

## **A DETAILED OVERVIEW OF THE CONTRACT FOR CONSTRUCTION**

Before the parties begin work on a project, they must first agree upon the terms of the construction contract. The written construction contract is a legal document that governs the parties' relationships throughout the course of the project. It sets forth the parties' respective rights and liabilities, as well as the scope of work and payment.

There are a number of different types of contracts used in the construction industry, some of which are handcrafted and some of which are merely printed forms issued by different industry organizations.

### **I. The Different Contract Types:**

Owners, contractors and subcontractors have several different types of contracts to choose from when negotiating provisions that will govern their affairs on a construction project. Construction contracts frequently come in various broad categories including the following:

- (a) lump sum contracts;
- (b) unit price contracts;
- (c) cost plus contracts;
- (d) cost plus contracts with a guaranteed maximum price;
- (e) design/build contracts;
- (f) construction management contracts (with contractor at-risk and not-at-risk); and
- (g) Job order contracts (JOC's) (indefinite supply contracts)



**A. Lump Sum Contracts.**

A lump sum contract is the traditional and most common type of contract used in the construction industry. The owner and contractor agree upon a fixed price for the completion of the work. Under the lump sum arrangement, the contractor bears all risk of loss with respect to the actual costs of completing the work within the scope defined by the owner's construction documents. Typically, lump sum projects are competitively bid, and they are commonly used for government work. Generally, if a contract is sent out by a government agency for competitive bidding, the bidders have little flexibility in negotiating the terms and conditions of the contract.

**B. Unit Price Contracts.**

A unit price contract is based on specified unit prices for estimated quantities of work. Unit price contracts are typically used on construction projects where the scope of the work to be performed is known by the parties, yet the precise quantities needed for the work are not yet determined. The owner pays only for the actual units or quantities that are constructed or supplied by the contractor. Typically a unit price contract concerns an easily measured quantity of work that needs to be performed, such as volume of earth removed, rock removed, concrete placed, etc. Different unit prices may be given for different anticipated volumes of work, thereby ensuring that volume discounts can be passed on to an owner while reducing the risk that a contractor may take in placing a low unit price on a small volume of work. Unit price contracts are common in public works project such as highway, dam, and bridge building projects.



### **C. Cost Plus Contracts.**

Cost plus contracts are also popular with private owners. In a cost plus contract, the owner pays for the actual cost of the project plus either a flat fee or a percentage of the project costs. The contractor is required to substantiate the costs expended in performing the work in order to be paid. An advantage of a cost plus contract is that the owner only pays for the work that is actually performed by the contractor. The perceived disadvantage of a cost plus contract is the fact that the contractor has little incentive to keep the construction costs down. There is a small body of law, however, that has emerged in connection with cost plus contracts wherein courts impose upon the contractor a "fiduciary relationship" with respect to the owner that compels the contractor to manage and control the costs. This contract method appears to have limited use, and experience dictates that it is generally favored where an owner retains a large degree of control over the scope of the work and the labor, material, equipment and supplies to be furnished. However, a cost plus contract places more of a management burden on the owner. As a result, another variation of this contract type has emerged, which is the cost plus with a guaranteed maximum price.

### **D. Cost Plus with a Guaranteed Maximum Price Contracts.**

The cost plus with a guaranteed maximum price contract is similar to a cost plus contract in that the owner only pays for the work that is actually performed by the contractor, plus a fixed fee. However, in addition, these contracts include provisions regarding a guaranteed maximum price for the construction. The advantage of that provision is that a contractor cannot charge for all of the work on the project without any bounds. Evidence of a breach of fiduciary duty to control costs is not necessary in order to deal with cost overruns. If work costs exceed the guaranteed maximum price, then the



contractor is simply responsible for the difference. These contracts frequently include shared savings clauses where the parties split cost savings when the cost of the work is less than the guaranteed maximum price. This is intended to provide an incentive for the contractor to keep the actual costs of the work down. This type of contract is very popular with private developers where projects are on a fast track. Developers often want to commence construction before a complete design is finalized and a lump sum price is established.

#### **E. Design/Build Contracts.**

In a design/build contract, an owner contracts with a single entity for both the design and construction of the project. A design/build contract is generally structured as a lump sum contract. However, it also may be written as a cost plus contract or a cost plus a fee with a guaranteed maximum price contract. Design/build contracts may enable construction to begin earlier and proceed faster due to the fact that the design need not be completely finished and ready for bid before construction can begin. This is also true because the shop drawings and submittal process is more streamlined with the single source responsibility. The design/bid contract delivery method has the advantages of speed, reduced cost and single source responsibility. *See Strain-Japan R-16 School District v. Landmark Systems, Inc.*, 965 S.W.2d 278 (Mo. App. 1998) (regarding a contractor's ability to furnish design services without compliance with Missouri designer licensing law). *See also Design-Build on Government Projects*, Ch. 8, in *The Architect's Guide to Design-Build Services* (G. William Quatman, II, *et al.* eds., 2003) (authored by Heather F. Shore, Esq); Kansas Committee on Appropriations House Bill No. 2394 (2006), concerning an Act for alternative project delivery construction and procurement regarding design/build construction and construction management in the State of Kansas



for public works; Missouri House Bill No. 1223 (2006), for public construction addressing prequalification procedures for bidders, construction manager at-risk delivery systems, design/build construction and job order contracting, including provisions regarding selection of contractors and the contracting process.

