Scribbles Squibs #18 - July 31, 2013 – What You Need To Know About Contracts: (Part Two: Different Forms of Construction Contracts)

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This is a subject which can't be reasonably dealt with in just a few pages. There have been any number of writers who have written multi-volume sets trying to explain contract law. In the wills and trusts law, there is a famous multi- volume set having to do with explaining the meaning of just *one sentence!* (The Rule Against Perpetuities.) That Rule was prepared, in part, to handle issues relating to the fertile octogenarian and the unborn widow! While that sounds interesting, possibly even deliciously scandalous, in practice this set may have been the first commonly available over the counter sleeping pill, assuming you were strong enough to carry it home. Hey, if this stuff was easy, *anyone* could do it! (Some of you may think that, based upon your own experiences, anyone already *does* do it!) Because of all of the heavy books that need to be carried around and read, being a lawyer requires both a strong back and good eyes – at least, (for the eyes) in the beginning. So, not claiming to consider this to be in the least way comprehensive, I'd like to touch on a few key contract law issues which I see come up in my practice from time to time.

I. LIABILITIES A CONTRACTOR FACES WITH A FIXED PRICE PER PLANS AND SPECIFICATIONS CONTRACT FOR INSUFFICIENT DESIGN.

The first thing to understand is that, ordinarily, a contractor complying with plans and specifications resulting in a poor end result is still entitled to be fully paid even, conceivably, if the building falls down. A leading case in this area from the United States Supreme Court has produced the "Spearin Doctrine", which so holds. In that case, the Court held that: "But if the contractor is bound to build according to plans and specifications prepared by the owner, the contractor will not be responsible for the consequences of defects in the plans and specifications."

This is consistent with Massachusetts decisional law. In the case of Thibeault v. Pickering, the Appeals Court stated that: "The defendant's duty arose out of and was to be measured by the terms of the written agreement . . ." In the case of Alpert v. Com, the Court stated: "It is well established that where one party furnishes plans and specifications for a contractor to follow in a construction job, and the contractor in good faith relies thereon, the party furnishing such plans impliedly warrants their sufficiency for the purpose intended."

It is important to note, however, three things which may prove to be exceptions to this rule. First of all, for the licensed skilled trades, a contractor performing work not in accordance with applicable codes and licenses is charged with the knowledge of what they require, even if he doesn't necessarily know of them. Thus, if the contract defects at odds with these codes and

licenses should have been discovered by the contractor by virtue of being subject to different codes and licenses, the above result may not obtain. Secondly, if there is a strong industry standard or customs and usage in your trade and the owner's bid documents require you to violate them, better practice would be to advise them of this fact as early as possible, preferably before bidding (if it is public work) and definitely before signing a contract if it is otherwise. Thirdly, if you see there is something obviously wrong with the plans and specifications for your trade before you bid the job, the legally correct thing to do is to tell the owner or architect or both before bids are being received requesting, where applicable, an addendum responding to your concerns. I understand that some contractors think when these see such things: 'here is where I am going to make up the money with change orders I need to replace the money I left on the table'. The problem with this is that Massachusetts' law is fairly consistent that a contractor can't bid a job it knows is incorrect in some material regard and then attempt to make a change order on the deficiency, particularly with regard to public construction. This issue seems more difficult when the defect is patent (obvious) than when the defect is latent.

II. LIABILITIES OF A CONTRACTOR UNDER A DESIGN-BUILD CONTRACT: THE INCREASE OF POTENTIAL LIABILITIES AND EXPOSURE.

There is a hidden problem here. A contractor might think: 'Good! This is the way things *should* be done. I don't have to build something riddled with the architect's many errors. I'll give the owner a design that works and is feasible economically for my company."

Here's the problem with design-build. On a plans and specifications job, a contractor's potential liability is simply to meet the requirements of the plans and specifications plus any applicable codes, all as described above. But, in a 'design-build' job, the contractor is really assuming *two* different roles. First, he is going to design the job to accomplish the owner's stated wishes. And, then, secondly, he will construct the project in accordance with his own design. But, what happens when there are problems with that design?

