Chapter I
THE CONTRACT FOR CONSTRUCTION: STANDARD FORMS AND COMMON RISK TRANSFERRING PROVISIONS

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> Stop! Think! Where did the standard form contract come from? I'll give you a hint: Which organization's name is on the form? Yes, that's who wrote it. Next question. Who is that agreement designed to protect? I'll give you a hint: Which organization's name is on the form? Next hint: Who brought the form to the negotiation? The form did not arrive with Moses from Mount Sinai. The form was prepared by an industry to protect its members or was prepared by the other party to the transaction.[1]

Form contracts have been used for over 100 years by virtually all members of the construction industry – owners, design professionals, contractors and subcontractors. There is a popular belief within the industry that the widespread use of such documents removes the necessity of drafting individual contracts tailored to each specific project and allows the parties to conform the allocation of risks, responsibilities, and costs to general construction industry standards.[2] Indeed, there are many advantages to using standard form contracts. Typically, these forms are developed only after discussion amongst various groups having varied interests in the forms. The contracts strive for a *rough parity* between the parties. In addition, standard contracts usually are revised in response to new developments in the construction industry as well as in response to court decisions. Standard forms are analyzed both in treatises and articles, as well as by the courts. Thus, much information is available regarding their advantages and disadvantages. In addition, such analysis provides a level of predictability when using form contracts.

However, simply because a provision is contained within a standard form contract does not necessarily mean that it serves the user's best interests. The user of form contracts must be cognizant of where the standard form contract came from, which organization's name is on the form, what party the agreement is designed to protect, and at whose risk.[3] At a minimum, if asked to execute a standard form contract, contractors should confirm whether it is a form which has been endorsed by an association of which it is a member. The best approach, of course, is to thoroughly review the terms of the form contract, or have an attorney review the form for you, to make sure that you fully understand the proposed terms and can negotiate the addition of terms that may be missing and/or favorably modify those terms that may be oppressive, deficient or ambiguous given the particular nature of the project.

With that advice, the reality of construction contract negotiation is that only in rare circumstances does a party sign a construction contract in which it is completely satisfied with all of its terms. This typically does not occur because the parties generally are not on equal ground. With a few notable exceptions, the party paying is bargaining from a more powerful position than the party being paid. Thus, the owner who is paying the contractor is in a more powerful bargaining position than the contractor. The contractor who is paying the subcontractor is in a more powerful position than the subcontractor. The practical consequence of this reality is that owners frequently can and do transfer the risks associated with construction projects to general contractors in prime contracts. Having contractually accepted these risks, general contractors attempt to pass them along to subcontractors.[4]

The challenge for any party in an inferior bargaining position is to neutralize their disadvantage as best they can. Sometimes this can be accomplished by trading terms for price. Very few parties typically will disregard a price concession in exchange for the modification an oppressive term.[5] Conversely, if greater risk is assumed, this should be reflected in the contract price. One of the cornerstones of proper risk allocation is that the risk assumed by a contractor should be in direct relation to the contractor's ability to

profit on the project. Another way to improve an inferior bargaining position is to try to obtain the other side's agreement to use a standard form contract from one of the various "families" of contracts published for use by the construction industry. Fortunately, self-interest can be taken only so far. In the end, a contract must represent to some degree industry norms and be consistent with the way the industry works in the real world.[6]

This Chapter will identify the various contractor and subcontractor construction form documents that are available for use and discuss the perspective from which they are written. It also will highlight various provisions which are found in these agreements and/or customized and proprietary contract documents of owners which attempt to shift and allocate risk between the parties, discuss the reaction of the courts to such provisions, and recommend ways to avoid, or at least minimize, various risks inherent in a construction project during contract negotiation.

A. The Construction Industry Families of Documents

The construction industry publishes several families of documents. The four primary sources for documents are:

> The Associated General Contractors of America ("AGC");
> The American Institute of Architects ("AIA");
> The Engineers Joint Contracts Documents Committee ("EJCDC")[7]; and
> The Design Build Institute of America ("DBIA").[8]

As most construction industry members typically will encounter either AIA or AGC contracts or subcontracts or customized versions of these documents, this Chapter will focus on key provisions from contracts and subcontracts from the AIA and AGC construction contract families which allocate or transfer risk.[9] While the design/build construction concept is an increasingly popular construction delivery method, and arguably the latest iteration in the construction industry's effort to allocate the risk of "projects gone bad", it is beyond this Chapter to discuss the unique features of such contracts.[10]

1. The AGC Contractor Construction Documents

The AGC is the nation's largest and oldest construction trade association composed of construction contractors and industry related companies. AGC contract documents are developed and revised through the work of AGC's Contract Documents Committee ("CDC") with the assistance of professional staff and consultants. The CDC defines its mission in the following terms:

> The Contract Documents Committee will be recognized as the leader in providing and continually improving balanced documents for the construction industry by: being aware of the needs and concerns of all AGC members and chapters; advocating equitable risk allocation between owners, architects, engineers and contractors; creating and endorsing a comprehensive family of documents and educating all parties in their use; providing critical information to the industry on contract documents issues; and reinforcing AGC's commitment to Skill, Responsibility and Integrity through contracts.[11]

The CDC currently is composed of over 100 members, who are experienced contractors, specialty contractors, attorneys, insurers, and other construction industry professionals from across the country.

Some time ago, the AGC realized that the design professional usually is involved with the owner prior to the contractor's involvement in the project. The design professional on many projects therefore selects the contract document family that will be used.[12] The AGC decided to address this perceived AIA advantage by soliciting owner input into the AGC owner/contractor documents. Thus, the AGC formed the Private Industry Advisory Council ("PIAC") which consists of design and construction professionals from Fortune 500 companies representing many sectors of the U.S. economy including, automobile

manufacturing, entertainment, banking, insurance, retailing, energy generation and distribution, and health care.[13]

The PIAC had significant input into the development of the AGC owner/contractor documents as did the Building Owners & Managers Association International ("BOMA").[14] As a result, the AGC 200 Series documents (General Contracting Documents) and 400 Series documents (Design/Build Documents) have been approved and endorsed by the PIAC and approved by BOMA.[15] By presenting documents that balance the perspectives of both owners and contractors, the AGC hopes to convince owners to utilize AGC documents.[16] The current AGC contractor construction documents are as follows:

AGC 200 "Standard Form of Agreement and General Conditions Between Owner and Contractor *(Where the Contract Price is a Lump Sum)"* (2000 edition);

AGC 230 "Standard Form of Agreement and General Conditions Between Owner and Contractor *(Where the Basis of Payment is the Cost of the Work with an Option for Preconstruction Services)"* (2000 edition); and

AGC 250 "Standard Form of Agreement and General Conditions Between Owner and Contractor *(Where the Basis of Payment is a GMP with an Option for Preconstruction Services)"* (2000 edition).

2. <u>The AIA Contractor Construction Documents</u>

The AIA is an association that represents member architects and related professionals. The AIA contract documents comprise over 80 forms and contracts that define contractual relationships and terms involved in design and construction projects.[17] Like the AGC standard forms, the AIA contract documents are drafted by the AIA with the consensus of contractors, attorneys, architects, and engineers.[18] As noted by one commentator,

> The AIA walks a thin line as it balances its various constituencies during document drafting. It is important to the AIA to have endorsement of national organizations in order to lessen controversy and aid sales of its documents. . . . It is also important to the AIA to remember who employs its members. Traditionally, then, AIA documents favor the parties to the construction process in the following hierarchy: architect; owner (and lender); subcontractor (and suppliers); and prime contractor. Subcontractor and suppliers take precedence over the prime contractor because of the difficulties presented by construction liens if the prime contractor fails or refuses to pay its subcontractors or suppliers.[19]

The AIA advertises that its standard forms reflect industry practice, offer predictability across different projects and types of projects, and allow repeated use and expeditious closing of transactions.[20] The forms are intended to stand by themselves and serve as a baseline for agreement.[21] The current AIA contractor construction (excluding CM versions) documents include the following:

A101 "Owner/Contractor Agreement - Stipulated Sum" (1997 edition);
A111 "Owner/Contractor Agreement - Cost Plus a Fee with a GMP" (1997 edition); and
A201 "General Conditions of the Contract for Construction" (1997 edition) (incorporated by reference into the A101 and A111).[22]

3. <u>The AGC/AIA Subcontractor Documents</u>

No discussion of construction contracts is complete without some mention of the standard form subcontractor documents. The most frequently used subcontract form developed by industry associations is the AIA's Standard Form of Agreement Between Contractor and Subcontractor, the A401 (1997

edition). The A401 is designed to supplement or interact with the A201, the AIA's General Conditions of the Contract for Construction.

