Understanding Contract Law

A Minority Perspective

An electronic handbook
compiled and edited by
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©January 2015

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Table of Contents

What is a Contract?

Contracts are agreements that the law will enforce. Contracts are individual, or private, rights and duties created by oral or written agreement and consent of the parties. Contracts may include obligations imposed by law even if the parties are not aware of those obligations.

United States contract law covers obligations established by agreement (express or implied) between private parties. Generally, contract law in transactions involving the sale of goods has become highly standardized nationwide as a result of the widespread adoption of the Uniform Commercial Code. However, there is still significant diversity in the interpretation of other kinds of contracts, depending upon the extent to which a given state has codified its common law of contracts or adopted portions of the Restatement (Second) of Contracts.

How to Approach Contract Law?

Contract law follows the dictates of common sense and fairness. After looking at all the facts and circumstances, you should answer the following questions:

1. Was there an agreement?
2. What did each party commit to do?
3. Did either party – or both – fail to do what he or she promised?
4. If yes, how do you measure the cost to the non-breaching party?

The usual objective of remedying contract claims is to put the parties in the position they would have occupied if the contract had not been breached.

Different Types of Contracts

Express Contract: The promises are communicated by language, either oral or written. Example: John promises to paint Dan's car in return for Dan's promise to pay him $100.

Implied Contract: The conduct of the parties indicates that they consented to be bound. Example: Toni fills her car with gas at Tina's gas station. There is a contract for the purchase and sale of gas.

Unilateral Contract: A person accepts an offer by performing a requested act. The terms of the offer must clearly indicate that an act is required for acceptance. Example: John tells Dan that he will pay Dan $100 if Dan paints his car, and that Dan should show acceptance of the offer by the act of painting the car. Dan accepts by painting the car.

Bilateral Contract: A person accepts an offer by promising to do the requested act. Example: Red Company offers to buy 100 widgets from Green Company for $100. Green Company promises to deliver the 100 widgets to Red Company.

The Elements of a Contract

1. Offer and Acceptance (often called a meeting of the minds)
2. Consideration (the value exchanged between the parties)
3. and Mutuality of Obligation (one cannot be required to give substantially more than the other)
4. Some also consider capacity, or the legal competence to enter into a contract, an element of its formation.

Remedies

Contracts usually have two primary forms of recovery: **damages**, or the money equivalent to the value the party would have received from the contract had there been no breach, and **specific performance**, or the requirement that the party must carry out its obligations under the agreement.

Both of these remedies award the non-breaching party with the lost benefit of the bargain or the expectation damages.

The Importance of Contract Law

Our society depends upon free exchange in the marketplace at every level. Contract law makes this possible. Exchanges in the marketplace always depend upon voluntary agreements between individuals or other "legal persons". Such voluntary agreements could never work without contract law.

Contract law serves to make these agreements "enforceable", which usually means that it allows one party to a contract to obtain money damages from the other party upon showing that the latter stands in breach. Without contract law, these voluntary agreements would instantly become impractical and unworkable.

Construction Contract Terms

A. Scope of Work/Performance Duties

1. Definition – A critical contract term -- scope of work -- is often overlooked. Contractors usually trust their estimating teams to fairly and adequately estimate the scope of work shown on the Owner's drawings. However, later (and vehement) disagreements about the Contractor's expectations for quality, completeness of design documents and nature/scope of duties are not uncommon.

2. Explanation - Subjects not adequately evaluated during negotiation of contract terms often include "gaps" in scope of work, adequacy and completeness of design documents, coordination responsibility during construction, and responsibility for correcting incomplete/deficient designs created by the Owner's design professionals. These problems are amplified in complex, fast track or design-build projects that often commence with incomplete design/performance specifications and by "design creep" (i.e., an Owner/designer attempts to abdicate design responsibility to the Contractor during construction).

3. Negotiation Strategies – Will the Owner expressly warrant that the design/construction documents are complete, fully coordinated, without defects, and ready for construction? If yes, include this express warranty in the contract for Contractor protection. If no, this unwillingness is a red flag. Alternatively, try to get the Owner to warrant the adequacy and completeness of all of the design with some minor exceptions.

B. Indemnification

1. Definition - Indemnification means that one contractual party agrees to assume responsibility for certain judgments resulting from third-party claims against the other party. One example is the indemnity clause from the AIA A201-2007 (General Conditions), Paragraph 3.18.1, which states in part that "the Contractor shall indemnify and hold harmless the Owner…from and against claims, damages, losses and expenses…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), but only to the extent caused by the 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."