As a practical matter, the contractor has gone from having only *one* set of potential exposures to having *two* sets of potential exposures. In other words, you now have the liabilities of the design professional as well as the liabilities of being the contractor. Being a contractor's lawyer, I would prefer just one set over two sets! In addition, CGL coverage probably does not cover you in your capacity as a designer. As it is, CGL coverage basically covers a contractor as to property damage and personal injury the contractor's acts and omissions cause but not, generally speaking, with the costs of repairing or replacing defective work (although I have had some cases which, one way or another, this was accomplished). As to insurance coverage issues, your best source of information is your insurance agent. To the best of my knowledge, CGL coverage does not cover any defects in performance that you might have as a designer. Typically, for a professional, this would be done through E & O (errors and omissions) insurance. The various times I have been exposed to the rates that architects pay for this, they are quite high, at least in comparison with legal malpractice rates. So, if this is something you are going to do much of, ascertaining whether you need some kind of E & O insurance before you sign a contract for such a project may be in your best interests. And, the costs of which

should be built into your annual overhead structure along with the estimated annual costs of your other insurances you generally carry. And, practically speaking, where you are both the designer and the contractor, you have the problem Martha and the Vandellas described in the song 'Nowhere to Run'. That is 'nowhere to hide'. Any way you look at it, you are more than likely responsible for a construction issue if you are both the designer and the contractor. Also, it is all the more likely that you won't be able to get change orders for added monies to correct errors in the design, at least to the extent that those errors are *yours*. But, an almost equal problem is that you probably won't be able to get any more *time* when it is necessary to correct a design error. This is particularly so for jobs having significant liquidated damages for not meeting a substantial completion date or for jobs having liquidated damages for not meeting specific contractual milestones even if you ultimately meet the substantial completion deadline. The possibility of these issues – inadequate design with resulting liquidated damages based on extended contracting performance – should be anticipated – or, at least, considered - in some fashion when preparing your price for the proposal. After all, unlike a per plans and specifications job, change orders for money and time are a lot less likely available here. And, please keep in mind that when your job doesn't provide for liquidated damages, this does not mean that you are necessarily relieved from exposure for delay damages. All that liquidated damages are is an estimated amount prior to contract performance as to what the actual delay damages *might* be. So, when your contract doesn't provide for liquidated damages, you may still be liable for *actual* delay damages which, in many situations, could be more than liquidated damages. Massachusetts contract law generally provides that a party to a contract can be liable for liquidated damages ***or*** for actual delay damages but not for both. Some contracts do waive delay (consequential) damages by one party against the other or they are probably in the minority.

Another practical issue I have seen with design-build contracts is that usually a schedule for pay purposes will be broken down into the design phase and then with regard to the construction phase. So, concerns over obtaining mobilization costs and any desired front end loading have to be figured with that in mind. Better practice would be to have a schedule for pay purposes for both design and for construction as part of your proposal. That way, you have a better chance of getting your requested schedule for pay purposes as, without it, your contracting party doesn't get the value of the price and of your performance. Handling the proposal (and any resulting contract) and the schedule for pay purposes as two different sequential items probably means that you have lost much of the leverage you might have had with regard to the schedule for pay purposes had both the proposal (contract) and schedule for pay purposes been treated as one item.

Here's a sense that I have about design-build contracts, which is, admittedly, totally unscientific. It's an impression that I have that when a contractor performs both the design and construction functions, the cost for both to the owner is probably less than it would have been had the owner been required to pay for both an architect and for a contractor. Granted, there very well could be price savings where one party both plans for and performs both activities. Still, I have this feeling that quite often contractors don't adequately charge for the design portion of their contract. This is not to say that they necessarily treat the design phase as a 'throw-away' or as primarily an inducement to get the construction contract. But, considering a

contractor's potentially increased exposures for performing both functions, these should be seriously taken into consideration when pricing both aspects of a design-build contract.

III. ISSUES WITH UNIT PRICE CONTRACTS

I would like to point out three specific issues.

The first issue is that with unit price contracts, the unit price might not be fixed in stone. Many contracting scenarios, beginning with the Federal Acquisition Regulations, allow either party to seek to renegotiate the unit price when the units increase to 115% of any estimate given in the bid documents or decrease to less than 85% than that which was anticipated. Either party to the contract can ask for these adjustments. The different percentages up or down may be different in different contracts although this 15% factor seems often used.