The AGC also publishes a series of subcontract documents which include AGC Document No. 650, "Standard Form of Agreement Between Contractor and Subcontractor *(Where the Contractor Assumes the Risk of Owner Payment)"* (1998 edition) and AGC Document No. 655, "Standard Form of Agreement Between Contractor and Subcontractor (*Where the Contractor and Subcontractor Share the Risk of Owner Payment)"* (1998 edition).[23] Both of these forms are designed to interact with the A201 General Conditions as well as AGC Document No. 200, which is the AGC's General Conditions for the Contract Between Owner and General Contractor. The main difference between the two AGC subcontract forms is that the AGC 655 contains a contingent-payment (i.e., pay-when-paid) clause, which conditions the general contractor's obligation to pay its subcontractor on receipt of payment from the owner. The AGC 650 is similar to the A401 which obligates the general contractor to pay a subcontractor even if the owner has not paid the general contractor through no fault of the subcontractor.

The Associated Specialty Contractors ("ASC")[24] participated in the development of the AGC 650 and has approved and endorsed this subcontract. Unlike the ASC, the American Subcontractors Association ("ASA") did not participate in the development and has not endorsed this subcontract form. Neither organization has endorsed the AGC 655, primarily because of its inclusion of a pay-when-paid provision.[25] Contractors and their counsel should be aware that the ASA publishes materials explaining the "benefits and pitfalls" for subcontractors for both the AIA and AGC forms. In addition, the ASA publishes documents to be used as addenda to the AIA and AGC forms[26] the intent of which is to block much of the risk shifting to subcontractors presented by these forms.

4. Some Final Warnings About Standard Forms

As noted above, most building construction projects will involve either the AIA or AGC documents. It is not unusual, however, for a contractor to be presented with an AIA contract with the owner, but then rely on and use its standard form AGC subcontract with its subcontractors.[27] If a contractor is going to mix families of documents, caution should be exercised to make sure that the risks are properly allocated between the contractor and its subcontractors and material suppliers.[28] Any holes in the transfer of risks or responsibilities to subcontractors and suppliers likely will result in the contractor being solely liable to the owner.[29]

Contractors also should be wary of standard forms that have been extensively modified. If a form is extensively altered, the contractor may lose the advantages inherent in the standard form. Moreover, a change oftentimes will be made in one area of the contract and not the corresponding or interrelated contract sections or contract documents. For instance, because the provisions of the A101, A201 and AGC 200 affect all parties involved in the project, including the architect and subcontractors, consideration must be given as to how such changes will affect the owner's and contractor's agreements with other parties and whether parallel changes will need to be made to the architect's or subcontractors' contract documents. Fortunately, if the change to the standard form is owner driven and creates ambiguity or inconsistency, any such ambiguities or inconsistencies in the contract documents will be construed against the owner and in favor of the contractor.[30] In subcontracts, however, any such ambiguities will be construed in favor of the subcontractor and against the contractor.[31]

B. Common Risk Shifting Provisions In Construction Contracts

Effective risk management when negotiating a construction contract requires the contractor to assess the risks of loss inherent in the undertaking. The risks which may be present in construction projects fall under various categories, and include, without limitation, the physical works (changed or differing site conditions, hazardous materials), delay (outside the parties' control, consequential losses, liquidated damages), damage to property (due to negligence, breach of warranty, design defects or uninsurable risks), and payment (insolvency of owner, cash flow or funding constraints).

Once the contractor assesses the risks of the project, a determination must then be made whether the reward -- the award of the contract -- is worth the risks and whether a cost effective strategy can be implemented to minimize those risks. That strategy should be consistent with the three "golden rules" of risk management on a construction project:

1. The party that is in the best position to control the risk should take responsibility for the risk;

2. If possible, risks that cannot be controlled should be transferred to someone else; and

3. Risks that cannot be controlled and cannot be transferred to someone else should be insured.[32]

Rule number 1 often is relied upon to justify many of the risk shifting clauses found in standard form construction contracts or the proprietary forms of owners and general contractors. Other provisions, as discussed above, simply exist because of the superior bargaining power of one of the contracting parties. An exhaustive discussion of all risk shifting clauses typically found in construction contracts is neither possible nor practical in this Chapter; however, discussed below are some of the common provisions.

1. Pay-when-Paid/Pay-if-Paid. Clauses in construction subcontracts that condition payment to the subcontractor on the general contractor's receipt of payment from the owner are generally referred to as pay-when-paid or pay-if-paid provisions. They provide, in essence, that the subcontractor will be paid if, as and when the general contractor receives payment from the owner. Consequently, if the general contractor never receives payment from the owner, the general contractor is not obligated to pay the subcontractor. The effect of such a provision can be to shift the risk of the owner's financial instability from the general contractor to the subcontractor.

Pay-when-paid clauses have been a source of frequent litigation between general contractors and their subcontractors following an owner's default or refusal to issue payment on a construction project. Due to the harsh results of the pay-when-paid clause, and the perceived unequal bargaining power of the subcontractors, such clauses are not favored by the courts.

Cases analyzing these clauses generally fall into one of three categories. The majority find that the clause expresses the parties' intent to pay the subcontractor within a reasonable time, not that the subcontractor has absorbed the risk of the owner's non-payment.[33] A minority strictly enforce such clauses finding that payment from the owner is a condition precedent to payment to the subcontractor.[34] Still other courts have held that notwithstanding the parties' clear intention to shift the risk of non-payment from the general contractor to the subcontractor, such risk-shifting is at odds with public policy, and therefore constitutes an unenforceable contract term.[35]

Courts closely examine the contract language to determine whether the clause is valid. Generally, pay-when-paid or pay-if-paid provisions must be clear and unambiguous to be enforceable. The leading Michigan case interpreting conditional payment clauses is Berkel & Company Contractors v. Christman Co.[36] There, the court held that an unambiguous pay-if-paid clause was enforceable. The subcontract explicitly used the term "condition precedent" in the conditional payment clause, and the subcontractor had fair warning that the clause not only was intended to delay payment for a period of time but that payment would be withheld altogether if the general contractor was not paid by the owner.[37]

Even when the contract contains an unambiguous pay-when-paid provision, enforcement of such clauses may be excused under certain circumstances. After finding that the subcontract created a valid condition precedent to payment, the court in Fisher & Wright v. Flakt, Inc.[38] went on to state that in order for the subcontractor to succeed, it must show that the condition precedent was either fulfilled or excused. That if nonpayment by the owner has occurred ". . . because of [the general contractor's] own conduct, a waiver may exist. For instance, if [the general contractor] breached the contract with [the owner] then [the

general contractor's] misconduct prevented [payment] from occurring."[39] Similarly, in Kasler Electric Co. v. Insurance Co. of North America,[40] the court found a valid condition precedent to payment in a construction subcontract, but indicated that if the general contractor "breach[ed] the contract, then [the subcontractor] will be entitled to damages according to accepted measures of damages for breach of contract, and in that event the 'pay-as- paid' provision appears to be irrelevant...."[41]