**F. Construction Management Contracts.**

Construction management contracts provide for the owner to retain a contractor (or even an architect, engineer or other person) in a management capacity to review plans and specifications and assist in budget preparation for the project, as well as manage the execution of the work. Construction management contracts typically take two forms; the at-risk form and the not-at-risk form. In the at-risk form, in addition to providing consultation, the manager may contract directly with some or all of the tradesmen and suffer the risk of loss for any cost overruns, nonperformance, or defects and deficiencies in the work. In the not-at-risk form, the manager may take bids from tradesmen but the owner contracts with them directly and suffers any attendant risk of loss during the course of performance. The manager simply assists in the work execution, among other management responsibility.

**G. Job Order Contracts (Indefinite Supply Contracts).**

Job order contracts (JOC's) generally involve a firm fixed price competitively bid procurement process with an indefinite quantity of work. This delivery system is designed generally for small to medium size construction projects, and it is also used for repair projects. These types of contracts are generally are used in the public setting as opposed to the private market and have as a primary feature the ability to contract multiple projects at one time avoiding the expense of competitively bidding each, every and all of the small projects.



## **II. Standard Form Agreements:**

The use of standard form agreements when drafting construction contracts is recommended because construction contracts have become very complicated. The provisions in the standard forms are generally recognized and accepted within the industry, and they have been tailored by use and experience to coordinate obligations for various responsibilities. Forms are available from the American Institute of Architects (AIA), the Engineering Joint Contract Documents Committee (EJCDC), and the Associated General Contractors (AGC), just to name a few. The AIA documents are frequently used in building construction and projects overseen by architects. The EJCDC documents are used more frequently for heavy and highway construction such as roads, dams, bridges and tunnels, where the designer is more likely to be an engineer rather than an architect. The AGC forms are frequently used and are considered reasonably balanced. They do not, however, enjoy the same popularity as the AIA documents, which are generally thought to be more evenly balanced in terms of the rights and liabilities of the parties.

Regardless of the standard form that is used by the parties, the forms need to be reviewed and individual provisions or terms negotiated in order to tailor the terms and scope of the services and work to the subject project. Automatic tailoring is not recommended unless specific requirements of the project mandate it.

## **III. The Ten Most Important Clauses of the Construction Contract (With Two More to Make an Even Dozen):**

For illustration purposes only, reference may be made from time to time to the AIA documents because they are the most comprehensive and widely used standard form agreements in the construction industry.



## **A. Payment.**

One of the most sensitive areas for all the parties involved in the construction project is the payment process. Owners, as well as lenders, are concerned about overpaying the general contractor before work is completed and about holding sufficient retainage as security. On the other hand, general contractors and subcontractors are concerned about prompt payment. Any delay in the cash flow can essentially force the general contractor or subcontractor to finance the project, which may ultimately result in the contractor's insolvency.

### **1. The Types of Documents Necessary for Payment.**

The AIA form contains requirements for progress payments. First, the contractor initiates the process by submitting an Application for Payment to the architect on a monthly basis. The application generally is itemized and notarized and supported by substantiating data. The owner will require supporting backup documents such as lien waivers, certified payrolls, schedule updates, test results and lien waivers. Because lien laws may differ, owners and lender should examine lien laws of the state in which the project is located before specifying these requirements. R.S.Mo. § 429.010, *et seq.* and K.S.A. § 60-1101, *et seq.* See also *Tharp v. Keeter/Schaefer Investment, L.P.*, 943 S.W.2d 811 (Mo. App. 1997) (holding that the release of lien rights for a progress payment does not include the release of rights to collect retainage withheld); R.S.Mo. § 429.005 (a contract clause waiving a mechanic's lien right is against public policy in Missouri and, therefore, unenforceable).

Before the contractor submits the first Application for Payment, however, the contractor must submit a Schedule of Values subject to the architect's approval. This schedule allocates portions of the contract price to designated work functions. The



architect then uses this schedule to scrutinize the applications as a check and balance system to front-end loading by the contractor (increased values placed on work at the beginning of the job) and advance payments prior to work being accomplished.

## **2. Payment Timing.**

If possible, the parties should establish their own deadlines for the payment process. The AIA documents generally set forth suggested payment procedures, but they leave it up to the parties to insert particular dates for payment. The parties should always specify the deadlines for the payment process by filling in the blanks; however, in doing so, the parties must be mindful of any laws governing the timing of payment. For example, Kansas' proposed Senate Bill 333 which, if passed, will govern public construction projects, sets forth a requirement of payment of no later than 30 days after the owner receives an undisputed payment application.

Contractors should also consider the Prompt Payment Acts in both Missouri and Kansas, which establish limits on the amount of time that a contractor may withhold payment from the subcontractor once the contractor has been paid the amounts owed to the subcontractor by the owner. *See, e.g.*, K.S.A. § 16-1803 (requiring payment to the contractor within 30 days from the date following the owner's receipt of a timely, properly completed, undisputed request for payment; requiring that the subcontractor receive payment within seven business days from the contractor's receipt of payment from the owner [this Act applies to projects involving new construction of more than 4 units]); R.S.Mo. § 431.180 (requiring that payment to the subcontractor be timely made in accordance with the schedule for payments set forth in the parties' contract on projects involving new construction of more than 4 units).





## **B. Retainage.**

Under most contracts, the owners retain a specified percentage from the progress payments until the end of the project which protects the owner in the event of a contractor breach or subcontractor liens. Retainage provides an incentive for the contractor to finish the work. Typical retainage amounts range from 5-10%.

