Breaking Ground

THE MAGAZINE OF THE MASTER BUILDERS' ASSOCIATION OF WESTERN PENNSYLVANIA

MAY/JUNE 2024

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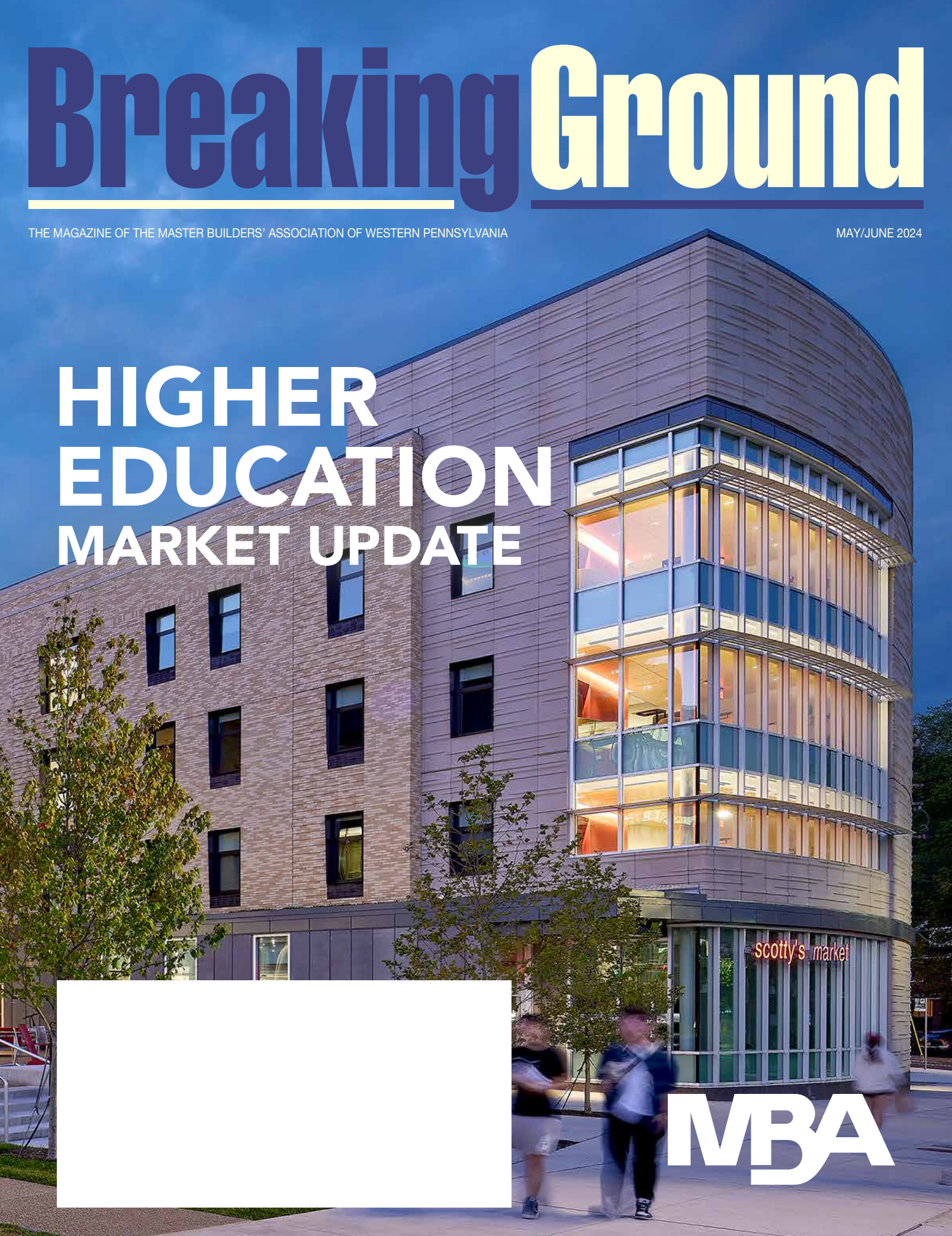

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LEGAL PERSPECTIVE

A PRACTICAL GUIDE TO DRAFTING CONSTRUCTION CONTRACTS: ESSENTIAL TIPS AND KEY CLAUSES

BY GERARD HORNBY AND DAVID MEREDITH

Contract drafting and agreement is a push-and-pull process. Everyone wants to pass down risk, limit risk, or blame someone else. A major part of the negotiated contract is risk control. The following six clauses should always be negotiated as required to control risk:

Pay If Paid/Pay When Paid Clauses shift the risk of non-payment to subcontractors or suppliers even though they may not have control over the circumstances that lead to non-payment. These are helpful for owners and general contractors while limiting the rights of subcontractors and suppliers.