Under 3.18.1, if a subcontractor's employee is injured because of actions or omissions of the Contractor, the Contractor must indemnify and "hold harmless" the Owner against resulting claims. In addition, the Contractor may be asked to indemnify the Owner against claims for property damage, IP infringement, liens and hazardous materials. Contractors are also frequently required by Owners to "flow down" such provisions in subcontracts.

2. Explanation – While the Contractor ideally wants to "flow down" the indemnity obligation/risk to subcontractors, that strategy does not always provide protection. Because multiple subcontractors may be working in the same area, it can be difficult to assign degrees of fault for a given act of negligence.

As examples, New Jersey law (N.J.S.A. § 2A:40A-1) prohibits a solely negligent Owner from seeking indemnification from a Contractor for property damage or

injury. However, a partially negligent Owner may seek indemnification from the Contractor if other parties have contributory negligence. New York law (NY Gen.Oblig. § 5-322.1) similarly prevents an Owner from seeking indemnification from a Contractor for property damage or injury to the extent such damage is caused by the Owner itself.

3.Negotiation Strategies – Whenever possible, the Contractor should strive to limit its indemnity obligations to items for which it can obtain insurance. Another possible negotiation strategy is to seek mutual indemnification. If a claim involves design, the Contractor, by obtaining a mutual indemnification provision, retains the ability to recover from the Owner (who bears responsibility for its design).

Because state laws regarding the enforceability of indemnification clauses differ, counsel for Contractors should confirm the enforceability of indemnification clauses in the relevant jurisdictions.

C. Warranties and Bonds

1. Definition – AIA A201-2007, Paragraph 3.5.1 (Warranty) states in part that "the Contractor warrants to the Owner and Architect that materials and equipment furnished under the Contract will be of good quality and new unless otherwise required as permitted by the Contract Documents, that the Work will be free from defects not inherent in the quality required or permitted, and that the Work will conform to the requirements of the Contract Documents . . . the Contractor's warranty excludes remedy for damage or defect caused by abuse, modifications not executed by the Contractor, improper or insufficient maintenance, improper operations, or normal wear and tear and normal usage."

This general warranty commences upon the date of Substantial Completion and continues through the applicable statute of limitations or repose (usually covering the shorter of the two) and may also include specific manufacturer's warranties for equipment, systems, and materials. A requirement that maintenance bonds be issued for some or all of the work for the duration of the warranty period may also be included. Systems, material and equipment warranties will typically commence upon the owner's use of the particular system, equipment, or product (especially in HVAC equipment warranties).

2. Explanation - Warranties allow the Contractor to "flow down" Owner complaints to Subcontractors and Suppliers. However, due to various warranty limitations, the Contractor may not receive complete protection from a warranty alone. The Contractor must guard against failures in coverage that may result in default and non-payment by the Owner. The Contractor's workmanship warranty and maintenance bond, if required, may expand responsibilities and, typically, will not include warranty disclaimers such as those provided by manufacturers.

Awareness of warranty terms is important since, after a product warranty expires, the Contractor's workmanship warranty may be called upon instead.

3. Negotiation Strategies - The Contractor should attempt to establish definite commencement/end dates for all warranties. Negotiate for a general warranty on materials/labor of one year. The Contractor should also consider whether to characterize repairs as "punch list" or "warranty" work. If the Contractor performs punch list work prior to final acceptance, the Contractor may still have lien rights as to retainage withheld by the Owner. On the other hand, if the Contractor characterizes the same repair activity as "warranty" work, the last date of such work cannot be used to establish the last day of work necessary for a lien claim. In the situation described above, it is against the Contractor's best interests to describe repairs as warranty work rather than punch list work. Finally, the Contractor should consider obtaining equal warranties from its Subcontractors (another example of "flow down") and requiring larger Subcontractors performing substantial amounts of work to provide their own maintenance bonds.

D. Project Changes and Change Orders

1. Definition – Construction projects often begin with the Owner providing plans and specifications, followed by the Contractor agreeing to build to them for a stated price. Equally often, during the course of a project 1) plans and specifications prove to be inconsistent; 2) the Owner or the Owner's design team wants to add/delete certain items; and 3) existing conditions prove different than expected. Suddenly, the project being built is different from the one the Contractor bid upon.

The contract documents typically address these situations through Change Order provisions that identify procedures for requesting and issuing Change Orders, timing, notifications, and dealing with the common situation of disagreement between the Contractor and Owner as to value of the changed work.

2. Explanation - The Contractor must assure its ability to recognize a change, promptly respond to change requests, and analyze the full impact of a change. Unfortunately, many standard form contracts do not provide for Change Orders initiated by the Contractor.