In a recent unpublished decision, the Michigan Court of Appeals in Citadel Corporation v. Eastbank Associates Limited Partnership[42] refused to adopt the subcontractor's claim that the pay-if-paid clause was unenforceable as matter of public policy because violative of the Michigan Construction Lien Act. First noting that the Construction Lien Act recognizes circumstances under which it is proper to reserve payment until a condition precedent occurs, the court reaffirmed the right of parties to enter into contracts containing terms of their own choosing, and held that "it is not against the public policy of this state to permit the parties to set payment terms, including requiring payment from a third-party as a condition precedent to payment to a subcontractor."[43]

Subcontractors in other states, however, successfully have argued that conditional payment clauses are unenforceable because they violate public policy embodied in lien statutes. For instance, the Court of Appeals of New York held in West-Fair Elec. Contractors v. Aetna Cas. & Sur. Co.[44] that a pay-when-paid provision which operates as a true condition precedent was contrary to the public policy found in that state's construction lien statute. The court determined that if operative, the "pay-when-paid provision extinguishes plaintiff subcontractor's ability to enforce a lien against the owner. . . . "[45] Therefore, the court concluded that "a pay-when-paid provision which forces the subcontractor to assume the risk that the owner will fail to pay the general contractor is void and unenforceable as contrary to the public policy set forth in the Lien Law §34."[46] However, the court also said "[b]y contrast, a pay-when-paid provision which merely fixes a time for payment does not indefinitely suspend a subcontractor's right to payment upon the failure of an owner to pay the general contractor and does not violate public policy. . . ."[47]

As noted by one commentator, "from a review of the cases, it appears that the courts are not so much changing their attitude towards [pay-when-paid] clauses as the drafters of such clauses are becoming specific in their intention."[48] Thus, to combat the court's disdain for pay-when-paid clauses, contractors must carefully draft the provision to leave the court less room to interpret its meaning. By adding the term "condition precedent" or otherwise clearly indicating that payment to the general contractor is a condition precedent to payment to the subcontractor as provided in Berkel, general contractors can limit the court's freedom to interpret the clause in favor of subcontractors. The payment terms of the prime contract also carefully should be reviewed to make sure that they do not create an ambiguity when read together with the subcontract.

2. Flow-Through Clauses. Flow-Through clauses (also sometimes referred to as "Flow-Down", "Pass-Through" or "Conduit" clauses), in their most basic form, transfer responsibility for the project from the general contractor to the subcontractor.[49] Obligations owed to the owner by the general contractor "flow-through" to the subcontractor. Paragraph 5.3 of the A201 General Conditions, for example, provides that subcontractors are bound to the terms of the "Contract Documents" and imposes responsibility on the contractor to require each subcontractor to abide by the terms of the Contract Documents "to the extent of the Work performed by the Subcontractor". This same provision requires the contractor to make the Contract Documents available to each subcontractor.

It is usually desirable for rights and duties to flow both ways, upward to the general contractor as well as downward to the subcontractors at each level. The general contractor is able to allocate risks that it assumes to the owner to those parties who actually perform that portion of the contract. In exchange, subcontractors often receive rights concerning the making of claims, protests and notice that the general contractor has against the owner. The new AGC subcontracts, for instance, give a subcontractor the same rights and redress as a general contractor toward an owner and architect under a prime contract.[50] Thus, the parties are placed on a relatively level field, even though there is no privity of contract between the owner and the lower-tier contractors.

Critics of flow-through clauses complain that such provisions often incorporate all of the prime contract documents into the subcontract.[51] Those prime contract documents include not only the technical plans and specifications pertaining to the subcontractor's installation and products, but also contain many other matters that govern the contractual relationship between the owner and general contractor.[52] "The AIA A201 is literally forty-four pages of small print that sets forth enumerable obligations of the contractor to the owner. A broad "flow-through" clause extrapolates all of them upon the subcontractor."[53]

While flow-through clauses are standard in the construction industry, the routine nature of their use in construction contracts does not insure that contractual rights and obligations flow down in every case. These provisions must be written expressly into the contract terms and conditions, and the intent to bind the subcontractor to the general contractor as the general contractor is bound to the owner must be clearly defined. General contractors and subcontractors should review both their standard subcontract forms and purchase orders to determine that both forms contain flow down clauses that are clear and comprehensive. Particular care should be given to drafting purchase orders to ensure that all needed general and special conditions of the upper tier or prime contract are adequately incorporated into the agreement. A reference to a particular division of the specifications may be sufficient to identify the basic scope of the work but may not be sufficient to flow down critical project requirements and obligations.

Finally, Article 5.3.1 of the A201 General Conditions provides that upon written request of the subcontractor, the general contractor shall identify to the subcontractor the terms and conditions of the "proposed subcontract" that may be at variance with the Contract Documents. Since the word "proposed" is used, it appears that an obligation is intended for the general contractor to provide this information during the negotiation process.[54] It is unclear precisely what rights this clause confers upon the subcontractor prior to the formation of the subcontract. Nevertheless, the clause clearly is intended to benefit the subcontractor, and hence, perhaps the subcontractor has rights as a third party beneficiary.[55] Arguably, if the contractor fails to identify a key provision in the subcontract which is at variance with the Contract Documents, the subcontractor may argue that it is not bound by Article 5.[56] Should the subcontractor succeed in such a claim, the contractor will be in breach of the contract.[57] Thus, requests from subcontractors for the identification of variant provisions should not be ignored.

3. <u>Design Responsibilities</u>. Design delegation is the practice by which responsibility for the design of certain elements of a construction project is shifted from the owner and its architect/engineer to the contractor and its subcontractors. Examples include the design of curtain walls, precast concrete panels, steel attachments, elevators, sprinkler systems, exhaust systems, HVAC systems, ceiling support systems, and the like. This practice developed, in part, simply because specialty contractors know more about their products, and are better able to design those products and how they fit into the project, than the design professional of record.[58] Critics of the practice "view design delegation as a matter of risk avoidance by Architects trying to distance themselves from the responsibility for the design."[59]

With the addition of Article 3.12.10 in the A201 General Conditions,[60] the longstanding industry practice of design delegation was recognized in writing in a standard industry contract. The design delegation procedure in this provision works as follows: the architect specifies performance and design criteria; the contractor retains a licensed design professional to perform the actual design; the delegated design professional must attach his seal to the design document; and the prime design architect reviews and approves the design documents for conformance with the "design concept" under the contract documents. The provision does not require general contractors to perform design services that would violate local law.

Opponents of the provision contend that it unfairly forces general contractors to assume design responsibilities for which they have (a) no experience; (b) no license to perform; and (c) no insurance.[61] Because of these concerns, general contractors must analyze and control their risk by making sure that the design professionals which it and/or its subcontractors retain have appropriate expertise to perform the design functions delegated to them. Contractors also must undertake a review of their insurance programs with regard to coverage for delegated design services. When a contractor undertakes design beyond that associated with shop drawings or similar incidental design necessitated by the means and methods of

construction, there is limited, if any, coverage for those design services under the typical commercial general liability ("CGL") policy. The intent of the insurance marketplace in most instances, under a CGL policy, is to provide only incidental design coverage for the construction means and methods of the contractor. Thus, with the introduction of Article 3.12.10,

> . . . Contractors will need to understand terms such as 'project specific errors and omissions coverage,' whether that coverage has a 'tail and the length of that tail.' Contractors will also be required to conduct a further review of their own CGL policies to determine whether the policies contain the traditional architects and engineers exclusion endorsement. If they do, Contractors should negotiate with their carriers to delete that endorsement. Contractors will also have to determine whether their policies contain endorsement CG 2280, an amended version of professional services exclusion that offers the Contractor limited design/build coverage. If the policy does not include that endorsement, it should be amended. Contractors should also explore the coverages available to them in the exploding new market for Contractors' contingent liability coverage as well as stand-alone design liability coverage when the Contractor is providing design through its Subcontractors.[62]

Since Article 3.12.10 has not been tested in the courts, it may be some time before this contract provision is clear as to where liability ultimately will rest with regard to the various design components of a given project. What is clear is that "prime contractors will no longer be able to hide behind the owner's warranty of the adequacy of the drawings and specifications, as set forth by the United States Supreme Court in United States v. Spearin[63] almost eighty years ago, if there is a problem with ancillary component design."[64] Thus, insurance coverage will become an even more important part of the contractor's risk allocation protection. One commentator suggests that insurance underwriters must refer to the Design Build Underwriting Guidelines to properly understand and address the issues of insurance, risk allocation and loss prevention.