Because contractors or subcontractors do not typically obtain retainage until the end of the project, this process essentially forces them to finance part of the work. Several states have sought to limit such inequities by imposing limitations on the amount of retainage, both in the public and private sector. R.S.Mo. § 436.300, *et seq.* (capping total retainage at 10% on Missouri private projects, allowing for substituted security, declaring retainage to be trust funds, mandating line item release of retainage and allowing for retainage of 150% of the value of punch list items); Missouri Public Works and Prompt Payment Act § 34.057(1) (allowing retainage of 200% of the value of a punch list item). *See also Epic, Inc. v. Kansas City, Mo.*, 37 S.W.3d 360 (Mo. App. 2001). In 2005, Kansas adopted the Kansas Fairness in Private Construction Act, K.S.A. § 16-1804, which allows an owner and, in turn, a contractor, on a private project to withhold up to 10% of retainage and which requires the contractor to pay the subcontractor its retainage within 7 business days from the date that the contractor receives retainage from the owner. Senate Bill 333 is currently being considered by the Kansas Legislature. If Senate Bill 333 passes, it would, among other things, limit the amount of retainage to 10% on public work's projects and will trigger additional interest if retainage is not timely paid.

Some contracts reduce or eliminate retainage as a certain portion of the work is completed. For example, if 50% or more of the work has been completed to the owner's satisfaction, the retainage may be reduced or eliminated completely. Other contracts



exempt certain parts of the billing from retainage, such as construction manager's fee, materials, general conditions, or the general contractor's own labor.

**C. Third Party Roles.**

To further complicate the construction contract process, the drafters must assess the third party roles of entities such as the architects and the lenders. The architect must have time to review the Application for Payment before approving it; the AIA form generally provides for seven days to do this. The lender's role also likely will impact the payment process because it may require lien waivers before any funds are released for progress payments. The lender may also want to independently verify work in place to insure the amount of the progress payment made is proper. Thus, additional time will likely be required to perform that function.

**D. Interest on Late Payments.**

The AIA documents provide an option of determining interest rates to be applied for late payments. A fair method is to use the interest rate that the owner is being charged on the construction loan for the project. By doing so, the owner would be discouraged from using the contractor as a financing source. In the absence of an interest provision, a default rate is provided by statute in both Missouri and Kansas. R.S.Mo. § 408.020 (9%); K.S.A. § 16-201 (10%).

**E. Provisions for Billing Disputed Work.**

Most construction contracts provide that any work disputed by the owner may not be billed. On the other hand, the owner may direct this work to be done through the process of a construction change directive with the amount to be paid for the work to be determined at a later time. The contractor may bill for this work up to the amount agreed to by the owner, which treats both parties fairly.



#### **IV. Pay When Paid/Pay If Paid Clauses:**

Payment clauses that seek to allocate payment risks tend to fall into either one of the following two categories:

1. Pay when paid clauses; and
2. Pay if paid clauses

Pay when paid clauses allow reasonable delay before the general contractor must pay the subcontractor.

Conversely, pay if paid clauses state that the general contractor's obligation to pay the subcontractor does not arise until the owner has paid the general contractor. That is, payment from the owner is a condition precedent to payment by the general contractor to the subcontractor. Courts will not view a clause as creating the latter category unless it explicitly states that the payment is a condition precedent. *See American Drilling Co. v. City of Springfield, Mo.*, 614 S.W.2d 266 (Mo. App. 1981); *Havens Steel Co. v. Randolph Engineering Co.*, 613 F. Supp. 514 (W.D. Mo. 1985). *But see* R.S.Mo. § 431.183 (contingent payment clauses do not prohibit the filing of a mechanic's lien); K.S.A. § 16-1803 (same).

The AIA documents have chosen a middle ground in attempting to assist the parties with avoiding any dispute regarding pay when paid/pay if paid clauses while attempting to protect the owner's interest. The AIA clause provides that the contractor promptly pays each subcontractor upon receipt of payment from the owner out of the amount that was paid to the contractor on account of that subcontractor's work. The clause is deliberately vague and states only what the prime contractor shall do if it is paid.

Some states have enacted prompt payment statutes for both public and private projects. Such statutes specify that after receiving payment, the contractor must pay the



subcontractor in a specified time. R.S.Mo. § 34.057.1 (Missouri Public Prompt Payment Act) and R.S.Mo. § 431.180 (Missouri Private Prompt Payment Act). *See also Vance Brothers, Inc. v. Obermiller Construction Services, Inc.*, No. WD62876, 2005 WL 147144 (Mo. App. January 25, 2005), *aff'd*, 2006 WL 44355 (Mo. January 10, 2006) (holding that the Private Prompt Payment Act applies only to contracts with periodic or scheduled payments); Missouri Senate Bill No. 800 (currently pending in the Missouri Legislature) to amend Section R.S.Mo § 431.180, to state that the Act applies to both lump sum and scheduled payment contracts. The Kansas Fairness in Private Construction Act, K.S.A. § 16-1802 *et seq.*, prohibits the waiver of a right to litigate, mechanic's lien rights and subrogation rights except in cases where there is wrap-up insurance; states that a pay when paid clause is not a defense to a bond claim or a mechanic's lien claim; states that an owner should pay a contractor within thirty days after receipt of an undisputed pay application; and, provides for payment to subcontractors within seven days after receipt of payment by the contractor from the owner (and an 18% interest penalty if not timely paid). The Kansas Act also allows contractors and subcontractors to suspend work if not timely paid and to receive a time extension and demobilization and remobilization costs for any delay. This provision excludes residential construction and public works. *See also* K.S.A. § 75-6401 and *D-1 Construction, Ltd. v. Unified School District No. 229*, 14 Kan. App.2d 245 (1990).