The Contractor may benefit from inclusion in the contract of a change order allowance as discussed below. Otherwise, the Contractor may be compelled to incorporate a value for change order risk into its contract price that could result in an unfavorable bargaining position or the Contractor losing the contract.

3. Negotiation Strategies - The Contractor should negotiate the valuation of change orders so overhead and profit are recoverable as well as labor materials

and equipment. Of course, an Owner has a legitimate interest in receiving reasonably timely notification of a Contractor's contentions concerning changes or delays for purposes of monitoring the project, budget, and schedule. However, the Contractor should insure that the prime contract contains sufficient time to provide notices and documentation, consistent with contractor's staffing. The authors recommend no less than ten business days to provide initial notice and a more extended period for analysis and submission of additional documentation regarding the full impact of a given change. Because one change can impact the time and/or costs for an entire series of critical path events, the Contractor may also want to reserve its rights to submit a cumulative impact analysis in such situations.

In the event of disagreement with the Owner regarding Change Order valuation, AIA A201-2007, Paragraph 7.3.9, provides for the Architect to determine the amount of payment to the Contractor pending resolution of the dispute. The Contractor should negotiate for modification of this provision to include, at minimum, payment of the Contractor's actual costs to perform the changed work during the dispute.

E. Delays

1. Definition - Standard form agreements allow Contractors to claim time extensions and/or damages when so-called "force majeure" delays occur, if the Contractor bears no responsibility for the delays. Force majeure delays, in addition to "acts of God," may include labor disputes, material shortages, government agency actions and delays caused by the Owner or Architect. Contractor delay damages, in addition to basic costs, may include price escalations, acceleration costs and extended home office/field office overhead and costs.

Of course, if the Contractor bears responsibility for project delays, the Owner will not approve additional time or money. Most agreements provide in such cases for Contractor acceleration of the work, at no cost to the Owner, to overcome Contractor-caused delays. Owners also often include "liquidated damage" provisions that provide for payment of a fixed daily sum to the Owner if the Contractor fails to timely achieve the contractual Substantial Completion date.

2. Explanation - AIA A201-2007, Paragraph 8.3, treats force majeure delay as grounds for a Contractor time extension claim but does not specifically address compensation. Owners often seize on this omission as justification to include "no-damage-for-delay" clauses in their customized contracts. Such clauses limit Contractor remedies for delay to non-compensable time extensions. Because this Owner position is arguably inequitable, no-damage-for-delay clauses have been the subject of numerous court decisions and statutes. As state laws vary

significantly regarding the applicability of no-damage-for-delay clauses to private construction projects, counsel for Contractors should confirm applicable laws if the project is in an unfamiliar jurisdiction.

3. Negotiation Strategies – The Contractor should strive in negotiations to include all possible non-Contractor-caused delays, including delays caused by the Owner's separate contractors, as compensable events. Amounts and types of compensation, rather than compensation or not, should be the focus.

If the Owner wants to include liquidated damages as protection against Contractor-caused delays, the Contractor may choose to appear cooperative to the Owner by agreeing to this provision but negotiating a set limit upon the maximum number of late days/dollars available to the Owner in such circumstances.

If the contract is of a "Cost-Plus" variety, with or without a Guaranteed Maximum Price, the Contractor should seek to include a "Construction Contingency" in the contract. The Construction Contingency is a percentage of the total value of the contract that is potentially dedicated to reimbursement of the Contractor for the costs of its mistakes (such as delays caused by its subcontractors).

Contractors often face huge risks from both performance-based issues and onerous terms / clauses in prime contracts. To assist in reducing these risks, Part 1 of this two part article (*Under Construction*, Vol. 15, No. 1) began a "Top Ten" list in which the authors briefly explain these provisions and identify potential negotiating points from the contractor's perspective. Part 2 similarly analyzes the following provisions: 1) termination and suspension; 2) insurance; 3) disputes, default and remedies; 4) securing performance; and 5) price and payment.

F. Suspension and Termination

Definition –A typical termination-for-cause clause may be invoked when a contractor: 1) persistently refuses or fails to supply enough properly skilled workers or proper materials; 2) fails to pay subcontractors; 3) persistently disregards laws, ordinances, rules, or regulations; or 4) substantially breaches the contract. The owner may also typically suspend or terminate the contract for the owner's own convenience.
Following a contractor's default, the owner may require the surety (if one exists) or another contractor to complete the work. A termination for cause following a default allows the owner to use the contract balance to pay for completion costs and seek damages associated with increased completion costs from the contractor.