A second issue with unit price contracts is that, of necessity, your overhead and profit factors are figured into the price of individual units, particularly when your contract is exclusively unit price and does not have a significant lump sum aspect. So, while a deduct may be appropriate in terms of deleted units, since those units contain the overall costs of overhead and profit spread among them, fairness suggests that a deduct in the unit price quantities should only be with regard to the actual cost of supplying, installing and performing each unit of work. Since the overhead and profit costs as estimated are spread throughout the units, an owner's insistence on having the same number for both adds and deducts - particularly with regard to the overhead - is probably not fair to the contractor. For, if your job diminishes by a factor of 15% or more, that deduct should not leave you where you are essentially being punished by having to take a hit to your overhead or profit numbers, neither of which much changes with variations in unit quantities. Better practice would be to provide for a higher number for adds (to include the costs of overhead and profit) and a lower number for deducts (to not subtract your overhead and profit numbers as to the deleted units). Looking at any such unit price contract should involve some consideration of these issues.

In my view, a unit price contract is different from a contract with a termination for convenience provision even though the latter contract could end up with a similar result as with the former: performance without all units or work being completed. Typically, a termination for convenience clause will specifically provide what costs are recoverable with regard to deleted units and, often, these will not include profit on deleted work. But here is where the unit contract differs from the contract with a termination for convenience clause. In a termination for convenience situation, since this is set out before the contract is signed, a party could decide either to not bid such a contract or to not sign such a contract or to increase the price somewhat for some protection against the possible invocation of a termination for convenience. (By my experience, this option is seldom exercised in non-federal jobs.) Also, by definition, a termination for convenience necessarily involves a situation where the contract is not going to be completely performed.

In a unit price contract, the only way to price the work is to assume all of the units are going to be used. To view this otherwise – put in a higher number in case the units are decreased – can only lead to one becoming non-competitive. Secondly, in a unit price contract,

irrespective of whatever the number of units ultimately is, by definition, the contract is fully-performed. Not so with a contract where a termination for convenience option has been exercised.

A third thing about unit price contracts is that having relatively minor adjustments in the units desired, variations should not necessarily be considered as change orders. After all, the rationale in having a unit price contract as compared with a lump sum contract is that at the go-in, no one is quite clear as to how many units will be required. This could be a function of what absolutely has to be replaced or repaired which may not be ascertainable before performance has commenced. Or, the final amount of units can also be dependent on at what point the owner runs out of money, which can be limited not only to budget issues but may also be affected by other factors involved with the design and construction of any given job, possibly affected by extended times for performance and for changes to the lump sum portion of a contract. So, where one would be expected to get a change order before performing an increase to a fixed price contract increasing the amount by ten percent, one would not necessarily be expected to get a change order for a ten percent increase in units. And, there is some law supporting these differences.

This is particularly useful to a contractor with specified requirements of providing written notice or getting written change orders before extra work is performed. As we all know, this often doesn't happen for one reason or another. And, Massachusetts is a tough state on not giving notice when notice is required by contract. Many court cases have held that when there are clear provisions in a contract stating what notices have to be given and in what form before performing extra work, a failure to comply with them can be considered to be a waiver of that potential claim. This is particularly so with regard to public projects.

My sense would be that obligations to give written notice/obtain change orders before performing extra work does not apply at all – or, at least, apply as much - to moderate variations in unit quantities. One situation, however, *may* require written notice/change orders with regard to unit price item increases. This would be when there is an absolutely huge increase in units, particularly one which one or both of the parties didn't/couldn't have contemplated when the contract was signed.

Case in point. One of my generals had a contract with the state to provide maintenance on some absolutely large pump motor housings and appurtenant parts, which typically are located under thirty feet of water, the pumps being used for flood control. The specification required that all surfaces were to be cleaned and coated as to any particular housing. Since the pump housings were disassembled at the time of cleaning and coating and where both the *outside* surface of the pump housing and the *inside* surface of the pump housing were equally exposed to the same long term negative effects of water, any reasonable interpretation of the exact contract language used could only mean that *both* surfaces were intended to be cleaned and coated. Since at the time of bidding the pumps were under thirty feet of water and fully-assembled, they couldn't be examined pre-bid. And, the pumps were quite old.