**V. The Contractor's Design Responsibility:**

**A. Design Review.**

Generally, construction projects are designed by architects or engineers, and built by the contractor who simply follows the plans and specifications. Every project involves details of construction that are not specified in the plans and specifications—that



is just the nature of construction. Nevertheless, most contractors know how those details should be completed. The situation can be complicated, however, with respect to certain types of work that are routinely designed by subcontractors specialized in the field, including mechanical, electrical and sprinkler systems, to name just a few. The contractor is generally responsible for following the plans and specifications and is liable for not conforming to them.

The contractor generally is not responsible for problems caused by the design and/or the design team. If the design is found to be defective, then the contractor typically bears no responsibility; the contractor may be entitled to extra compensation for any loss that it incurs because of the design problem. Some owners may seek to shift this allocation of responsibility back to the contractor by imposing a duty on the contractor to review the plans and specifications and attempt to discover design errors and inconsistencies before starting work. Contractors should resist this shifting process by arguing that architects (or engineers) have more time and skill, and are charged with the responsibility, to prepare the design, and it is unfair to shift that burden to a contractor who has limited time or skills to review and understand the design during the bidding phase. These types of liability-shifting provisions are often found in supplementary conditions or in amendments to the standard form General Conditions, and they must carefully be considered prior to agreeing to the contract.

#### **B. Shop Drawing Review.**

Contractors are typically required to provide shop drawings with respect to how they plan to supply the details of the design that are not specified in the contract documents. These designs are shown on shop drawings prepared by each subcontractor, and they illustrate how the subcontractor will handle its part of the work. Generally,



these documents are submitted to the designer through the general contractor for review and a stamp of approval.

Many disputes arise from the shop drawing process. Architects and engineers attempt to avoid responsibility for the sufficiency of the detail in the shop drawings by reviewing and/or stamping them only for general conformity with the project design, while disclaiming any assurance that they are proper and will meet the intent of the contract documents. Subcontractors and contractors, on the other hand, argue that review and acceptance of their shop drawings gives the drawings the same legal effect as the original contract documents, such that they can be relied on by the contractor. Subcontractors and contractors typically also argue that approved or stamped shop drawings are the fault of the reviewing design professional if they prove to be incorrect or defective.

Disputes also arise from the speed of the shop drawing process. Time is important and costly on a project, and the parties must be attentive to the length of the process of shop drawing submittal, review and return. This process may severely impact the contractor's ability to meet the owner's schedule provided in the contract documents. Documentation is very important in those instances where the contractor or subcontractor is waiting on a submittal review that is delaying its work at the project.

#### **VI. Differing Site Conditions :**

One of the biggest challenges to cost estimating in advance of any work being performed by the contractor is estimating the costs associated with constructing those areas that are not visible. It is not uncommon for a contractor to encounter a physical condition, usually subsurface, that was not anticipated by the parties at the time of the contract. Examples are underground rock, water, obstructions such as buried fuel tanks,



buried foundation structures, utilities, fiber optics, etc. These add to the cost of completing the work. Often these unanticipated physical site conditions, or "differing site conditions", provide grounds for construction claims. Note, however, differing site conditions typically do not provide a basis for deeming the contract null and void or for arguing that there was no meeting of the minds at the time of contracting.

**A. Type I Claims.**

The Type I differing site condition exists when subsurface or latent (non-obvious) physical conditions at the site differ materially from those indicated in the contract. As noted above, these could be rock, water, underground utilities, etc. In order for a contractor to recover increased costs associated with these types of conditions, the contractor must prove the following facts: First, the contractor must show that the contract actually indicates the subsurface condition that forms the basis of the contractor's claim. It is important that the documents say something about the condition in order for there to be a misrepresentation. Second, the contractor must demonstrate that it relied on such indications and that the contractor's interpretation of the contract and the indication was reasonable. Third, the contractor must demonstrate that the conditions encountered were materially or substantially different from those conditions indicated in the contract and that they were not reasonably foreseeable. Again, it is important that the documents indicate something about the conditions so that a difference can be measured. Finally, the contractor must show that the damages claimed are directly attributable to the unforeseen conditions and not the contractor's own lack of a proper bid, inefficient operations, etc.



## **B. Type II Claims.**

Where a contract fails to indicate a subsurface or latent condition altogether, a contractor still may be entitled to claim extra monies for encountering differing site conditions. Under a Type II claim, the contractor may assert that it encountered a condition that differed from conditions usually found on similar projects. A Type II claim is not concerned with the precise representation that was made in the contract documents or the difference that was found on the site. Rather, a Type II claim is concerned with what is usual and normal for the type of work involved and what is different from that about the particular site. In order for the contractor to recover, the contract must be silent on the subsurface or latent condition that forms the basis of the claim.

However, the absence of contract language regarding conditions makes the contractor's proof of a Type II claim more difficult. Recovery on a Type II claim requires both a subjective and objective inquiry. The contractor must first establish the type of conditions that would normally be encountered on a similar project. The contractor must then show the conditions that were actually encountered and prove that those conditions differed materially or substantially from the physical conditions that would ordinarily be encountered at a similar project. Finally, the contractor must show that the conditions caused an increase in the cost of performance and that increase was not attributable to the contractor.