4. No Damage for Delay. Many owners attempt to avoid liability for damages arising from delay to the contractor's work by including a "no damages for delay" clause in the construction contract. If a construction contract includes such a provision, a time extension typically is the exclusive remedy available to the contractor by reason of the delay. In general, such clauses are upheld against claims that they violate public policy.[65] This includes Michigan where the clause has been recognized as a valid exculpatory contract clause.[66]

Similar to pay-when-paid clauses, however, no damage for delay clauses also are not favored by the courts and, as a result, are strictly construed against the owner.[67] This strict construction has given rise to a number of exceptions to the enforcement of "no damage" clauses. Widely recognized exceptions include:

1. delay caused by bad faith, fraud, concealment, or misrepresentation on the part of the party asserting the clause's protection;

2. delays not within the contemplation of the parties at the time of contracting;

3. a delay of an unreasonable length amounting to an abandonment of the contract; and

4. a breach by the party claiming the clause's protection of a fundamental obligation of the contract, such as active interference.[68]

Any one of the foregoing exceptions is sufficient to render the clause unenforceable.[69] In addition, in other jurisdictions, contractors sometimes have succeeded in avoiding the harsh consequences of a no

damage for delay provision by "labeling" the claims as something other than "delay" claims. For example, in Edward E. Gillen Co. v. City of Lake Forest,[70] the court recognized a claim asserted by a contractor that its damages arose from excess work made necessary because of faulty materials, rather than from a delay occasioned by the provision of faulty materials. One commentator has suggested that contractors label their delay cause of action as a "disruption claim" rather than a delay claim to circumvent the express limitations of the provision.[71]

5. Indemnification. Indemnification obligations arise in one of two ways – contractually and by operation of law. The purpose of indemnification is to pass the risk of loss to the party responsible for the loss. The desired end result is to place the performing party in the same position it would have occupied but for the other's failure to perform. Common law indemnity arises when a party who pays damages to an injured party seeks to shift this loss to another party who committed the wrongful act.[72] Contractual indemnification provisions in standard form construction contracts are common. As noted by one commentator,

> It is difficult to predict at the onset of a construction project what will go wrong and how much damage will be caused by the problem. And when something goes wrong in a construction project short of total failure to perform by one party, it is often difficult to sort out whose fault was greater. In other words, few problems arise solely on account of the fault of one party. The line of responsibility is difficult to draw. Because of this, the parties seek to do it artificially and to allocate the financial risk of loss through indemnification provisions.[73]

Typical indemnity provisions require the indemnitor (the payor) to defend, indemnify, and hold the indemnitee (the payee) harmless from loss, damage or liability from a stated cause. A standard indemnification clause in a construction contract generally requires the contractor to indemnify the owner for damage or loss resulting from the contractor's work, limited to claims for bodily injury and property damage.[74] Subcontractor contracts also generally include an indemnification clause protecting the general contractor.[75]

Interpretation and enforcement of indemnity clauses is complicated by opposing policy concerns. One policy is to enforce contracts according to their terms. Another is to avoid the inequitable enforcement of contracts of adhesion, i.e., standard contracts imposed on a party of weaker bargaining strength.[76] Problems typically arise when the owner/indemnitee demands indemnification from the general contractor for all loss, liability or damages from (a) any cause whatsoever, except the sole negligence of the indemnitee and (b) any cause whatsoever, including the sole negligence of the indemnitee.

Michigan law permits an indemnitee in a construction contract to be indemnified for its own negligence in an express contractual provision. Indemnification is not permitted, however, if based upon the indemnitee's sole negligence. Such provisions are deemed unenforceable as against public policy under MCL 691.991.[77] Under this indemnity statute, the focus is on the cause of the harm in deciding whether the indemnification agreement provides indemnity for the indemnitee's sole negligence in violation of the statute. The appropriate focus is on the injury as a whole rather than on that portion of damages attributable to the indemnitee.[78]

Broad, all-inclusive indemnification language may be interpreted to protect the indemnitee against its own negligence if such intent can be ascertained from other language in the contract, surrounding circumstances, or from the purpose sought to be accomplished by the parties. For instance, in Paquin v. Harnischfeger Corp.,[79] the court used several factors to determine whether the parties intended to protect the indemnitee against its own negligence. Among others, the court recognized that an exclusionary clause, which expressly precluded indemnification for injuries caused by the indemnitee's sole negligence, indicated the intent to provide indemnification for all other situations involving the indemnitee's own negligence.[80] However, in Fischbach-Natkin Co. v. Power Process Piping, Inc.,[81] the court construed an indemnity provision which provided for indemnity against "any and all" damages

arising out of a construction contract, as one not including indemnification for the indemnitee's own negligence.

Indemnity agreements are closely related to insurance contracts both in function and in effect.[82] A contractor usually purchases insurance which will protect it in the event the contractor must indemnify the owner. The cost of the insurance generally is included in the contract bid, which essentially passes the cost back to the owner. When purchasing insurance for indemnification purposes, the contractor must ensure that the insurance includes contractual liabilities (general liability insurance may not cover a contractually-assumed risk).[83] It is good practice for contractors to submit proposed indemnity clauses to their insurance carriers for review prior to signing an agreement. No contractor should inadvertently put itself in the position of having to self-insure a risk. Finally, depending on how significantly the contractor's indemnity obligation is increased and whether the contractor can obtain adequate insurance protection, the contractor should consider adjusting its compensation to account for the increased indemnity risk.

6. Mutual Waiver of Consequential Damages. It is not unusual for owners to try to expand the scope of the contractor's indemnity to include consequential damages such as lost profits. When amended in 1997, the A201 General Conditions included Article 4.3.10 which is a "mutual waiver of consequential damages" provision. In effect, the owner and contractor mutually release each other for "consequential damages arising out of or relating to" the contract while allowing the parties to recover for "direct damages." This waiver is broad enough to include all such damages and specifically removes the owner's ability to recover for lost use, rental expenses and costs, income or profit absent a liquidated damages clause.

The rationale for the mutual waiver was to allow the parties to predict with some certainty their potential liability under the contract. This provision also was intended to relieve the contractor from the more draconian effects of the design delegation provision in Article 3.12.10 of the General Conditions discussed above. The fact that the mutual waiver Article does not preclude liquidated damages makes the provision somewhat one-sided. Although future litigation regarding whether damage is "direct" or "consequential" can be expected, the probable intent of this provision is to have the owner assume the risk of lost profits due to delay. In return, the contractor waives any damages for principal office expenses, loss of financing, and damage to business and reputation. The new AGC subcontract forms include mutual waivers of consequential damages between a general contractor and subcontractor. See AGC 650 and 655 subcontract forms, Article 5.4.1. These waivers only apply if a prime contract also provides for a mutual waiver of consequential damages between the general contractor and owner.