Explanation - Upon a termination for convenience, the contractor can recover costs for all work performed and may also be entitled to recover certain "termination costs." Where the owner suspends the work, the contractor will be

prevented from declaring a termination and must remain prepared to return to the site to complete the work subject to the compensation and time extension provisions in the suspension clause. Suspension clauses can also include compensable or non-compensable time extensions.

Negotiation Strategies - The contractor should seek to protect its rights in the event of a termination for default or a wrongful termination by the owner. Since the contractor has very little control over the owner's ability to invoke a termination for convenience clause, the contractor should attempt to negotiate fair and reasonable compensation in the event of a termination for convenience. The contractor's goals in negotiations should include specific entitlement under the contract to demobilization costs, labor costs for manpower pending reassignment of projects for a reasonable period of time, costs associated with cancellation of orders for materials and equipment and some level of lost anticipated profits (since its overall work schedule and business can be dramatically changed by a termination for convenience).

The contractor should similarly negotiate to obtain costs associated with any suspensions (including remobilization costs), as well as price escalation provisions for labor and materials.

G. Insurance

Definition – Most contracts require comprehensive general liability coverage ("CGL"), automobile, and workers compensation coverage and may require proof of coverage for these items from some or all subcontractors. The owner typically provides, or at least pays for, all-risk insurance coverage during a project that protects against catastrophic events.

Explanation - The contractor must obtain insurance that meets the contract requirements both in coverage and amount to protect itself from claims that may arise during or after the project. The contractor should also factor insurance costs into the contract price, particularly where the insurance requirements exceed the contractor's normal coverages.
In design-build projects, CGL policies only cover "bodily injury" and "property damage." They do not cover the risk of exposure to the design builder for design errors and omissions. This gap in coverage can only be bridged by Professional Liability Coverage that covers the design builder against liability due to negligent errors and omissions in providing design services.

Negotiating Strategies - The contractor should confirm that its insurance coverage includes the work of subcontractors and require appropriate insurance from all major subcontractors. The contractor should also consider insurance against the default of its sub-contractors under the "Sub Guard" program.

The contractor should also negotiate to require 1) proof of errors and omissions coverage on the part of those performing the design services; 2) a copy of the owner's all risk insurance coverage; and 3) waivers of subrogation under the all risk insurance policy for the contractor and subcontractors. The contractor should also consider a "tail" for its insurance coverage that extends for a period of time beyond the completion and acceptance of the project.

H. Dispute, Default and Remedies

Definition - Default provisions define the events that constitute either a violation of contractual obligations or breach of contract. Default provisions also define the triggering events for ultimate termination capability. In most agreements, default events fall into specific categories as well as a catch-all category dealing with any other material breach of the contract provisions. Events constituting owner default are usually limited to the owner's stoppage of work without fault by the contractor, failure to provide assurance of owner's financial ability to pay, or failure to make payments as required under the contract. Standard default provisions typically include formal notice of default, an opportunity to cure, and define specific remedies in the absence of cure.

Explanation - Most construction contracts address default issues through contract language, terms and conditions, supplemental terms and conditions, and front-end documentation that define the responsibilities in great detail.

Negotiation Strategies - The contractor is best served by creating cure provisions that give it a reasonable opportunity to both respond to default notices and cure the circumstances giving rise to such notices. The contractor should consider a provision that allows it to protest a default event through an intermediate ADR process or some other dispute resolution procedure before the owner is entitled to withhold payment or terminate the contract.
The contractor should seek protection from an owner declaring the contractor in default while simultaneously refusing to pay the contractor, or an owner on a multiple prime project declaring a default as a result of the acts or omissions of other contractors.

Careful thought must also be given to dispute resolution provisions, including forum selection clauses, jury waivers, arbitration clauses, and/or any other form of dispute resolution clauses.

I. Securing the Parties' Performance

Definition - The owner and the general contractor share an interest in requiring one another to provide adequate assurances of contractual performance. Traditionally, the owner's most common method of doing so is

requiring the contractor to post payment and performance bonds. The contractor traditionally assures itself before the time of the contract that owner is adequately capitalized for the project. The contractor may also rely upon mechanics liens to secure payment during performance of a non-public project.