The AIA documents provide for a standard changed condition clause in the General Conditions. AIA document A201. Section 4.3.4 of A201 defines the type of differing site conditions described above, while Section 4.3.6 provides the remedy for the contractor who encounters the condition. The AIA General Conditions also require that





the contractor notify the owner, who, in turn, investigates the encountered conditions and determines whether the conditions differ materially and whether the conditions actually caused the contractor to incur additional costs.

### **C. Exculpatory Clauses.**

In addition to standard contract clauses governing differing site conditions, a contract may also include clauses that absolve a party from any liability for a changed or unforeseen condition, or even deficient plans and specifications.

#### **1. Pre-bid Inspection.**

Many contracts include a clause requiring the contractor to examine the construction site before submitting a bid on the project. This type of clause is typically included in the contract in order to shift some of the risk from the owner on to the contractor. A pre-bid inspection clause usually requires that any condition that "should have been seen" by the contractor during a pre-bid inspection will be deemed disclosed and, therefore, not the subject of a claim.

#### **2. Duty to Discover Obvious Errors.**

It is also common to include a clause that requires the contractor to examine the contract documents and discover any patent or obvious errors. Such a clause may also require the contractor to discover conflicting provisions or ambiguities and notify the owner of the same so that the owner can clarify such ambiguities by addendum before the bids are opened. Like the pre-bid inspection clause, the duty to discover patent errors clause shifts some of the risk of loss from the owner back to the contractor. Generally, a contractor is bound only to "discover" those ambiguities and errors a reasonably prudent contractor would find. There is no duty to perform a plan review. The intent generally is for the contractor to report what is otherwise found and not remain silent on those issues.



### **3. No Damages for Delay Clause.**

Today many construction contracts also contain a "No Damages for Delay" clause regarding the contractor's right to adjust the contract price for encountering differing site conditions. The presence of a no damages for delay clause can have an effect on a contractor that encounters either a Type I or Type II differing site condition. Often times encountering these types of conditions not only involves the cost of removing them or dealing with them directly, but, it may also impact the schedule for the project. In a case where the schedule is impacted, the contractor may only be entitled to additional time to complete the work but not an equitable adjustment for the delays and impact on the contractor's general conditions and overhead. Missouri generally recognizes the effectiveness of such a clause in the private setting, *Roy A. Elam Masonry, Inc. v. Fru-Con Construction Corp.*, 922 S.W.2d 783 (Mo. App. 1996); but not in the public setting where the law provides that they are void as against public policy, except for contracts with the Missouri Department of Transportation. See R.S.Mo. § 34.058. At least one case in Kansas, *Peter Kiewit & Sons v. State Highway Commission*, 184 Kan. 737, 339 P.2d 267 (1959), implies that a no damages for delay such a clause would be construed strictly against the drafter.

#### **D. Handling Changed Conditions.**

For owners it is important to disclose all that is known about the conditions on the project and to give the contractor access to all prior drawings. Owners should also use standard clauses, as any ambiguities will be construed against the drafter. An owner should pay close attention to the bidder's questions and disclose any information in the owner's possession in response to those questions. An owner should also respond



promptly to any notice by the contractor of a differing site condition and investigate the alleged condition as required by most differing site condition clauses.

Contractors, on the other hand, should ask for and pay careful attention to existing drawings. They should also attend pre-bid inspections and ask questions at those meetings. It is also important for the contractor to keep careful cost records where possible, and to maintain joint cost records with the owner if feasible. Contractors should give prompt notice of any differing site conditions encountered on the project, as well as errors and ambiguities in the plans and specifications.

## **VII. Dispute Resolution or Similar Clauses:**

Having a pre-agreed procedure to resolve disputes and claims on the project is vital to any construction contracts. Most construction contracts employ a process by which claims and disputes are first heard and decided by the design professional. If necessary, a dispute may proceed to mediation and conclude in arbitration or a lawsuit. Often this approach is the best process, but not always. Owners and contractors should consider a number of factors in making a decision about how their disputes should be resolved. Some of these factors include the project size, the complexity of the project, the number of parties involved, the complexity of contractual relationships, the risk to both the owner and the contractor, and the length of construction. It may be that the three tiered approach is inefficient or that litigating disputes may be more appropriate than arbitration.

It is often said that arbitration is faster and cheaper than litigation, but that is not always true, particularly in complicated construction cases. Arbitration may, however, insure that disputes which are very technical in nature are heard by parties who are trained to hear and decide such technicalities in light of the applicable facts and law.



Unless parties agree contractually, or unless it is allowed by the governing arbitration rules, joinder of parties or multi-party arbitrations may be precluded in many jurisdictions and under many contracts. Yet at the same time those jurisdictions may allow consolidation or joinder of parties in court litigation. Therefore, if the nature of the project likely may involve disputes between more than two parties, it is important to consider whether the parties would prefer that the dispute resolution process allow for joinder and consolidation of parties and claims. Often times a construction contract might indicate that proceeding in court is the appropriate venue, but proceeding in arbitration likewise can be appropriate if all of the contract documents among the owner, designer, contractor and subcontractor provide for consolidation and joinder.

Also, discovery in arbitration is limited, and it is intended to be a more streamlined process. If significant discovery is necessary, consideration should be given to another dispute resolution process. The subpoena power of arbitration panels is usually limited to requiring the production of documents or witnesses at a hearing; but if discovery is necessary from third parties not in privity, it may be difficult to secure that discovery pre-hearing.

