

## Outside Counsel

# Protecting Owners and Developers In Their Construction Contracts

Owners in today's difficult economic circumstances can no longer rely on the standardized form agreements for the project architect and construction team. These form agreements contain advantages to the design and construction team members, which are in turn adverse to the interests of the owner. Most significantly, the form agreements do not provide for a fixed lump sum construction price. Consequently, the agreements permit contractors to bid low and make their profits on myriad change orders and project delays. These open ended agreements leave owners vulnerable to cost overruns and countless change order claims.

In today's economic environment epitomized by a tight credit market, owners and developers must discover novel ways to manage and control a construction project in order to keep construction costs and overhead to a minimum.

The economic slowdown will likely extend into the third/fourth quarters of 2009, and perhaps even later. And even after credit loosens, lenders will still be disinclined to extend credit to owners to cover construction change order and cost overruns claims.

The most judicious method to protect an owner when representing its interests on a construction project is through its construction agreement with the general contractor/construction manager hired for the project. Drafting and negotiating an agreement which contains protective language for an owner is the most potent mechanism to safeguard the owner against costly claims and litigation expenses. This article is designed to offer an owner several recommended provisions to include in its agreements with the contractor so as to avoid having to pay excessive claims that may be asserted

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by the contractor as well as third parties.

• **First** and foremost, to stabilize costs, owners should employ what are known as "Equitable Risk Allocation" agreements, coordinated among all team members. These agreements provide for a fixed-price for construction that provides maximum protection for owners. The agreements equitably allocate the risks associated with a given project amongst the owner, design professionals, and the contractor. By a fair sharing of risk, the owner is assured of avoiding cost over-

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runs and additional change orders that enhance the project cost.

• **Second**, indemnification affords an owner protection against third party claims that may be the result of the contractor's work. The provision should be as broad and encompassing as drafted by counsel. The provision should include not only coverage for liability but defense costs as well. It should include the owner and its agents, as well as the "additional insureds" as identified by the owner in the agreement.

Counsel should also include language which protects the owner from and against claims, costs, judgments, lawsuits, damages, expenses and liability, including reasonable attorneys' fees, that are attributable to personal injury, bodily injury, economic loss, sickness, disease, death, or to damage to or destruction of property, including loss of the use, which are caused by the performances of the contractor's work or the work of its subcontractors. It should be noted

that New York prohibits the indemnification of an owner for its own negligence.

• **Third**, it is imperative that an owner ensure that the contractor procure and maintain ample insurance coverage to protect itself as well as the owner against potential claims arising out of the work.

The contractor should provide evidence, directly from its insurer, with all appropriate declaration and endorsements pages, prior to the commencement of its work, that it has or shall procure the insurance and in the amounts designated in the agreement, covering the contractor, and such other persons or interests as are listed by the owner as "additional insureds."

The contractor should maintain records of all insurance coverage and certificates or policies of insurance required, and, upon request of the owner, provide the owner with such records and certificates of such insurance and policies.

Naming the owner, as well as designated persons listed by the owner, as additional insureds, affords such additional insureds with the same insurance protection as the contractor.

If any of the insurance coverages are required to remain in force after final payment, an additional certificate evidencing continuation of such coverage should be submitted with the final Requisition.

• **Fourth**, it is prudent to provide for an expeditious dispute resolution procedure to resolve disputes that may arise between the owner and contractor during the project. The provision should require the contractor to continue to perform its services and maintain the project schedule during any dispute or proceeding between the parties.

Initially any claim by the contractor or the owner related to the work should be resolved, if possible, by their respective project managers at the first weekly job site progress meeting occurring after the claim is made. If the project managers are unable to resolve the claim by the time of the second job site progress meeting after the claim is made, then the claim is to be submitted to binding arbitration.

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Either the owner or contractor may bring its claim in writing, setting forth the details of its claim. The other party shall then be obligated to accept arbitration and within 10 days of receipt of the written demand, set forth any counterclaim of its own.

In order to resolve all disputes among the construction and design team for the project, i.e., owner, contractor, design professionals, consultants and subcontractors, the agreement should provide for the joinder of all these parties as a party to the arbitration. The agreement should also require the contractor to provide for the joinder of these parties in its respective agreements with other such parties. The contractor should also agree to being joined in any arbitration proceeding arising from claims resulting from the services performed under the agreement and related to the project.

The owner and contractor should agree upon the designation and name of a sole arbiter. If the parties cannot agree on the appointment of an arbiter, they can agree to utilize American Arbitration Association rules for the administrative appointment of an Arbiter.

Within 10 days of his or her appointment, the arbiter will hold a hearing or hearings, limited to no more than two days per party.

The Arbiter shall render his/her decision within 48 hours after the close of the hearings. The decision rendered by the arbiter shall be final and judgment may be entered in the court.

• **Fifth**, it is imperative that the owner include protective language in its agreement concerning change orders. A change order authorizes any change in the work which would result in (i) a change in the basic character or design of the project; (ii) a deviation from design standards established by the contract documents for the project; (iii) an extension of the substantial completion date and/or the final completion date; or (iv) an increase or decrease in the contract price.