Explanation - The contractor nearly always finds itself lending money to the owner through its performance prior to payment. How much credit the contractor extends to the owner varies with the contract terms, including such key terms as the timing of payment and the amount of retainage. The extent of credit can be unexpectedly expanded with changes for which the owner might refuse to pay.
The contractor's rights to mechanics liens are governed by statute and vary from state to state. For non-public projects, the proper exercise of a mechanics lien can tie up the owner's financing. The owner's lender will often insist that the owner promptly remove liens, thereby providing the contractor with leverage for payment of sums due. State statutes typically penalize fraudulent claims for mechanics lien.
For publicly funded projects, project staff training regarding the compliance requirements of federal or state false claims acts is strongly encouraged.

Negotiating Strategies - The contractor should resist an owner's attempt to require any pre-payment waiver of mechanics liens rights.
In projects involving a letter of credit in lieu of a performance bond, contractors should insist upon reasonable limitations upon the owner's ability to draw down the letter of credit. Without any limitation, the owner can usually easily draw down and obtain access to the funds represented by a letter of credit during the pendency of the dispute between the owner and the contractor. To protect against potential overreaching in this regard, it is wise to require appropriate conditions precedent to drawing down a letter of credit, such as certification by an independent party that grounds or good cause exists to do so, or ideally, a judgment or award at the conclusion of the agreed upon dispute resolution process. At a minimum, the contractor should insist upon broad notice and cure rights as conditions precedent to the owner's right to call the letter of credit.

J. Price and Payment Provisions

Definition - Common payment provisions require a schedule of values assigning a line item value for identified items of work. As the project progresses, the contractor certifies that a given percentage of the work is completed during each month and will seek payment therefor. Applications for payment typically identify each schedule of value item, the percentage completed, and the value of that percentage based upon the line item schedule of values. It will then provide a cumulative tally of the total contract, change orders, what has been paid, what has been retained, and the current payment due. The owner is then responsible to

make that payment less the assigned amount of retainage unless one or more of an identified list of withholding events have occurred.

Explanation - Three variables exist in the standard payment application process: the schedule of values, the amount of retainage, and the withholding events.
The contractor's interest lies in maintaining retainage at a level intended to assure that adequate funds exist at the end of the project for completion of punchlist and other closeout work, but not such a large amount of retainage that it creates financial hardship. The owner's withholding ability can create problems if withholding events are poorly defined.

The contractor must also concern itself with the timing of payments and any conditions precedent to the owner's obligation to pay. Where the owner's obligation is triggered by the architect's certification that the work has been completed in a satisfactory fashion, courts have typically held that an owner's withholding of payment constitutes a fundamental breach of the contract and the contractor may elect to 1) cease performance and recover in quantum meruit for labor and material costs or 2) continue performance under the contract and bring an action for contract damages following substantial performance. Where an owner attempts to withhold a progress payment by asserting that a contractor's work is defective, the contractor should be aware that unless the alleged defective work constitutes a large proportion of the work completed to date, the owner's withholding of payment still amounts to breach of contract and the above-mentioned remedies usually still apply.

Negotiation Strategies The contractor should attempt to build into the schedule of values certain early project expenditures such as bonding, mobilization and similar items so that it will not find itself as the sole financer of these costs. At the same time, the contractor must exercise some caution in this regard because owners may be particularly sensitive to the issue of "front loaded" contracts. The goal is to achieve a balanced resolution. The contractor should also seek clear articulation of the instances where it is entitled to seek payment for fabricated-but-undelivered materials or delivered-but-uninstalled materials.

While the contractor may not be in a position to require or bargain for reduction of retainage at interim phases of the project, it might consider seeking a release or reduction of retainage of earlier work, where that work has been fully incorporated into the project without objection. For example, where excavation has been long completed, the contractor may be able to convince an owner that the owner can avoid potential mechanic's and construction liens by approving a reduction in that retainage after that work has been inspected and incorporated into the project. The contractor should negotiate for provisions that, at the point

of substantial completion, limit the remaining retainage to 150% of the estimated cost for the completion of the punchlist or other specific completion items.

Finally, with regard to withholding events, the contractor must recognize that, in certain situations, withholdings are justifiable. Negotiating efforts should be made to articulate and limit those events and to provide for a mechanism whereby any such withheld monies will be promptly released upon curing of that particular event.

Project Risk Management

The success of construction lenders, owners, contractors or subcontractors may depend on how well each of them addresses project risks. This is called "risk management." A major part of risk management is "risk allocation," whereby a party assigns by contract the responsibility for a certain risk to another party, who will then bear that risk. Yet another part of risk management is the manner in which a party handles its assumed risk so that the possibility (and resulting cost) of the risk is minimized.