The 1997 edition of the AIA construction documents contains an arbitration provision in the General Conditions (AIA A201). However, whether or not you utilize a form contract there are necessary elements to be considered in crafting an arbitration provision including the following:

1. All claims must be put in writing and be addressed to a previously identified individual.
2. Parties must make claims within a finite period of time from the discovery of the claim.



3. Parties must continue performing other obligations under the contract documents notwithstanding the fact that claims are being made.

4. Parties must commence mediation within a finite period of time from when the claim is submitted to the design professional.

5. Parties must file arbitration demands within a finite period of time from that same benchmark.

6. Parties must designate an applicable set of rules (or a jurisdiction) as well as the location for both the mediation and the arbitration.

### **VIII. Liquidated Damages:**

Time is money in construction. An owner may suffer significant losses when a project is delivered late. Major disputes arise with respect to an owner's losses for late delivery. To address these issues, owners frequently use liquidated damage clauses in construction contracts. These clauses almost always work by assigning a daily charge for substantial completion of the work later than the scheduled date. Often in public contracts the daily charge will go beyond substantial completion to final completion.

#### **A. Enforceability of Liquidated Damages Clauses.**

The standard rule of law is that the courts will enforce liquidated damages as long as the clause does not constitute a penalty. *See, e.g., Standard Improvement Co. v. DiGiovanni*, 768 S.W.2d 190 (Mo. App. 1989). The courts will generally find that to be the case only when an owner is not suffering any damages at all from the passage of time. Nonetheless, when liquidated damages are grossly disproportionate to the owner's actual damages, courts or arbitrators may intervene and refuse to enforce them. *See Goldberg v. Charles Chevrolet, Inc.*, 672 S.W.2d 177 (Mo. App. 1984). An owner can avoid this risk by a few simple considerations. First, the owner can avoid the use of the word "penalty"



in referring to these types of damages in a contract. Second, if the damage figure seems a bit high, the owner should include in the contract language explaining the importance of prompt completion and the serious nature of the harm from late completion and explaining specifically the types of damages that will be suffered. Third, the owner can bolster the enforceability of a liquidated damage clause by offering an early completion bonus to the contractor.

### **1. Elements of Liquidated Damages.**

The liquidated damage sum should be a combination of the lost profits from late completion and administrative expenses from continued oversight of the project coupled with the cost of disruption to move into the project. In the public and not-for-profit sector, calculating the damage can pose a challenge. Loss of revenue may be the critical factor for a highway or bridge project. One approach may be to take the daily interest cost or the capital cost of the project as of the completion. Another approach might be to evaluate the cost based upon the value that the project is intended to ultimately provide the user. There really is no simple solution.

Another approach for liquidated damages is to have a step liquidated damages by which the daily rate rises after a certain point. For example, an owner may charge one price for a major delay and another price for a minor delay. This approach may allow the owner to avoid appearing punitive. The owner may also assess one charge for failing to meet a substantial completion date and another rate for failing to meet a final completion date at a reduced rate.



## **IX. Delays and Extension of Time:**

Every construction project has a schedule that determines in advance the sequence of work. For the owner, a schedule provides the answer to the owner's number one concern: When will the project be finished?

The contract documents dictate which party is responsible for the delay and whether the contractor is entitled to an extension of time or for reimbursement of costs incurred as a result of the delay.

### **A. Types of Delays.**

#### **1. Nonexcusable Delay.**

Generally, nonexcusable delays are those delays caused by or within the control of the contractor or his subcontractors. Examples of nonexcusable delays include equipment problems, slow work, poor management, poor coordination, lack of manpower, lack of equipment, etc. In such a case, the contractor bears all the responsibility for the delay and will not be entitled to any additional time on the schedule or monetary compensation for the cost of the delay to the contractor.

#### **2. Excusable Delay.**

Excusable delay, on the other hand, is the type of delay that falls outside of the control of either party. This type of delay may involve labor disputes, severe weather, national shortage of materials, etc. The owner is required to give the contractor additional time to finish the project but may not necessarily be required to pay the contractor any money since neither the owner nor the contractor had any control over the event.

In some cases the owner may require the contractor to finish the contract by the original scheduled date even though an excusable delay appears. When this happens, the



owner has "accelerated" the work and may have to pay the contractor for any costs incurred as a result of such acceleration. Often these costs are substantial because acceleration requires additional crews, overtime, double shifts, accelerated material deliveries, etc. "Escalation" costs are somewhat related and typically result from a schedule shift where completion is delayed by the owner beyond the original completion date and the contractor suffers increased costs due to escalation in labor and material or equipment costs.

### **3. Compensable Delays.**

As noted, not all excusable delays are compensable. Compensable delays are those delays for which the owner bears responsibility and must give the contractor not only additional time, but additional money. Examples of compensable delays may be design changes, errors that slow down the progress of the work, interference with site access not anticipated by the contractor, excessive change orders, failure by the owner to secure necessary building permits, or delayed decision making by the owner resulting in work delays.

