

Mitigating Risk through Construction Contracts and Claims Avoidance

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Risks on Construction Projects

- * Design defects
- * Construction defects
- * Nonpayment
- * Concealed and subsurface conditions
- * Natural disasters/Weather
- * Delays and impacts
- * Loss of funding sources
- * Cost overruns
- * Personal Injury/Death
- * Theft and vandalism
- * Environmental damage/Pollution
- * Business losses
- * Contractor Insolvency/Bankruptcy
- * Data breaches/losses
- * Terrorism/War
- * Labor unrest/Strikes

The Contract

Choose the contract that is most appropriate for each project

- * Don't just choose and use any form without regard to its provisions – provisions must be suited to the circumstances, goals, and risks of each project

Review contract documents and requirements with your risk manager, insurance broker, and legal counsel before advertising a project for bid

Contract documents should be coordinated, consistent, and complimentary

Rights and duties should be expressly and clearly articulated in the contract documents

Allocation of Risk in Contract

General rule of thumb: Allocate risks to the party who is either: (1) most likely to create the risk or (2) in the best position to control and manage the risk

Goals:

- * Protect yourself from exposure to risk and loss
- * Achieve a successful project that is completed on time, within budget, and in accordance with your design and operational intent

Equitable Considerations in Allocating Risk

What are the effects of overburdening the contractor with risks?

Allocation of particular risks

Concealed and subsurface conditions

- * Usually allocated to owner
 - * Prudence of surveys and geotechnical investigation
- * Contractor should have notice and claim requirements upon discovery; obligation to mitigate

Project safety

- * Usually allocated to general contractor

Natural disasters, Armed conflicts, Labor unrest

- * Risk sharing (e.g., compensation but extension of time for period of impact)

Contractual Insurance Requirements

Types of insurance commonly required on construction projects:

- * **Commercial General Liability** – bodily injury, property damage, advertising injury caused by contractor and subcontractor negligence relating to ongoing and completed operations; Products liability
 - * Often does not cover the contractor's defective work itself
- * **Professional Liability** – errors and omissions of professionals such as architects, engineers, surveyors and mappers
- * **Automobile Liability** – bodily injury and property damage arising out of use of automobiles for business purposes
- * **Workers' Compensation and Employer's Liability** – work-related injuries and illnesses
- * **Builder's Risk** – damages to materials and equipment used in construction and damages to property under construction
 - * Usually obtained by owner, but contract may obligate contractor
 - * Typically provides coverage through owner's acceptance of project
- * **Pollution Liability** – pollution conditions arising from the insured's operations

- * Types and amounts of insurance appropriate for the scope and risk on each individual project
 - * Must be discussed with your Risk Manager or Insurance Broker
- * Insurance requirements should be **incorporated into your contract** and should be made to **flow down to subcontractors**
- * Contract should require the insurance to cover the contractor's/design professional's **contractual indemnity obligations** (discussed further below)
- * Contract should require that you, your employees, and agents be **additional insureds** on the contractor's insurance policy
 - * Flow-down provisions in subcontracts
- * Designation of contractor's policies as **primary and non-contributory**
 - * Keeps your insurance policies out of the mix
- * Can require the contractor to **waive subrogation** against you and your separate insurers
 - * Ensures that the risk for the covered loss stays with insurer

Require your contractor/design professional to immediately, and before beginning to perform any work, provide you with a **complete copy of the policy** – Do not rely on certificate of insurance

Immediately review the policy to ensure it actually provides the insurance required by your contract – Reject the insurance if it does not

Do not invite a waiver argument

Familiarize yourself with the notice and claims reporting provisions of the policy

Indemnification and Defense Provisions

Indemnification

- * A right of an injured person to claim and receive reimbursement for its loss, damage or liability from a person who has a duty to make such reimbursement – shifts the responsibility for making good on a loss suffered by another person
 - * Indemnatee and indemnitor
 - * Regardless of whether the indemnity obligation is covered by insurance, indemnity provisions shifting responsibility for certain losses are an essential risk mitigation tool to include in contracts

Example – Owner has to pay out to settle a contractor's claim for delays and extra work caused by deficiencies in plans and specifications prepared by the architect

- * The contract must clearly express the range of the persons who may be indemnified and the scope of the acts or losses against which indemnity is given

Legal limitations on indemnity in some jurisdictions

- * Classes of persons who may receive indemnity
- * Scope of the acts or losses for which indemnity may be given (e.g., negligence of indemnitee)

As a means of protecting against the possibility of a contractual indemnity provision being declared invalid, you may desire to preface it with language such as:

“To the fullest extent permitted by applicable law, Contractor agrees to indemnify, defend, and hold harmless Owner . . .”