Some of the most important risk management tools at a party's disposal are the contracts into which it enters with others involved in the construction project. Within those contracts, risk is primarily allocated through indemnity and insurance requirement provisions. Managing risks can be handled not only by sound business and construction practices (such as proper preconstruction planning, proven construction means and methods, use of experienced personnel, and stringent safety programs) but also by careful contract preparation and review. What follows is a brief overview of some of the key risk allocation and risk management concepts to consider when preparing or entering into your next construction contract.

Allocating Risk to the Party That Is in the Best Position to Control That Risk
A fundamental risk management concept is that owners and contractors should anticipate potential project risks and determine whether it is more advantageous to accept responsibility for each risk or to allocate responsibility for that risk to another party. From a risk management perspective, it is important to assign a project risk to the party best able to control and manage it. For example, a project owner will want to allocate the risk that someone is hurt by construction operations to the contractor, who is in the best position to provide a safe work site. A contractor will want to allocate the risk of design errors to the owner, who often holds the contract with the architect and therefore is in a better position to address and minimize these losses. These are the types of risks that a construction contract should address, so that the parties know in advance who is responsible for what risk.

Allocating Risk Through Indemnity Provisions

An indemnity provision generally is a section in a contract that requires one party to pay for losses incurred by the other party (and, often, to defend the other party against claims for such losses) as a result of claims made by third parties. Following up on the risk allocation example set forth above, a construction contract indemnity provision often requires the contractor to indemnify and defend the owner from and against claims for bodily injury and property damage that arise from the negligence of the contractor or one of its subcontractors while performing the work. Another indemnity clause may require the owner to indemnify and defend the contractor from and against claims based on the existence of hazardous materials on the project site over which the contractor has no control.

Backing Up Indemnity Provisions With Insurance

Contractual indemnity provisions included in contracts are only as good as the indemnitor's ability to honor them. The indemnitor must have the financial ability to satisfy its indemnification obligations. Accordingly, when transferring risk through an indemnity provision, it is important to ensure that the transferee (or the indemnitor) has, or is able to procure in a cost-effective manner, insurance coverage sufficient to pay for the assumed indemnity obligations. One caveat to this general principle is that some risks allocated in an indemnity provision, such as liability arising out of an indemnitor's intentional misconduct, are not insurable due to moral hazard and/or public policy considerations. The lack of insurability for such conduct, however, does not necessarily constitute a valid argument for not requiring the indemnity—the party best able to control the loss should be the one indemnifying the other party from and against that loss, regardless of whether insurance is available to backstop the indemnity.

Insurance Is a Fundamental Way to Manage Risk

If a party has responsibility for a type of loss on a project, it will want to obtain insurance for that loss to minimize its costs, should the loss be realized. Accordingly, when preparing insurance requirements for construction-related contracts, it is important to identify and address the risk obligations associated with each project discipline and to make sure that the limits are adequate to address possible losses.

Design Professionals

Contract insurance requirements for design professionals (e.g., architects, engineers, etc.) should include auto and commercial general liability; workers compensation/employers liability; and, most importantly, professional liability insurance. The limits of design professionals' professional liability coverage are particularly important. Because a professional liability policy typically will cover losses arising on all of a design professional's projects, not just your project, it is

important that the aggregate limit be sufficiently high. Indeed, owners often consider requiring excess limits for professional liability coverage or requiring that the coverage be "project specific" either through a separate project policy or sublimits applicable only to the project. For large projects, an owner also may wish to consider obtaining owners protective professional liability insurance coverage, which indemnifies the owner directly for losses arising out of the design professional's professional negligence that exceeds the limits available under the design professional's own professional liability policy.

Contractors and Subcontractors

Those contractor and subcontractor entities performing construction work on the project should be required to carry automobile liability, commercial general liability (CGL) and workers compensation/employers liability policies, as well as an excess liability policy providing coverage over the automobile and CGL policies' limits. For those contractors and subcontractors performing any design-build functions, professional liability coverage also should be required. To prevent coverage gaps, contractors' and subcontractors' insurance requirements should include pollution liability coverage. If the owner will procure the property or builder's risk coverage, as discussed below, contractors and subcontractors should consider the need for an "installation floater" or similar coverage to protect their equipment and supplies on-site, off-site, and in transit.

