liability limited to set amount, which may be more or less than contractor's fee.

(a) E.g., Contractor's liability limited to $10,000 or some other agreeable figure.

v. Limitation of contractor's liability to subkr to amount paid by owner

vi. Liability on a comparative negligence basis

(1) Limitation of liability to % fault that one party bears for the problem.

(a) E.g., contractor may limit liability to owner to the percentage share that contractor's negligence or fault bears to the total negligence of the owner, other contractors, the A/E, and all other negligent parties.

(b) Reduces the owner's expectations of recovery

(i) May lead to earlier resolution or settlement of dispute

i. Incorporation by reference

i. Incorporates by reference many items or documents not attached to the contract

(1) Incorporated documents fully become a part of contract

(2) Incorporated documents may contain onerous provisions

(3) Difficulty in obtaining some of incorporated documents

(a) Document problems in obtaining incorporated materials

(4) Contrary / inconsistent provisions in incorporated documents

ii. Subjects subcontractors to all obligations contractor owes to owner in general contract

(1) Subcontractor should limit obligations to own scope of work

(2) Often does not require GC to assume toward subkr all of owner's obligations to contractor.

j. Liquidated damages

i. Pre-determined damages for late completion

(1) When starts

(a) Reflects extensions of time?

(2) When ceases

(a) Substantial completion or final acceptance

(3) Calendar vs. working day

k. Obligation of continuing performance

i. Requires contractor to continue work despite dispute with owner

ii. Contractor may have to keep working despite not being paid

l. Right to stop work

i. Right exists unless prohibited in contract

m. Termination for convenience

i. Allows owner to terminate contract for owner's convenience

(1) Limits owner's liability to specified amount

n. Final Payment as waiver of all claims

i. Contractor's acceptance of final payment may waive all claims against owner

(1) E.g., "The contractor's acceptance of final payment constitutes a full and complete release and discharge of Owner for any and all claims relating to the Project."

o. Venue

i. Venue for all suits may be in a foreign or inconvenient state or location.

p. Attorney's fees

i. Texas law provides for attorney's fees for recovery of money under contract

(1) Expert costs not included

ii. Clause to permit reimbursement of expert costs and internal management

q. Decision on claims is final and binding on claimant

i. Decision by owner or A/E is final and binding on claimant

r. Lien waiver before construction starts

7. Practical tools to manage onerous contract clauses

a. Read the contract

i. Find ambiguous words like "may"

(1) E.g., if contract says that "owner may pay for materials stored offsite"

(a) Owner is not required to pay, the owner can if the owner so chooses pay for materials stored offsite.

b. "Reasonable" approach

i. Insert the word "reasonable" wherever the other party is being heavy handed

(1) Tough for other side not to be reasonable

c. Goose and gander

i. What's sauce for the goose is sauce for the gander

ii. Use for other party's assertion of some right

(1) E.g., other party demands attorney's fees

d. Superintendent's daily log

i. List all the categories or items the superintendent should consider in filling out log

(1) Listing of added work or delay, start date, resources impacted, and resolution date

ii. Circulate logs daily to make sure the logs are being correctly filled out

e. Check legal enforceability

i. Some owners place contract clauses in contracts knowing that they are not enforceable

f. Use disputes review boards

i. DRB is an administrative response to change order problem solving when the parties cannot agree among themselves.

ii. DRB decision can be binding or advisory.

iii. DRB is a low cost, fast way to prevent claims.

iv. DRB can be added to the contract after bids are submitted.