The owner may require changes in the work consisting of additions, deletions or other revisions. Generally, required changes in the work are requested via a field change authorization, and is submitted to the owner and the architect by the contractor. In order to be deemed part of the work and authorized by the owner, the field change authorization is prepared by the contractor and, when countersigned by the owner becomes a "change order."

All field change authorizations should contain the following information: suitable breakdowns by trade, as well as the contractor's estimate of: (i) the cost of the change including subcontractor take-offs and time sheets reflected in the field change authorization; (ii) any resulting increase or decrease in the contract price; (iii) the agreed-upon cost for subcontractor overhead and profit of the cost for the labor and materials reflected in the proposed change order(s); (iv) any changes in the work and/or the project schedule which would result from implementation of the field change authorization.

Added protection is afforded the owner by providing that any work performed by the contractor which is contrary to the work as required by the contract documents is performed at the contractor's sole risk, cost and expense, unless the work is authorized by a change order, signed by the owner.

The agreement should also provide that all payments made by the owner for change order work constitutes full payment for the additional work and for any delay or expense occasioned by such change and releases the owner from any further liability to the contractor. In addition, no time extension shall be granted to the contractor by reason of the issuance of any change order unless it is expressly stated therein. Further, the agreement should provide that the contractor must continue to prosecute disputed work even in the event a change order is not approved.

• **Sixth**, in making payments to the contractor, an owner must be aware of pitfalls to avoid. First, the contractor's trade payment breakdown, assigning dollar values to each trade activity which cumulatively equal the contract price, should be annexed as an exhibit to the agreement. The trade payment breakdown should be used to monitor the contract values of the work of the project as the work is being performed.

Progress payments are to be based on a schedule of values submitted by the contractor and approved by the owner. Payments are to be made monthly, provided the contractor submits to the owner, for review and approval, a requisition for partial payment setting forth, for the period for which payment is requested, the following: (i) the cost of the work incurred by the contractor and performed during the immediately preceding thirty day period for which the contractor is seeking reimbursement; (ii) the names of all subcontractors included in such application; (iii) the total cost of the work performed by

subcontractors; (iv) the total amount paid by the owner to the contractor and the amount retained by the owner to the date of application, (v) the amount of the current application and the balance due on the cost of the work to be performed by subcontractors after such payment is made; (vi) the percentage of completion, as approved by the owner, on a trade-by-trade basis of the work; and (vii) satisfactory evidence of all appropriate lien waivers as required under the agreement.

The owner should retain 10 percent of the amount of each payment application until final completion.

Within 30 days after the owner's approval of the requisition and provided that no mechanic's liens shall remain of record and further provided that the contractor shall furnish waivers of lien from all subcontractors for the work done and materials furnished through the date covered by the last preceding requisition, and its own affidavit of payment certifying that all subcontractors have been paid for the work performed and materials furnished through such date except for any permitted retainage, the owner is to pay the contractor an amount equal to the amount corresponding to the portion of the work performed less the retainage. The agreement should require the contractor to execute a waiver of lien at the time payment is made based upon a requisition submitted for the work performed through the date of the requisition.

• **Seventh**, protection against mechanic's liens filed by subcontractors is important for an owner. First, if, at any time a mechanic's lien is filed for work or materials furnished for which the owner paid the contractor, unless such lien has been discharged of record by payment, or a bond, at the contractor's sole cost and expense, the owner shall have the right to retain out of any payment then due to the contractor an amount sufficient to indemnify the owner fully for any and all costs and expenses, including reasonable attorneys fees and disbursements, which it might incur by reason of such lien.

Additionally, if such lien is not canceled and discharged by the contractor, the owner shall have the right to cause such lien to be canceled and discharged and, in such event, all costs and expenses incurred by the owner, including premiums for any bond furnished in connection with such discharge, and attorneys fees and disbursements, shall be paid by the contractor to the owner, or, at the option of the owner, shall be deducted from any payment then due to the contractor.

• **Eighth**, the owner may require the contractor to furnish payment and performance bonds guaranteeing the full performance by the contractor of its obligations under the agreement and the full payment of all obligations. The payment bond protects the owner against claims by subcontractors who are not paid by the contractor for their work. The performance bond protects the owner against the abandonment of the project and the failure of the contractor to complete the work.

• **Ninth**, it is essential that the owner have the ability to terminate the contractor for cause and, alternatively, at its convenience. Upon termination of the agreement by the owner for cause, subcontracts entered into by the contractor in connection with the work may, at the owner's option, be assigned to the owner or such other contractor as the owner may direct.

Additionally, the owner at any time, may terminate the agreement for its own convenience. Upon receipt of any notice of termination, the contractor shall stop all work unless directed otherwise by the owner and terminate all subcontracts entered into by the contractor.

## Conclusion

In summary, for private-sector developers committed to building projects in a manner that properly protects investors—or for public-sector entities committed to building projects in a manner that properly protects taxpayers—effective construction cost management is essential. The stakes are even greater in a time of recession.

Open-ended contracts that lead to budget-busting cost overruns should be abandoned. In these credit constrained times, fixed price contracts must become the order of the day. Further, these added provisions will go a long way toward minimizing claims asserted against the owner and helping the owner reap the benefits of its project's development.

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