The owner in giving estimated unit quantities used a figure that only worked out to be for the *outside* of the pump housings. The contractor, having taken these gigantic things apart,

looked at the specifications and reasonably interpreted this to mean that *both* sides had to be done. After the work was complete, the contractor submitted a bill for twice the estimated quantities indicated in the bid documents. A fair interpretation of the facts suggests that the contractor simply did the work that was required by the contract documents to be done – both sides. And, the contractor didn't realize the architect's error of only indicating the unit quantities for just the outside of the pump housing until the job was done and the contractor couldn't figure out how it had so greatly exceeded his labor and, particularly, material quantities to perform the job.

The case went through its various litigation phases and settled at approximately the value of *both* sides of the pump housings before any depositions had been taken. While pleased that we were successful, I could see how the case could have gone the other way.

IV. ISSUES INVOLVED WITH TRADE CONTRACTORS AS COMPARED WITH FILED SUBBIDDERS

Public construction in Massachusetts has traditionally been generally described as either horizontal construction (roads, water and sewer) as described in MGL C. 30, s. 39M or as vertical construction (buildings) as described in MGL C. 149, s. 44A-H. Both systems generally contemplate fixed price general contracts. With regard to vertical construction, the public owner under the 'filed subbidder' system takes bids directly from various 'filed subbidders' with regard to seventeen specific trades, which bids are generally received at least four days before the due date for general contractor bids. The general bidders are only able to 'carry' for any particular filed subbid trade those bidders listed on the owner's filed subbidder tabulation. Under this system, the general bidder is not able to adjust either the scope of the work of the filed subbidder or the price of the work of the filed subbidder, each of which is fixed by the respective filed subbid bids, which bids are submitted directly to the owner.

One of the incidences of this system is that if the general bidder wishes for the filed subbidder to post payment and performance bonds, this is indicated on the general's bid form. In this case, the general contractor itself has to pay the price of the subcontractor's bonds. This has two main impacts on the filed subbidder. First of all, the filed subbider ***must*** have a pre-existing surety bond line. Granted, it may be that only occasionally – possibly, even, *never* – the general contractor may request bonds. But, since the filed subbidder does not know which generals will actually bid the job and, especially, which general will be low, the filed subbidder has to have a pre-existing surety bond line.

Several years ago, a new concept came into being in Massachusetts for the performance of public work, known as the 'contractor-at-risk' program, governed by MGL C. 149A. Here the various subcontractors are required to submit bids as to their work as 'trade contractors' to a certain already-selected general contractor who works as the 'contractor-at-risk', where the basis of its compensation is a set fee.

In many regards, the provisions as to 'trade contractors' are very similar to those applicable to filed subbidders with regard to bonds with two important differences.

The first is that *all* trade contractors are required to submit their bids with payment and performance bonds included in their price. Meaning, that unlike filed subbidders who get general bidders to pay for their bond premiums when bonds are required, 'trade contractors' have to include in their bid the cost of their own bonds, which are required on all jobs, paying for them themselves. As the costs of such bonds can be substantial, both filed subbidders and 'trade contractors' have to know the differences between under what situations the general bidder pays for their bond premiums and under what situations the contractor-at-risk contractor ***doesn't.*** This is an important distinction to understand as quite often subcontractors could be either filed subbidders or trade contractors, depending on the procurement method employed for any particular project by the owner, which, for a lot of jobs could be interchangeable.

The second thing is that all trade contractors must have a bonding line. It is technically possible, however, for a filed subbidder to not need bonds, particularly when it 'restricts to' a specific general contractor with regard to its bid, a general contractor the filed subbidder knows in advance will not be requiring bonds.

For newer and smaller subcontractors and general contractors reading this, performing Massachusetts public work is a way of growing, sometimes significantly and rather quickly so. (Please keep in mind, however, that rapid growth with regard to a subcontractor or general contractor is one of the five or six basic reasons why contractors fail: when they outstrip their capital resources and administrative infra-structure.) If you do not have a surety line and don't know what Massachusetts insurance agents to talk with, I can put you in touch with several quality insurance agents who have access to multiple surety markets and in whom I have confidence. Just give me a telephone call or email and I can give you some names. Access to multiple markets is important as, particularly with subcontractors and general contractors new to surety bonds, you may have to be initially put in what is called a 'substandard market' (higher risk) surety or surety program. A prerequisite for nearly all of them is that you have some form of audited financial statements *first.* The insurance agent will be able to advise you as to the kinds of paperwork you will need to get a surety bond from any specific carrier.