### **4. Concurrent Delays.**

Occasionally, two different types of delays will overlap on a particular project. Such occurrences are commonly referred to as concurrent delays. The parties must independently identify and evaluate these delays. If the delays would cause the project to be delayed for a similar or the same period of time, the delays are considered to be concurrent. It is not easy to apportion responsibility in situations involving concurrent delays. One established rule, however, is that where a compensable delay for the contractor is concurrent with a non-excusable delay, the period of delay is reclassified as excusable. For example, where an owner-related design change delay may overlap with





the contractor's lack of equipment to perform the work in any event. Thus, the contractor may receive additional time to complete the work but will not be compensated for the costs incurred as a result of the delay. If the concurrent delays can be "allocated" in time to the owner and/or the contractor, then the contractor may only receive extensions for that portion of the owner delay which exceeds the contractor's own delay.

**X. Indemnification and Insurance:**

Generally there are three types of indemnification clauses that are typically included in a construction contract. The first is often called the "board form" indemnification clause where the indemnitor accepts all risk of loss even if the indemnitee is 100% responsible. Early cases found these types of clauses unenforceable unless expressly stated. More recently, additional limitations are being placed. For example, in Missouri it is against public policy to insert such a clause into a contract, and such clauses are generally not enforceable unless insurance is in place to cover the risk. The risk is limited to the insurance and the cost of the insurance is paid for in the contract. *See* R.S.Mo. § 434.100. *See also* Kansas Special Committee on Judiciary Senate Bill (2006) regarding indemnification provisions in construction contracts in Kansas providing that an indemnification provision requiring an indemnitor to indemnify the indemnitee for his own negligence would be void against public policy. This would be true without regard to any insurance provisions.

The second type of indemnification provision that may be found is called "intermediate form" where the indemnitor takes all risk unless the indemnitee is 100% responsible. This is a shared risk concept involving comparative fault. *See Dillard v. Shaughnessy Fickel and Scott Architects, Inc.*, 884 S.W.2d 723 (Mo.App. 1994).



The third form of indemnity is called the "limited form". In that instance, the indemnitee takes risk only for its own negligence. *See* R.S.Mo. § 434.100.

As noted, insurance often fills gaps left by indemnity. Moreover, insurance provides an incentive to the indemnitor to assume indemnity obligations since it can insure them and pass the costs associated therewith back to the indemnitee, who is usually the owner.

When drafting contract provisions that involve indemnity and require a party to obtain insurance, it is also important to require inclusion of the indemnitee in that policy as an additional insured. The most common document requested to insure that a party has been included as an additional insured is a Certificate of Insurance. These are commonly given on construction projects. However, Certificates of Insurance are not policies of insurance; rather, they are only informational documents. Without an express amendment to the policy adding the indemnitee as an additional insured, there may very well not be coverage. Also, it is important to require that the policy may continue on without interruption until completion of the work. Many policies also have completed operations coverage and it is important to deal with that issue and make sure that it is retained for some reasonable period of time. Finally, it is important to require notice of cancellation of any policies to assure that the risk remains insured.

#### **XI. Notice of Claim Requirements:**

Most construction contracts require parties who are asserting a claim to provide prompt notice to the other party of that claim. The AIA documents contain many sophisticated schemes of notice, most of which apply when a contractor encounters a field condition that will delay the work or cause cost overruns. The typical clause requires notice of a claim within a certain number of days of the time the claimant learns



of the facts leading to the claim and in any event prior to the date on which the claimant begins to expend extra funds for which it will seek compensation.

There are several reasons for inclusion of notice of claim requirements, including:

1. Notice of a claim gives the recipient an opportunity to gather information relating to the claim before it is lost. Notice permits the parties to measure, photograph, or sample the buried structure or the rock that the claimant claims will lead to the additional cost. If the recipient of a claim is not given notice, the claimant may remove the rock or the structure before the recipient has the chance to preserve evidence that may very well govern entitlement to the claim.

2. Notice may enable the parties to reach an agreement regarding the amount of the loss and the claim after prompt investigation and thus avoid further claims and litigation.

3. The notice requirements may help assess whether the claim is genuine. Recipients of claims often believe that once the claimant completes the project and discovers that the project lost money, the claimant begins asserting claims in an attempt to recoup that loss. Requiring and providing prompt notice at the time of the event in question helps avoid afterthoughts and these negative inferences or assumptions.

4. The recipients of the claims have to manage and budget their construction project and make decisions based on information available to them. If the recipient does not learn until late in the job that there will be cost overruns, it has less ability to arrange financing, manage the budget, make alterations or changes in the project design, or exert other efforts to save the money that may be needed to cover the claim.

Often claimants seek to circumvent notice requirements by arguing that it would be inequitable to enforce technical requirements of a notice clause where the purpose of



the clause, in fact, has been met; such as where minutes of job meetings confirm actual discussions and consideration of a potential claim. In effect, the claimant will argue that that the recipient has "actual notice" of its claim. However, merely showing that the recipient had knowledge of the field condition at issue may not prove compliance with the notice clause. For example, if a recipient is aware that the contractor has encountered an underground condition that is slowing the progress of the work or is costing extra money to remove, then that does not necessarily mean the recipient understands that the contractor considers it to be an owner-related problem for which the recipient is to pay the claimant extra costs.

This distinction is important because if the contractor plans to effectively spend the owner's money, the owner is entitled to give direction on whether and how to proceed, how much to spend, modification of any design issues, dictation of means and methods, etc.

## **XII. Termination Clauses:**

### **A. Termination for Convenience.**

Termination for Convenience clauses allow an owner to cancel a project after the construction contract has been executed, for any reason. This usually only happens when something very dramatic occurs on the project; for instance, the owner loses all of its financing, the owner is having financial problems, permits to do the work are not issued or are withdrawn, etc.