7. Differing Site Conditions[84] During the course of almost every construction project, circumstances will arise that were not contemplated when the contract documents were prepared and therefore are not addressed in the contract. Changes may become necessary when unexpected conditions are encountered on the job site. These differing site changes are different from change orders or extras in that a differing site condition consists not only of conditions differing materially from those stated in the contract, but also of unknown and unusual conditions not ordinarily encountered in the kind of work provided for in the contract which increase the amount of time and/or money required to complete the project. A differing site condition has been defined as:

> A physical condition other than the weather, climate or act of God discovered on or affecting a construction site that differs in some material respect from what reasonably was anticipated. The phraseology sometimes varies; for example, early case law sometimes referred to changed conditions, adverse physical conditions, or concealed conditions. Regardless of the specific label, however, the condition must be physical. Thus, changes in economic, labor, or political conditions do not constitute differing site conditions. Also, it is not necessary that the condition encountered be in existence at the time of contracting; it may come into existence after the contract award.[85]

The parties to a construction contract can assign the responsibility for site conditions to either the owner or the contractor. In the absence of fraud or nondisclosure, a construction contract requiring a contractor to assume responsibility for site conditions is enforceable.[86] Most standard form construction contracts allocate such risks to the owner and contain a clause allowing the contractor to obtain an equitable adjustment for changed, differing, or unanticipated site conditions. The purpose of a "differing site conditions" clause in a construction contract is to allocate the risk of increased performance costs, resulting from the unknown, change or different condition from the contractor to the owner. By including a differing or changed site conditions clause, bidding contractors do not need to include a risk contingency for problematic subsurface or other unforeseen conditions in their bids.[87]

Article 4.3.4 of the A201 General Conditions contains a differing site conditions provision which provides for an equitable adjustment in the contract sum and/or contract time for two types of differing site conditions – "Type I" and "Type II".[88] A Type I condition depends on the representations made in the contract documents as to the conditions the contractor is likely to encounter. A Type II condition occurs when the contract does not purport to detail the conditions the contractor will encounter and unexpected conditions are discovered in the course of the work. AGC 650 and 655 subcontract forms are consistent with AIA and standard federal government contract clauses that establish the two conditions that entitle a subcontractor to additional compensation.

Many standard industry contracts require the contractor to visit the site before signing a contract or beginning the work.[89] After discovering a differing site condition, most construction contracts require the contractor to give prompt notice to the owner.[90] Before a contractor will be allowed to recover under a changed conditions clause, it will have to prove compliance with all of the notice provisions or other prerequisites to recovery set forth in the contract documents. Contractors also should be wary of owner defenses to differing site conditions claims. They generally appear in the contract documents as disclaimers or exculpatory clauses. To the extent that they shift the risk of a differing site condition back to the contractor, notwithstanding a differing site conditions provision, the contractor may need to recognize the shift in its bid.

8. <u>Environmental Risk Allocation</u>.[91] The most effective way for a contractor to protect itself from environmental liability is by including provisions in the contract which attempt to insulate or limit its exposure. Some common provisions include the following:

a. Scope of Work Clause: if the contractor does not intend to be held responsible for any environmental problems that may develop during construction, this should be clearly stated in the scope of work clause. When including limitations in the scope of work clause, contractors should confirm that no other provisions in the contract expand the scope of the work. Usually such an unintended expansion will be found in the change order provision of the contract.

b. Differing Site Condition: if the contractor does not intend to be held responsible for any environmental problems, the contractor also should include a clause which details the rights of the parties in the event hazardous waste is found. Article 10.3.2 is such a clause in the A201 General Conditions. This provision sets forth the owner's obligations upon the discovery of hazardous material and expressly requires the owner to extend the contract time and equitably adjust the contract sum to allow the contractor to recover costs associated with shut-down, delay and start-up attributable to the discovery of such materials.

c. Site Information Provided by Owner: a clause may be included in a contract which establishes an affirmative duty upon the owner to provide all known site information to the contractor and which provides that the contractor may rely upon this information in performing its work.

d. Indemnification: if there is a chance of encountering hazardous materials at a project site, the contractor also may protect its interest with an indemnification clause. The effect of the clause would be to hold the owner responsible for indemnifying the contractor for claims and damages arising out of the

release or disposal of such waste. The A201 General Conditions in Article 10.3.3 limit the owner's indemnity to damage, loss or expense attributable to "bodily injury, sickness, disease or death, or to injury to or destruction of tangible property (other than the Work itself) . . ." [92]

Aside from the clauses contractors can insert into contracts to protect against environmental liability, contractors also should consider avoiding certain provisions. For example, contractors should avoid warranting that the work will conform to all EPA standards, policies and guidelines, as in most instances; there are simply too many guidelines for a contractor to read, understand and apply.

9. Liquidated Damages. The time of completion of the project is important to both the owner and the contractor. In most contracts, dates will be specified for starting and completing the work. The contractor is bound to do the work by the due date, and will be liable for damages if it fails to complete the work on time. Many construction contracts include a liquidated damages provision that requires the contractor to pay a pre-set stipulated amount for each day of delay beyond the final completion date of the project.[93] Liquidated damages also can be assessed upon the contractor's failure to meet interim completion dates or milestones.

The concept of liquidated damages is based on the fact that sometimes the damages suffered by the owner due to delays in project completion are hard, or even impossible, to determine at the time the contract is signed. This is because of the existence of many unknowns. The owner therefore will try to evaluate, in anticipation, the value of its losses at the time of contracting. In the absence of a liquidated damages provision in the contract, the owner would have to itemize its actual damages and present them to the contractor in order to be made whole. The liquidated damages provision relieves the owner from this burden, and the effect is to substitute a contract remedy for a common law breach remedy.

The general rule followed by most courts is that the fixed dollar amount of liquidated damages bears some reasonable relationship to the amount of damages which the owner could have predictably suffered in the event of construction delay.[94] Liquidated damage amounts which impose unreasonable penalties upon the contractor rather than reasonably compensate the owner for its delay losses usually are not legally enforceable. It is not unusual for courts and arbitrators to completely ignore liquidated damages provisions containing daily dollar amounts inserted arbitrarily and without consideration of the reasonable amount of damages the owner might sustain because of delay.[95] In contract negotiations the parties should consider what predictable loss the owner might suffer if construction is delayed. The contractor should be prepared to negotiate the liquidated damages amount by making plausible arguments in favor of reductions calculated to fix that amount realistically and by assuring that the contract completion date will provide sufficient time to complete - with some margin for contingencies.

The contract likewise should include provisions excusing delays for circumstances beyond the contractor's control such as strikes, shortages or unavailability of materials, fires, floods and other acts of God or circumstances beyond the contractor's control. Liquidated damages may be applied only to unexcused late completion. Late completion which does not result from a breach of contract, but from causes beyond the contractor's control justifying contract time extensions, is not subject to assessment of liquidated damages or any other damages.[96]

Use of a liquidated damages provision based upon a reasonable completion schedule and realistic dollar figure sometimes can benefit the contractor. With a liquidated damages clause, the contractor will know precisely what its risk might be if its work is delayed. When the parties provide for liquidated damages, such damages are the sole recovery, and actual damages that flow from a breach covered by the liquidated damages clause are not recoverable. However, the clause also can work to a contractor's disadvantage. If the agreed upon damage amount actually is higher than the actual damages experienced, then the contractor must pay more money than it otherwise would have had without such a provision. The contractor also must be wary of a liquidated damages clause which purports to compensate the owner for only specified kinds of delay damages. In such a case, the owner may not be precluded from recovering additional delay damages beyond the liquidated amount which are not within the scope of the clause. Finally, the contract oftentimes will require the contractor to object to the imposition of liquidated

damages within a certain time frame. Absent a timely objection, the right to challenge may be waived.

10. Retention. The owner of a project typically will withhold a certain amount of each progress payment as "retainage" to insure that the project is completed. General contractors, in turn, will require similar retention in all subcontracts. While not as obvious a risk transferring provision, as, for instance, a pay when paid provision, retention is yet another contracting tool available to the owner which can have a negative financial impact on a general contractor and its subcontractors. Most owners feel that retention will motivate tradesmen to return to the project to complete small unprofitable punchlist items. Retention also provides the owner (and general contractor) with money to correct defective work if a subcontractor abandons the project and provides funds to pay the mechanic's lien claims of unpaid suppliers.