Lastly, both filed subbidders and trade contractors have statutorily-provided forms for subcontracts. For filed subbidders, this is MGL C. 149, s. 44F. For trade contractors, this is MGL C. 149A, s. 8. Both of these forms are very similar but are not identical. The point in knowing about this is that general contractors out of ignorance or otherwise may tender to you their custom form to be signed in either situation. Some subcontractors and their counsel take the position that where the subcontract forms are provided by statute, one can't be required to sign anything else. In some situations, this might be worth looking into further. One issue that this might be helpful with is indemnification. There are no specific indemnification provisions contained in either form of subcontract. Typically, the indemnification provisions tendered by a general contractor in its' own custom form are quite substantial, maybe even onerous and require much more from a subcontractor than is required by MGL C. 149, s. 29C, a statute specifically saying what that obligation is limited to. By knowing that you may have a right to limit your subcontract to that contained in the respective statutes may be a way of getting out from underneath such provisions.

V. MISCELLANEOUS ISSUES AS TO DIFFERENT CONTRACT FORMS

Since there are so many different contract forms used in different situations, a final ten impressions/comments is all the room we have left.

1. For subcontractors, be wary of forms tendered to you by general contractor trade associations such as Associated General Contractors. These forms might not have been drafted with your interests primarily in mind! The same could be said as to any trade association contract you are asked to sign where the goals of that organization are to serve someone different from your own trade or tier. Also, when a general contractor has tendered to you its own form subcontract, this bears reading more carefully than a more indifferent form of contract, such as one of the AIA documents. When a contractor has thought it prudent to spend money (possibly, a *lot* of money) to have a custom form of subcontract prepared, chances are that there are a lot of things in it that you and I will simply not like when viewing the subcontract from a subcontractor perspective.

2. A subcontractor has three preferred forms for subcontract.

The first would be your own proposal form, where the terms and conditions on the back side of the page are your own.

The second would be to use the 'statutory subcontract' spelled out in MGL C. 149, s. 44F for filed subbidders. This subcontract form is only two pages long and is quite fair. Specifically, it provides for specific strict time deadlines as to the provision of notice by general contractors to subcontractors for general contractor backcharges involving a general contractor's supply of labor and materials to the subcontractor's account. That this form is specified with regard to filed subbidders does not mean it cannot be used in other situations. It is a good, simple contract.

The third form would be an applicable version of an AIA A401. I have seen such forms which have the same time limitations for notice on general contractor backcharges as does have the statutory subcontract. And, since AIA forms are primarily drawn with the greatest attention paid to the owners' and architects' interests, they tend to be pretty fair as between subcontractors and general contractors (neither one of which the AIA seems to have a particular use for!) So, assuming you have a license for AIA contract forms, I'd use one of these striking out all references to arbitration, one of the devil's recent and certainly most abhorrent creations.

3. The most important contract clauses to read and understand in your contract are: (a) any clauses pertaining to notice for claims or for extra work; (b) any clauses applicable to either requesting an architect's final decision or appealing from an architect's final decision; and (c) any clauses describing the prosecution of disputes. You can't comply with them if you don't know what they are. And, if you hold off really reading and understanding them until such time as you have a real problem, it may be too late at that time to take some of the actions that were either required or which might have been useful.

4. Always be mindful of other contract documents incorporated into your contract by reference irrespective of whether you have seen them or not. If they are listed as contract documents, that you have never been shown them may not be any form of defense to their enforcement against you.

5. Various federal contracts I have seen may simply list clause numbers from various of the Federal Acquisition Regulations (FAR) without actually setting them forth. You will have to go to the Code of Federal Regulations to read them.

6. For Massachusetts public works contracts, be aware of the fact that 'The Blue Book' from Mass DOT is often an identified contract document and this book makes provisions that may be at variance (possibly fairer) than various provisions in your own contract documents. Also, since this is a fairly comprehensive book with regard to bidding, contract execution and contract performance issues, this may be the only contract document actually covering the issue you are concerned with.