Duty of Defense

- * Obligation of one person to defend or pay for the defense of another against certain claims
- * Triggered by allegations of conduct within the scope of the duty – the duty arises from the time the claim is made and notice and tender given to the party with the duty of defense
- * Related to, but different from, duty to indemnify – the duty to indemnify only requires payment or reimbursement once the liability of the indemnitee has been determined or a loss is paid by the indemnitee

Example of indemnity and defense provision

To the fullest extent permitted by applicable law, the Contractor shall **indemnify, defend, and hold harmless** the Owner, Architect, Architect's consultants, and agents and employees or any of them from and against claims, damages, losses and expenses, including but not limited to, attorneys' fees, arising out of or resulting from performance of the Work, provided that such claim, damage, loss or expense is attributable to bodily injury, sickness, disease or death, or to injury to or destruction of tangible property (other than the Work itself), but only to the extent caused by the negligent acts or omissions, recklessness, or intentional wrongful conduct of the Contractor, a subcontractor, anyone directly or indirectly employed by them or anyone for whose acts they may be liable, regardless of whether or not such claim, damage, loss or expense is caused in part by a party indemnified hereunder.

Exculpatory Provisions

Exculpatory provision

- * A contractual provision that relieves a party from liability or certain types of damages
- * Generally, must be articulated clearly and unambiguously in the contract

Owners should seek to avoid agreeing to limit the liability of or damages recoverable from a contractor or design professional

However, generally, greater liability of prospective contractors and design professionals could result in higher bid/proposal amounts, fewer bidders/proposers, or both

Examples of common exculpatory provisions in prime contracts:

1. Waiver of consequential and incidental damages

Consequential damages = Indirect damages; losses that do not flow directly and immediately from an injurious act but that indirectly result from the act (e.g., lost profits, lost bonding capacity)

Incidental damages = losses reasonably associated with or related to actual damages (e.g., expenses incurred in inspecting or returning goods that do not conform to contract specifications)

Specific losses indirectly flowing from and related to a party's actions or inactions could be far-reaching and costly

You want to limit the consequential and incidental damages for which you could be liable

HOWEVER, you do not want to preclude yourself from being able to recover those damages that your contractor or design professional causes you

Example – losses of revenue and rent concessions that you may suffer resulting from defective or untimely construction

Equity may dictate a mutual waiver by both you and your customer

Risk assessment and cost/benefit analysis should be conducted with respect to each project, considering the intended use of the facility constructed and the financial implications of your inability to use the facility consistent with your intentions

Example of waiver of consequential damages in favor of only the owner

Notwithstanding any statements contained herein to the contrary, in no event shall Owner be liable for any special, indirect, incidental, or consequential damages (including, without limitation, any claim for delay, loss of efficiency, impact, loss of production or anticipated revenues and profits) with respect to any Work to be furnished hereunder by Contractor.

Example of mutual waiver of consequential damages

Except as otherwise set forth in the Contract Documents, the Contractor and Owner waive claims against each other for consequential damages arising out of or relating to this Contract. This mutual waiver includes, but is not necessarily limited to:

- (1) damages incurred by the Owner for rental expenses, for losses of use, income, profit, financing, business and reputation, and for loss of management or employee productivity or of the services of such persons; and
- (2) damages incurred by the Contractor for principal office expenses including the compensation of personnel stationed there, for losses of financing, business and reputation, and for loss of profit.

2. No damages for delay provisions

- * Limit contractors to extensions of contract time and precludes claims for monetary compensation for delays
- * These clauses are invalid in some states and valid in others – consult local law to ensure enforceability
- * When enforceable, exceptions in some states can preclude enforcement (e.g., the owner's active interference with the contractor's work)

Example of a no damages for delay provision

The Contractor's sole and exclusive remedy for any delays or other time-related impacts to the performance of the Work or the Contract Documents caused by events beyond the Contractor's control, including, but not limited to, delays claimed to be caused by the Owner or attributable to the Owner, including claims based on breach of contract, negligence, or any other legal or equitable theory, shall be an equitable adjustment to the Contract Time. The Contractor waives and shall not be entitled to any monetary damages or any other damages for delay or other time-related impact.

Even if the owner precludes a contractor's ability to recover monetary damages for delays, the owner may want to include a **liquidated damages** provision for the contractor's untimely completion of the contract

- * Amount per day must be reasonable
- * Amount must be the best estimate, at time of contract, of the damages that would be caused by a breach
- * Cannot function as a penalty

Payment and Performance Bonds

Payment Bond

- * Affords payment protection to certain tiers of subcontractors and suppliers for labor, services, materials and equipment furnished for a project

Performance Bond

- * Guarantees completion of the prime contract upon default by the contractor
- * **Shifts the risk of contractor non-completion from the owner to the surety**

Not insurance – The bond surety expects to be repaid by its principal for any amounts paid out

State and federal laws usually require the contractor to give the owner one or both of these types of bonds on public improvement projects

- * Exceptions – smaller projects

Regardless of whether required by law, project owners should require their contractors to furnish payment and performance bonds in the contract between the owner and the contractor

Aids in defense of subcontractor and supplier nonpayment claims against owner on equitable grounds, such as unjust enrichment

Claims Avoidance and Risk Mitigation in the Performance of the Contract

Review and inspection of the work

Architect/Engineer role

Adherence to and enforcement of contractual and statutory requirements

Notice and claims procedures

Punch list procedures

Prompt payment

Diligence vs. acquiescence

Open communications and dialogue; Cooperation

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