Subcontractors often argue that retention is unnecessary, counter-productive and abused and point to contractual warranties and performance and payment bonds as providing adequate protection for owners. This criticism particularly rings true on large projects where the retention amount may become so large that the retention ultimately penalizes the contractor for completed work and the contractor ends up financing the project until the retention is released. Oftentimes, the retention can represent a large proportion, or all, of the profit on a job. To mitigate the negative impact of this result, contractors should attempt to modify Article 5 of the A101 and make like changes to Article 7 of the A201. Instead of waiting until final payment to receive retention, contractors should lobby for payment in full for the completed work of subcontractors that provide work early in the project such as excavators and steel erectors. Similarly, as the construction progresses to completion, the amount of retention should be proportionally reduced. Finally, upon substantial completion, retention should be reduced so that the owner is only withholding 150% of the value of the punchlist items.

In addition to the foregoing negotiating points, contractors and subcontractors alike should be aware of the retention reform which the ASA and other groups have achieved, particularly on public projects. The federal government and most states, including Michigan, have passed "prompt pay" laws.[97] Some states have statutorily limited the amount of retention to 5 percent and required that retention must be placed in interest bearing accounts for the benefit of the general contractor and all subcontractors.

In order to be successful, contractors and subcontractors must approach the collection of progress payments as one of the most important elements of their business. This requires a consistent and thought out approach to obtaining payment in a timely manner. This process includes identifying your payment terms in your bid; negotiating the most favorable payment terms in your contract, including the retention provision; and knowing and exercising your legal rights.

Conclusion

It is never prudent simply to sign an agreement without reading it trusting that the other party will deal with you fairly, regardless of what the "paper work" says. While many contracts are signed, filed away, and never again taken out of the file drawer, some projects do not proceed as planned. When that happens, the parties turn to the written contract to identify their respective rights and responsibilities. Commenting on the basic purposes of written construction contracts, one commentator colorfully noted:

> Often contracting parties start out as naïve star-struck lovers for whom nothing can go wrong. Perhaps the construction contract will be completed and there will be no problems or disputes. Generally this is not the case. The contract becomes the basis for the divorce settlement.[98]

In formulating and agreeing upon the contract terms which address risk allocation questions, contractors, owners and attorneys often will turn to form contracts for standard language. When utilizing such forms, contractors and their counsel must thoroughly understand how the form contract allocates potential risks (and on whose behalf the contract forms were drafted), the nature and degree of those risks, the degree to

which the contract's clauses will be enforced by the courts, and the manner in which the contract price should be affected by the risk allocations within the contract. Oftentimes, standard form contracts will not best serve the contractor's interests in the event of a "divorce". Therefore, a contractor must protect its interests prior to signing the contract and the start of the work. "Details" should not be left for later discussion and agreement. It goes without saying, the contract that you sign may greatly affect the success and profitability of the project.

ENDNOTES

[1] *See* Samuel Frank Schoninger, Drafting Construction Contracts, Strategy and Forms for Contractors, at 17 (Wiley Law Publications 1990).

[2] *See* Rick Ensor, *Changes in Design and Construction Contracts*, WBC Bulletin (March, 2000).

[3] *See* G. Mark Albright, *Construction Contract Clauses*, available at <http://www.aswalaw.com/construction.htm> (last visited August 6, 2003).

[4] In his article, *Killer Subcontractor Clauses*, Richard Thomas notes,

> In the distant past, a subcontract documented the business relationship between the parties without any extraordinary attempt to shift risk from one party to the other. Subcontracts were commonly one page long. Beginning around the early 1970's, a trend commenced to shift many of the risks on construction projects to the subcontractor. Around the early to mid-1980's, this trend accelerated to the point where currently, some subcontracts are over one hundred pages long! Risk shifting became the norm in the industry. Under that trend, the vast majority of risks were transferred to subcontractors.
>
> Many rationales were advanced to justify this trend. One of the most popular was that since subcontractors perform the majority of work, they are the ones that had the real control over most risks. Hence, the risks properly belong with the subcontractor.

See Richard Gary Thomas, *Killer Subcontractor Clauses*, at 2, available at <http://www.constlaw.org/../papers/thomas13.pdf> (last visited August 6, 2003).

[5] *See* Schoninger, *supra* note 1, at 28.

[6] In touting its standard forms of construction contracts, the Associated General Contractors advertises:

> Since the major risks and responsibilities already have been efficiently and equitably allocated, AGC document users save considerable transaction costs. Users have an industry-accepted foundation for their transaction. They no longer need to go through a painstaking negotiation process for each transaction risk. Rather, they and their legal and insurance advisers may only need to review transaction-specific additions to and deletions from the AGC standard form. This saves time and expense for both contracting parties.

See <http://www.agc.org/contractdocuments/intro.asp>.

[7] The EJCDC is a consortium of the Professional Engineers in the Private Practice division of the National Society of Professional Engineers, the American Consulting Engineers Council and the American Society of Civil Engineers. EJCDC documents primarily are used in "horizontal" or "engineered" construction projects such as wastewater treatment plants where the engineer is the lead design professional. The AGC has had some input into the creation of some of the EJCDC construction documents. As a tradeoff for this input, the AGC has endorsed some EJCDC documents.

[8] The DBIA focuses on the publication of construction documents for use with the design/build project delivery system. However, the AIA, AGC and EJCDC also publish design/build construction documents. By way of

example, the AGC's design/build documents can be found in its "400" series. AGC 410 is a "Standard Form of Design-Build Agreement and General Conditions Between Owner and Design-Builder *(Where the Basis of Payment is the Cost of the Work Plus a Fee with a Guaranteed Maximum Price)*.

[9] If form contracts are used, the user should make sure, among other things, that it is executing the most recent forms published by the AIA and AGC. Among other ways, the AIA forms can be ordered through the AIA Rizzoli Bookstore at http://www.aiabookstore.com. The forms will be sent as printed documents as they currently are not available for downloading or delivery via email. However, the documents are available in electronic format if a license is purchased from the AIA. For more information regarding AIA licensing, go to http://www.aia.org/documents/ef/techsupportfaq.asp. For a discussion regarding the AGC standard form contracts, a listing of the contracts offered for sale, and ordering information, go to http://www.agc.org/contractdocuments/at_a_glance/introduction.asp.

[10] The design/builder is exposed to a greater degree of liability for project related defects than if the project were designed or constructed independently. The design/builder is liable for defective project-related conditions irrespective of whether the project was designed in accordance with industry standards or whether the work was performed in accordance with the plans and specifications. Rather than merely warranting workmanlike performance, the design/builder warrants the performance of the project as a product. The process reflects the owner/developer's attempt to shift risk to the design/builder irrespective of fault.

[11] *See* <http://www.agc.org/contractdocuments/intro.asp>.

[12] *See* Gregory M. Bistram, *An Overview of the Construction Families of Documents With Special Attention to the AGC Subcontract*, at 7, presented at the November 13, 2001 Minnesota Construction Law MILE Seminar.

[13] *See* <http://www.agc.org/contractdocuments/intro.asp>.

[14] *See* Bistram, *supra* note 12, at 6.

[15] Id. at 7.

[16] Id.

[17] *See* <http://www.aia.org/documents/>.

[18] Id.

[19] *See* Charles R. Schrader, *Subcontractors Gain More Power Under New AIA Forms*, available at <http://www.jordanschrader.com/articles/article0006.html> (last visited August 6, 2003).

[20] *See* <http://www.aia.org/documents/>.

[21] Changes, if made, are to be clearly shown within the document by strikeout, interlineation, or supplementary conditions. For this reason, the AIA guards its copyright rights strictly, and encourages use of its proprietary electronic document format which highlights changes showing the new as well as the deleted or changed language. *See* Schrader, *supra* note 19.