These clauses generally provide that an owner must pay the contractor its actual costs up to the point of notice of termination for convenience. The contractor may also receive demobilization costs. If any overhead costs have not been recovered through billings for the work performed to date, the contractor may seek to be compensated. On



occasion, the parties provide for the payment of lost profits on the unperformed portion of the work although owners generally resist any obligation to pay lost profits for work not performed.

**B. Termination for Cause by the Owner.**

The AIA form A201 contains a basic clause concerning owner termination for cause and provides that the owner may terminate the contract if the contractor persistently fails or refuses to supply properly skilled workers and materials, fails to pay its bills to subcontractors and suppliers, persistently disregards applicable laws, ordinances or rules, or is otherwise guilty of any substantial breach of the contract which is nothing more than a "catch-all" phrase which might include failure to provide insurance, bonding, or other technical requirements.

The AIA scheme requires that the architect (or the design professional appointed to fill that role for the project) certify that the cause exists, and then owner may, without prejudice to other rights and remedies, terminate the contractor after providing further written notice (typically seven days). These provisions are often negotiated to provide multiple notices or to extend the notice time and to give rights to cure. If the cost to complete the work exceeds the unpaid balance of the contract sum, which is almost always the case, the contractor is responsible for the amounts over and above the contract sum. It is helpful to add a provision that the surety, by issuance of its bond, agrees to likewise be held responsible.

**C. Termination for Cause by the Contractor.**

Contractors seldom wish to terminate contracts. However, in some instances job conditions may be so unbearable that a contractor decides to take that dramatic action of terminating the contract for cause. Contractors typically may terminate if the owner fails



to make payment for thirty days or if the architect fails to recommend payment for thirty days, through no fault of the contractor. The AIA contracts require that the contractor provide seven days written notice to the owner and the architect prior to terminating the contract. However, a procedure preferable to termination for cause by the contractor is to follow any procedures in the contract for alternative dispute resolution. For example, a contract may provide for mediation or arbitration during the course of the work on an accelerated track. These provisions should be included in the contract and taken advantage of to avoid a contractor leaving the project.

Experience and case law dictates that any time a contractor leaves a project prior to its completion, no matter what the reasons, that contractor's actions will be looked on unfavorably except in the most extreme of circumstances.

### **XIII. Incorporation by Reference and Flow Down Clauses:**

Incorporation by reference and flow down clauses are generally found at the beginning of any written contract and they typically provide that various other documents and writings referred to in the contract are incorporated into the contract as if fully set forth therein, and that those referenced documents become part of the terms and provisions of the contract between the parties. Incorporation by reference provisions are enforceable. *See, e.g., State ex rel. Union Indemnity Co. v. Shain*, 66 S.W.2d 102 (Mo. 1933). Generally it is not necessary to attach the incorporated documents to the contract being signed, *Wasson v. Schubert*, 964 S.W.2d 520 (Mo. App. 1998); *Dillard v. Shaughnessy Fickel and Scott Architects*, 943 S.W.2d 711 (Mo.App. 1997), however, it is always good practice to do so. Even so, some cases have indicated that it is not even necessary that the documents exist at the time. For example, plans or specifications that



have not yet been developed fully for distribution and construction but which have been otherwise identified. *See, e.g., Wasson v. Schubert supra.*

One of the most significant issues with respect to documents incorporated by reference, particularly for subcontractors, is that general contractors are reluctant, in most instances, to provide copies of those documents in full to the subcontractor. It is rare that a general contractor will allow the subcontractor to view his price, schedule, or cost breakdown. Subcontractors should be keenly aware of this difficulty and insist on seeing any documents to which the contractor intends to hold them.

The flow down clause, on the other hand, is a simple clause which provides that; for example, the subcontractor shall assume to the general contractor all obligations which the general contractor assumes to the owner with respect to the subcontractor's scope of work. Likewise, these clauses generally provide that the liabilities will flow the same way. *Air Cooling & Energy, Inc. v. Midwestern Construction Company of Missouri, Inc.*, 602 S.W.2d 920 (Mo. App. 1980).

Often there is a dispute between subcontractors and contractors about which clauses, terms, provisions and conditions flow down. For example, do only terms and conditions regarding the subcontractor's scope of work flow down or do all conditions flow down including terms and conditions contained in the general and supplementary provisions regarding insurance, bonding, dispute resolution, notices of claim, alternative dispute resolution, etc.? *See, e.g., Jim Carlson Construction, Inc. v. Barley*, 769 S.W.2d 480 (Mo. App. 1989) (providing that an arbitration clause is incorporated into a subcontract through incorporation of the contractor's general conditions with the owner). *But see Metro Demolition & Excavating Co. v. HBD Contracting, Inc.*, 37 S.W.3d 843 (Mo. App. 2001) (holding that arbitration cannot be incorporated into a subcontract by



reference; but reaching that conclusion apparently because the general contract did not exist at the time when the subcontract was signed). This logic may conflict or run afoul of the logic in *Wasson v. Schubert supra*, and *Dillard v. Shaughnessy Fickel and Scott Architects supra*. Therefore, close attention to these kinds of provisions should be paid by the drafter.

As a general proposition, however, to the extent that there is conflict between the provisions of the subcontract and the general contract, most courts will hold that the more specific provisions of the subcontract prevail over provisions of the general contract or the provisions of documents incorporated by reference into the general contract.



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