Subcontractors and suppliers should do their best to avoid pay if paid and pay when paid clauses. At a minimum, subcontractors and suppliers should attempt to negotiate language that allows the contractor to withhold payment only if the owner's withholding of payment from the contractor is related to the performance of the subcontractor or supplier.

Indemnity Clauses provide that one party (the indemnifying party) will compensate the other party (the indemnified party) for any losses or damages that may arise from a particular event or circumstance. Many times, these clauses will provide that a contractor or subcontractor will indemnify the owner and design professionals from everything and anything that could go wrong on the project, from personal injury to property damage to environmental issues to economic damages.

As a general contractor, subcontractor, or supplier, you should only agree to indemnify parties when you caused or participated in the cause of the loss. This means only indemnify to the percentile extent your conduct was the proximate cause of the loss and limit your indemnification obligations to property damage and/or personal injury. As an owner, do not agree to language providing that an indemnifying party is only liable in the event of "sole" negligence.

Liquidated Damages provisions specify a predetermined amount of money that must be paid as damages if one party fails to meet certain contractual requirements. These clauses can provide for damages for late completion at the end of the job, or on milestones, or even for the failure of the completed project to meet specified performance criteria.

A well-drafted clause eliminates the optional nature of the clause, specifies the rationale for liquidating damages, identifies the types of losses to be liquidated (and not to be liquidated), and clarifies the events that will (and will not) trigger the clause. This can significantly reduce the types of litigation that commonly attend liquidated damages clauses. As an owner that is seeking to include a liquidated damages provision, have the engineer or architect generate a memorandum indicating how the liquidated damages were calculated. Consider also including language indicating that damages will be difficult to ascertain and that the liquidated damages are a fair and reasonable estimate of likely damages. As a contractor negotiating a liquidated damages provision, provide that liquidated damages are the exclusive damages recoverable in the event of a delay or performance issue. Another option is to negotiate a cap on all damages based on a percentage of the contract's value.

No Damages for Delay Clauses essentially provide that, if there is a delay not caused by you, you get more time, but not more money. A contractor negotiating a no damages for delay provision should seek to limit application of the provision to specifically contemplated events of delay, and also negotiate to provide for some objective means to calculate damages based on a reasonable per diem or percentage that ties into the original bid estimated costs for field and home office overhead. Negotiate to limit your right to recover to direct, provable costs, such as project supervision, jobsite equipment, and other project specific costs rather than no damages at all. As an owner, consider avoiding overly broad clauses, as they could lead to inflated initial pricing, excess contingency, claims for additional costs outside of delay, or a contractor default. If the owner actively interferes with the contractor's ability to perform its contractual duties, these clauses can be challenged as unenforceable.

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Incorporation by Reference/Flow Down Clauses in a subcontract incorporate the general contract by reference

and bind the subcontractor to the general contractor to the same extent the general contractor is bound to the owner. Subcontractors often take pains to negotiate changes to the subcontract, but then ignore the fact that all those contractual "gains" may well be trumped by the fact that the terms of the prime contract— equally as onerous and one-sided—still govern because of this quiet, silent rogue.

As a contractor or subcontractor, at a minimum, make sure you have everything you are agreeing to by reference. Do you have all the documents incorporated by reference? What do the documents say? How do they affect the risk? If possible, negotiate that the terms of your contract take precedence over whatever is being referenced OR negotiate a reciprocal flow down provision where the general contractor assumes to the subcontractor the obligations that the owner owes to the general contractor. From the perspective of the owner, collaborate and ensure that all required documents are easily accessible to downstream entities.

Material Escalation Clauses are typically used where there is a lump sum/fixed fee or guaranteed maximum price contract, especially where the duration of a construction project is long and complex, so that there can be an adjustment to the price to be paid by the owner if there are sharp increases in the price of materials or labor.

There are several key factors to consider when negotiating a material escalation clause. The provisions generally require that the parties must identify the materials that are anticipated to have price fluctuations during the course of construction. After identification, parties will agree to the "baseline price" for the materials. Material escalation clauses can be "cost-based" or "index-based." Index-based clauses are linked to published material cost indexes such as the U.S. Bureau of Labor Statistics. There may also be limits as to the maximum adjustment amount, such as a 10 percent increase limit. Contractors may include language intended to limit their liability for delays in the delivery of materials.

The bottom line is that typical risk avoidance techniques and unfavorable contract terms are here to stay. However, if recognized and dealt with during the negotiation of the contract, these terms—and any potential risk exposure—can and should be managed. BG

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