[22] The AGC had input into the current AIA General Conditions and has endorsed this AIA contract document.

[23] Each of these subcontracts has its own "short form" versions. AGC Document No. 604, Standard Short Form Agreement Between Contractor and Subcontractor *(Where Contractor and Subcontractor Share Risk of Owner Payment)*, is the companion subcontract to the AGC 655. AGC Document No. 603, Standard Short Form Agreement Between Contractor and Subcontractor *(Where Contractor Assumes Risk of Owner Payment)*, is the companion subcontract to the AGC 650.

[24] The ASC is a federation of eight construction contractor associations. Its members include the Mason Contractors Association, the Mechanical Contractors Association of America, the National Electrical Contractors

Association, the National Insulation Association, National Roofing Contractors of America, Painting and Decorating Contractors of America, Plumbing-Heating-Cooling Contractors National Association, Sheet Metal and Air Conditioning Contractors National Association.

[25] In 1994, the AGC, ASA and ASC jointly developed a standard form construction subcontract, AGC Document No. 640. This subcontract was intended to be compatible with the A201. The cooperation of the various trade groups led to a document in which the parties' rights and responsibilities were more evenly apportioned than other documents. Although originally viewed as a breakthrough in contractor/subcontractor relations, shortly after its introduction, the AGC withdrew its support of the document primarily because of an outcry from local AGC chapters over the absence of a pay-if-paid provision in the document. As a result, contractor's use of this standard form is rare. The AGC 650 and 655 subcontractor forms drafted in 1998 were intended to be a compromise to the AGC/ASA/ASC subcontract form.

[26] The ASA Addendum to Standard Form of Agreement Between Contractor and Subcontractor, AGC 650/655, is for use with the AGC forms. The ASA Addendum to Subcontract, ASA/FASA Document No. 4191, is for use with the A401.

[27] *See* Bistram, *supra* note 12, at 4.

[28] Id.

[29] Id.

[30] Id.

[31] Id.

[32] *See* David B. Ratterman, *Managing Risk: Insurance and Indemnity Clauses in Construction Contracts*, Modern Steel Construction (April 2003).

[33] *See* Thos J Dyer Co. v. Bishop International Engineering Co., 303 F.2d 655 (6th Cir. 1962).

[34] *See, e.g.*, Star Contracting Corp. v. Manway Constr. Co., 32 Conn. Supp. 64, 337 A.2d 669 (Conn. Super. 1973); DEC Elec., Inc. v. Raphael Constr. Corp., 558 So.2d 427 (Fla. 1990); Jerome Distribs., Inc. v. B.L.I. Constr. Co., Inc., 237 S.E. 2d 13 (Ga. Ct. App. 1977); New Amsterdam Cas. Co. v. Allen Co., 446 S.W. 2d 278 (Ky. 1969); Mascioni v. I.B. Miller, Inc., 261 N.Y. 1, 184 N.E. 473 (N.Y. 1933); North Harris County Junior College Dist. v. Fleetwood Constr. Co., 604 S.W.2d 247 (Tex. App. 1980).

[35] *See, e.g.*, West-Fair Elec. Contractors v. Aetna Cas. & Sur. Co., 87 N.Y.2d 148, 638 N.Y.S.2d 394, 399, 661 N.E.2d 967, 972 (1995) and Wm. R. Clarke Corp. v. Safeco Ins. Co. of America, 15 Cal. 882, 938 P.2d 372, 64 Cal. Rptr. 2d 578 (1997).

[36] 210 Mich. App. 416, 533 N.W. 2d 838 (1995) *app. den.*, 450 Mich. 1019, 549 N.W.2d 562 (1996).

[37] As discussed above, the A401 and AGC 650 standard subcontract forms do not include a pay-when-paid or paid-if-paid provision. The AGC 655 pay-when-paid provision expressly provides as follows:

> TIME OF PAYMENT: Receipt of payment by the Contractor from the Owner for the Subcontract work is a condition precedent to payment by the Contractor to the Subcontractor. The Subcontractor hereby acknowledges that it relies on the credit of the Owner, not the Contractor, for payment of Subcontractor work. Progress payments received from the Owner for the Subcontractor for satisfactory performance of the Subcontract Work shall be made no later than seven (7) days after the receipt by the Contractor of payment from the Owner for the Subcontract Work.

[38] 1991 US Dist LEXIS 19589 (E.D. Mich. 1991).

[39] Id. at fn. [*4].

[40] 911 F.2d 734 (Table, Text in WESTLAW), Unpublished Disposition, 1990 WL 121473 (6th Cir. Mich., Aug 22, 1990).

[41] Id.

[42] 2002 WL 31105030 (Mich. App., Sept. 20, 2002).

[43] Id. at *3.

[44] 87 N.Y.2d 148, 638 N.Y. S. 2d 394, 661 N.E. 2d 967 (1995).

[45] Id. at 159, 638 N.Y.S.2d 394, 661 N.W.2d 967 (1995).

[46] Id. at 158, 638 N.Y.S.2d 394, 661 N.W.2d 967 (1995).

[47] Id.

[48] John G. Cameron, Jr., A Practitioner's Guide to Construction Law, p. 11-23 (ALI-ABA 2000)(hereinafter, "Practitioner's Guide").

[49] Related to "flow-through" provisions are "incorporation by reference" provisions. If a contract incorporates by reference another document, the incorporated document is treated as part of the contract. Consequently, a contractor is bound to the terms and provisions of the contract and the incorporated document. This is true whether or not the contractor has reviewed the incorporated document. As a result, it is imperative for a contractor to review all documents before entering into a contract which incorporates them into the signed agreement. This is especially important on large and contractually complex projects where an incorporation clause can bind a party to contract provisions which are never seen, or which may even seemingly contradict provisions in the contractor's direct contract.

[50] *See, e.g.*, Paragraph 3.1 of AGC subcontract forms 650 and 655.

[51] For instance, by definition, the "Contract Documents" in the A201 include the Agreement between Owner and Contractor, Conditions of the Contract (General, Supplementary and other Conditions), Drawings, Specifications, Addenda issued prior to the execution of the Contract, other documents listed in the Agreement and Modifications issued after the execution of the Contract. All of these documents are incorporated by reference into the subcontract by virtue of the flow-through provision in Paragraph 5.3 of the General Conditions.

[52] *See* Thomas, *supra* note 4, at 6.

[53] Id. at 9.

[54] Id. at 11.

[55] Id.

[56] James E. Stephenson, Alternative Clauses to Standard Construction Contracts, ¶15.7, at 407 (John Wiley & Sons 1990).

[57] Id.

[58] *See* Charles R. Schrader, *Design Delegation*, available at <http://www.jordanschrader.com/articles/article0010.html > (last visited August 6, 2003).

[59] *See New AIA Document A201 (1997 Edition): From the Contractor's Perspective – It Ain't What It Used to Be*, 1998 Wiley Construction Law Update (John Wiley & Sons, Inc. 1998) hereinafter "It Ain't What It Used to Be".

[60] The provision also appears in the A101 and A111 standard contract forms for utilizing a stipulated sum and cost of the work plus a fee, respectively. Consistent with the A201, the AGC subcontract forms 650 and 655 provide for delegation of design responsibility to subcontractors. If subcontract documents specifically require a subcontractor to provide design services and specify design and performance criteria, a subcontractor is to procure those design services from a licensed design professional.

[61] *See* Schrader, *supra* note 58. Mr. Schrader also notes that a lawsuit is pending in New York to determine if the design delegation inherent in the A201 General Conditions is legal in that state. "Also at issue is whether this provision violates competitive bidding laws, will result in unsafe buildings, will create an economic incentive to under design, and whether, in the last analysis, it is fair." Id.

[62] It Ain't What It Used to Be, *supra* note 59.

[63] 248 U.S. 132, 39 S. Ct. 59, 63 L. Ed. 166 (1918).