Property/Builder's Risk Coverage

While the liability coverage referenced above covers most project accidents resulting in (i) bodily injury and (ii) damage to property other than what is being constructed, in most cases it does not cover damage to the structure being built or the materials being used. This damage, however, can be covered by obtaining a "builder's risk" policy. While it is sometimes possible to cover damage to construction projects under an owner's existing property policy, there are coverage limitations in standard property insurance forms that make procurement of a builder's risk policy desirable in most cases. If a builder's risk policy is procured, consideration should be given to whether the owner or the contractor obtains it. This determination is best made on a project-by-project basis, taking into consideration such factors as the type of project (e.g., new construction or renovation of an existing structure), type of contract (cost plus or stipulated sum), financing/lender's requirements (owner may want to "bundle" soft cost and loss of income coverage with the builder's risk policy to avoid claim delays and argument among insurers over coverage), the presence of a master property program (owner or contractor), location of project, the parties' relative economic leverage to negotiate the most favorable premium and coverage, the contractor's level of sophistication, and the owner's desire to participate in project-specific risk management. That being said, it is more common for owners than contractors to purchase builder's risk insurance, which covers the interests

of all of the other parties having an interest in the project.

Surety Bonds Are Also Used to Manage Risk

The risks of nonperformance and of nonpayment are shared by owners, contractors and subcontractors of all tiers. Both of these risks can affect the timely and on-budget completion of the project. For this reason, owners often require contractors to post a performance bond, which typically obligates the issuer of the bond (known as the "surety") to complete the project if the contractor is terminated, and a payment bond, which typically obligates the surety to make payments due from the contractor to subcontractors if the contractor does not do so. Likewise, contractors will require payment and performance bonds from subcontractors to mitigate the risk of subcontractor nonperformance and failure of subcontractors to pay sub-subcontractors or suppliers. In some instances, contractors will use "subcontractor default insurance" that will reimburse the insured contractor for damages incurred as a result of the subcontractor's failure to perform.

Addressing Potential Insurance and Bond Coverage Gaps

As discussed above, many risk management products, including insurance policies and bonds, are required to cover the risks presented by a construction project. Insurance policy provisions are drafted to create in one policy the exact coverage that is excluded by another policy. To the greatest extent possible, the coverage provided by these policies should fit together. It is therefore wise to have an insurance broker and/or attorney review the entire risk management program to identify gaps in coverage and to suggest amendments, endorsements and additional coverage to close these gaps.

Adding Protection by Including Additional Insured Requirements

Owners and contractors should require all downstream contractors and/or subcontractors to add the owner and contractor as an additional insured under the downstream parties' liability policies. Additional insured status adds a layer of protection not only to an owner's or contractor's indemnity requirements but also to its own insurance coverage. A key advantage to being an additional insured is that the insurer has an up-front duty to defend claims made against additional insureds, whereas most indemnity provisions require only that the indemnitee provide reimbursement of any defense costs. When drafting additional insured provisions, it is often advisable to include a requirement that the additional insured endorsement be broad enough to cover both ongoing and completed operations, as well as the additional insured's liability arising out of the work, on a primary and noncontributory basis. Be sure, however, not to ask to be named as an "additional named insured," as this may impose undesirable obligations such as paying a deductible, self-insured retention or premium if the first named insured fails to do so.

Ensuring That Waivers of Subrogation Are in Place

Including waivers of subrogation ensures that many project risks are properly transferred from the contracting parties to their insurers. Basically, such provisions prevent insurers from passing risk back to downstream project parties by precluding insurers from seeking reimbursement from other project participants for amounts paid on claims. Because an insurer "stands in the shoes" of its insured when bringing a subrogation claim, it cannot bring such a claim if its insured has waived this right in its contract with the allegedly culpable party. For this reason, waivers of subrogation ensure that transferred project risk stays with the insurers.

Don't Rely on Certificates of Insurance

Many parties to a construction project fail to adequately confirm that the project insurance requirements have been satisfied, either upon execution of the contract or throughout the duration of the project. Required coverage limits, additional insured status and waivers of subrogation provide no benefit if they were not obtained or are permitted to lapse. Owners and contractors frequently rely on a cursory review of certificates of insurance to "confirm" compliance with insurance requirements. This practice is risky, as many insurance certificates include incorrect and/or incomplete information, such as omitting mention of risk-changing exclusions or endorsements. In addition, most certificates of insurance are prepared using an industry-standard form. Courts have found that these forms are so replete with express disclaimers that they are not legally binding on the party providing them. As such, it is advisable to require in the contract not only a certificate of insurance evidencing the proper insurance coverage, additional insured status and waiver of subrogation but also delivery of applicable endorsements (if not the full policies themselves) evidencing such coverage. Performing a diligent review of the information provided will greatly diminish, if not remove, the anguish, costs and lost time suffered upon discovery, after a claim is made, that the coverage identified in the certificate of insurance in fact is not what the actual policies provide and is not what is required under the relevant contract.