7. Irrespective of whatever tier you are with regard to the various construction relationships, don't be afraid to negotiate your contract. For one thing, if you ask for no changes, this is an indication to your future contracting party that you are either dumb or a pushover, which could have lots of negative effects as to issues you might face with regard to change orders, time extensions and payments down the road. If you are a subcontractor, realistically, if you can amend or strike two or three of the most egregious terms in a form subcontract tendered to you, that's probably doing pretty well. Several times a year, I'll have new subcontractors come to me and ask for me to provide them an analysis of a contract they are being asked to sign. There is definitely value there for a subcontractor who is not aware of what the typical issues are and/or doesn't know how to read a subcontract. Once I point them out, the subcontractor hopefully will see them itself in further tendered subcontracts. But, as to any particular subcontract you are presented with for signature, you'll probably have limited opportunities for changing language. That might be a different situation if you have an historical and favorable relationship with an owner where that owner might use its good offices to assist you in not getting too beat up. Once the owner is sticking up for you, a lot of problems seem to go away or at least get better.

8. A great many, if not, most, of the contracts I see these days have no damage for delay, pay-when-paid and termination for convenience clauses. That means, for better or worse, that they have become rather standard. For a Massachusetts public works/building contract, there is a statutory right for having delay damage claims as is contained in MGL C. 30, s. 39O, which could be in addition to whatever contractual rights you have or don't have as contained in your contract. Recently, there has been some legislation on the limitation of pay-when-paid clauses as to Massachusetts private construction contracts. But, people think that such changes were better than they really were if you take time to read the act. There has been recent case law saying that a general contractor's payment bond surety does not have the right to enforce a pay-when-paid clause in a subcontract against a subcontractor even when it is contained within the subcontract and the general contractor could have enforced it.

9. Be mindful of the fact that not all contract clauses are 'legal'. Requirements in a Massachusetts subcontract stating that the subcontractor will give up all rights to file a mechanic's lien are void as against public policy and are specifically prohibited by statute.

10. Be mindful of the fact that not all contractual clauses are enforceable as written or not subject to possible modification. A common contract term is that all change orders are only enforceable if in writing and that no oral contract modifications are valid. There is case law saying that such a provision can be orally modified.

*(These materials are intended as general information only, not specific legal advice. When confronted with a legal problem you don't understand, seek the assistance of legal counsel. Construction law is something that most 'general' lawyers don't do a lot of. At Sauer & Sauer, we **only** practice construction law and we attempt to assist our clients with their contractual needs and issues whenever possible.)*

SEVEN QUICK THINGS TO KNOW ABOUT OUR FIRM:

1. No charge to non-clients for quick answers to *general* Massachusetts construction law questions.

2. We guarantee our billing rate for five years in writing for all new clients through the end of this year who mention this offer at engagement.

3. As trials can be expensive, take a great deal of management time and the result of which is uncertain, we make our best efforts towards seeing whether something short of a trial – such as mediation – might be possible for resolving the matter. If a trial is necessary, however, we have a lot of experience trying cases.

4. We endeavor to maintain, wherever possible, possible future business relationships with your contracting party by emphasizing a fair and reasonable approach to the resolution of disputes, which often helps promote earlier (and cheaper) case resolutions than does 'mean and angry'. And, while you might say now that 'I'd never work for that guy again', a lot of experience over several decades suggests otherwise. Given the right job, he'd be given another chance, particularly if it was a good job!

5. We try to defer until later in the case the more expensive elements of discovery – i.e. depositions – in order to try less expensive discovery first. We recently obtained a 1.5 million dollar settlement for a subcontractor against a bankrupt general contractor's payment bond surety on three projects without a single deposition ever being taken and without our client's even having to answer and sign interrogatories.

6. Being a smaller firm, our attention is focused *solely* on our clients and their problems, not on feeding the overhead of a fancy office and many partners, associates and support staff. We only have to feed our five dogs, most of which, however, are *quite large!* (If you ever meet The Worm, be respectful and, perhaps, a bit wary. After all, Rotties *can* be difficult! Especially around meal times. For big dogs like this, it is almost *always* around meal times! Or, close enough.)

7. Satellite offices in Boston and Worcester for more convenient meetings.