Before Signing, Have Contracts Reviewed by a Knowledgeable Attorney and Read Contracts for Consistency

Each construction project includes multiple contracts, all of which should be consistent and complementary. For example, dispute resolution provisions should be harmonized so that all parties involved can be in the same proceeding at the same time; this will avoid inconsistent results that may arise if there are several different cases addressing the same issues. Project lenders' and owners' requirements regarding payment timing and limitations should be properly flowed down into all project contracts so that payment provisions are consistent throughout the contracts. In addition, many lenders, owners and contractors use

form contracts with insurance and indemnity requirements that are outdated, unenforceable or otherwise unobtainable. Forcing a party to obtain insurance in a form that is no longer offered, or offered only at a cost-prohibitive premium, is not in the project's best interest. To avoid these problems, it is crucial to have an experienced attorney review the contracts. Just as important, there is no substitute for each party reading its contract very carefully before signing. Beyond the obvious problems of errors and inaccurate information that creep into negotiated contracts, careful review may reveal additional risks, improperly allocated risks and other issues that a lawyer, who often is not as familiar as the client with the project, would not catch. Remember always that few agreements are perfect and that vigilant contract review is one of the most crucial steps in the risk management process.

Ten Things to Consider Before You Sign a Contract

At some point you will probably find yourself wondering whether you should really sign the contract in front of you. If you order items from a-door-to door salesman, hire a contractor for a home improvement project, or go to work for someone as a consultant, you will be faced with a document, hopefully, designed to protect both you and the other party. Ideally, a contract allows the parties to define, in specific terms, the extent of their obligations to each other relative to the delivery of products or services and payment terms. When the contract is signed, it generally cannot be changed unless both parties agree. Consequently, it is important to protect yourself prior to signing a contract by understanding exactly what it is you are committing yourself to. Use the following list as a general guide. Make sure that contract terms are workable for you. If they are not, attempt to negotiate terms that are more reasonable.

1. TIME FRAME. The agreement should have a time frame if any aspect of your transaction will occur in the future. If you are the party delivering the services or goods, make sure that you are allowing yourself enough time to complete the job. If you are the party receiving the goods or services, make sure that the delivery schedule conforms to your needs. If you want to contract for month-to-month services, make sure that you are not signing an agreement that obligates you for a longer period.

2. PRICES. The agreement should clearly state prices. Be wary of additional charges that you have not discussed with the other party. For example, when you contract with a professional, you will often be quoted an hourly rate that will not include additional charges for things like photocopying and postage. Make sure you know what the additional fees are and ask for an estimate.

3. PAYMENT METHOD. Determine the terms of payment and whether it is appropriate to your financial situation. For example, the contract may call for

payments at the end of the month when the majority of your bills are due. You may also be able to negotiate installment payments if you cannot afford a lump sum.

4. PAYMENT PENALTIES. Determine whether there are late payment penalties and if they are reasonable.

5. MATERIAL TERMS. If you and the other party have an understanding about the goods or services, make sure that the particular terms are in the contract. For example, if you have agreed to make a collection of dresses out of silk-like polyester, then it should be in the contract. This will help you make your point should the buyer demand that the dresses were supposed to be made of silk.

6. TRANSACTION RULES FOR PARTICULAR INDUSTRIES. Particular industries have rules by which transactions are governed. If you see something in a contract that makes an assumption of following a particular industry procedure, but doesn't set out the procedure in the contract, make sure you know what the industry procedure is before you sign.

7. INABILITY TO AGREE. If you need to have work started immediately, but cannot come to an agreement on the final terms of an agreement, you need to make sure that you are signing a contract that is not going to be enforceable as a permanent agreement. You can accomplish this by adding language like, "This interim agreement is in effect only until a more permanent agreement can be negotiated by both parties."

8. RESOLUTION OF ANTICIPATED DISPUTES. No matter how careful you are or how good your relationship with the other party, a dispute may arise. Many contracts include an arbitration clause, which means that a dispute must be settled in arbitration as opposed to in court. Arbitration is generally less costly and less formal than court, but if you sign the contract with the clause intact, you have probably waived your right to take the matter to court.

9. ANTICIPATED PROBLEMS. The party with whom you are contracting may have had prior experiences that have led it to add particular methods of resolution to the contract. Those ideas may be perfectly agreeable, but they could also be unfairly beneficial to the other party. Analyze whether these terms will benefit you.

10. ATTORNEYS' FEES. Determine whether you will be charged for the other party's attorney's fees if you breach the contract and lose the case that will probably arise to enforce it. If you are prone to breaching contracts, this is the kind of clause you should avoid.

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