[64] *See* Schrader, *supra* note 58.

[65] In response to the harsh and unfair results caused by no damage for delay clauses, in June, 1994, the Michigan House of Representatives passed House Bill 4927 which voids such provisions. The bill, which was unanimously passed by the House, prohibits owners from passing on their mistakes to others. However, according to the office of Joseph Palamara (the Representative who introduced House Bill 4927), the Senate never acted upon the bill.

[66] *See* Phoenix Contractors, Inc. v. General Motors Corp., 135 Mich. App. 787, 355 N.W.2d 673 (1984).

[67] *See* John E. Green Plumbing and Heating Co., Inc. v. Turner Const. Co., 742 F.2d 965 (6th Cir. 1984), *cert den*, 471 U.S. 1102, 105 S.Ct. 2328, 85 L. Ed. 845 (1985).

[68] *See* Phoenix Contractors, 135 Mich. at 792.

[69] Id. at 796-797.

[70] 3 F.3d 193 (7th Cir. 1993).

[71] *See* Practitioner's Guide, *supra* note 48, at p. 17-21 citing Robert A. King and Philip L. Brooks, in "Types of Claims" *Proving and Pricing Construction Claims*, at 1-7 (2d ed. 1996)("[A]lthough many contracts contain a no damages for delay clause, few preclude damages for owner-caused disruptions. Therefore, a contractor who would be unable to recover for a delay claim might be able to recover for a disruption claim simply because of the contractual language.")

[72] *See, e.g.,* Provencal v. Parker, 66 Mich. App. 431, 239 N.W. 2d 623 (1976). As an equitable principle intended to shift fault from an innocent party to an offending party, the common law right of indemnification will not arise when the party that is seeking to be indemnified was at fault for the injury in question.

[73] Practitioner's Guide, *supra* note 48, at p. 9-28, fn. 169.

[74] For instance, the indemnification provision found in Article 3.18.1 of the A201 provides in relevant part:

> To the fullest extent permitted by law . . . the Contractor shall indemnify and hold harmless the Owner, Architect . . . from and against claims, damages, losses and expenses . . . arising out of or resulting from performance of the Work, provided such claim, damage, loss or expense is attributable to bodily injury, sickness, disease or death, or to injury to or destruction of tangible property (other than the Work itself), but only to the extent caused by the negligent acts or omissions of the Contractor, a Subcontractor, . . .

regardless of whether or not such claim . . . is caused by a party indemnified hereunder. . .

[75] In the AGC subcontract documents, a subcontractor's indemnity obligation is limited to the extent the damage or loss is attributable to its negligence or someone for whose acts the subcontractor may be liable. See AGC 650 and 655 subcontracts, Article 9.1.1.

[76] *See* Albright, *supra* note 3, at 14.

[77] That statute provides:

> A covenant, promise, agreement or understanding in, or in connection with or collateral to, a contract or agreement relative to the construction, alteration, repair or maintenance of a building, structure, appurtenance and appliance, including moving, demolition and excavating connected therewith, purporting to indemnify the promisee against liability for damages arising out of bodily injury to persons or damage to property caused by or resulting from the sole negligence of the promisee or indemnitee, his agents or employees, is against public policy and is void and unenforceable.

[78] *See*, Chrysler Corporation v. Skyline Industries Services, Inc., 448 Mich. 113, 528 N.W. 2d 698 (1995); Sherman v. DeMaria Bld. Co., 203 Mich. App. 593, 513 N.W. 2d 187 (1994).

[79] 113 Mich. App. 43, 317 N.W.2d 279 (1982).

[80] Id. at 52.

[81] 157 Mich. App. 448, 403 N.W.2d 569 (1987).

[82] According to Ratterman, the insurance industry essentially delineates between two types of contracts: there are "insured" contracts, and there is everything else. The golden rule of indemnification clauses is:

1. If you agreed to do it, then you are going to have to do it; and

2. If you agreed to do too much, you might not have insurance to cover it.

See Ratterman, *supra* note 32, at 2.

[83] Another insurance product which is available to contractors to protect against loss is subcontractor default insurance ("SDI"). SDI is a first party insurance policy designed to provide coverage for the insured general contractor against losses suffered as a result of a subcontractor (and material supplier) failing to fulfill the obligations under its subcontract. Coverage under an SDI policy follows the underlying subcontract agreement and is triggered by a default of the subcontractor under the agreement. Typically, SDI covers, over a certain deductible, the cost of completing the subcontractor's contractual obligation, the cost of correcting defective or nonconforming work, legal costs incurred as a result of the subcontractor's default, costs incurred in the investigation, adjustment and defense of disputes for qualifying losses, and indirect costs such as liquidated damages, acceleration costs and extended overhead. This last category of losses will be subject to a separate sublimit.

[84] As the subject of Contract Changes/Differing Site Conditions is discussed at length in Chapter 4 of this book, differing site conditions clauses will only briefly be addressed in this Chapter.

[85] Robert F. Cushman, Craig Jacobson and P.J. Trimble, Proving and Pricing Construction Claims §7.1, at 72-73 (Wiley 1996).

[86] *See, e.g.,* Bilotta Constr. Corp. v. Village of Mamaroneck, 199 A.D.2d 230, 604 N.Y.S.2d 966 (1993).

[87] As stated by the court in Foster Construction C.A. & Williams Bros. Co. v. United States, 435 F.2d 873, 887 (Ct. Cl. 1970):

> The purpose of the changed conditions clause is thus to take at least some of the gamble on subsurface conditions out of bidding. Bidders need not weigh the cost and ease of making their own borings against the risk of encountering an adverse subsurface, and they need not consider how large a contingency should be added to the bid to cover the risk. They will have no windfalls and no disasters. The Government benefits from more accurate bidding, without inflation for risks which may not eventuate. It pays for difficult subsurface work only when it is encountered and was not indicated in the logs.

See also, Iacobelli Const. Inc. v. County of Monroe, 32 F.3d 19, 40 Fed. R. Evid. Serv. 1193 (2d. Cir. 1994)(the purpose of the differing site conditions clause is to reduce speculative contingency costs in bids and reduce "inflated bidding.").

[88] This distinction arises out of the way differing site conditions were defined in the federal differing site conditions clause, Federal Acquisition Regulations 48 C.F.R. 52.236-2(a). The distinction between the two categories has been widely adopted in both the federal and state courts.

[89] *See* A201 General Conditions, Articles 1.5.2 and 3.2.1.

[90] *See* Id. at Article 4.3.4.

[91] This discussion of Environmental Risk Allocation substantially appeared in the form presented here in Chapter 1 of the 1995 edition of this Guide and was authored by Kevin Hendrick and Mary Dirkes, now of the Clark Hill law firm.

[92] In the A401, the indemnification provision relating to hazardous materials requires the contractor to indemnify the subcontractor so long as the loss at issue does not result solely from the subcontractor's actions (Art. 4.3.4).

[93] When liquidated damages are included in the prime contract, the general contractor may be able to enforce the same liquidated damages against its subcontractors, but only to the extent the owner actually has assessed liquidated damages against the general contractor, and only to the extent any particular subcontractor is responsible for delaying actual completion.

[94] Items which often are considered in computing a liquidated damages amount include loss of net income (total income less operating costs), interest costs for borrowed monies, potential inflationary factors, seasonal effects of delayed completion, and possible loss of long-term financing or potential interest rate increases because of delayed completion.

[95] A liquidated damage clause will be enforced in Michigan where it would be difficult to determine the actual damages that will be suffered by a breach at the time of contracting; the agreed upon amount is reasonable under the circumstances at the time of contracting; and the clause does not serve as a penalty to the breaching party. Solomon v. Department of Highways and Transp., 131 Mich. App. 479, 345 N.W. 2d 717 (1984); Hall v. Gargaro, 310 Mich. 693, 17 N.W. 2d 795 (1945).

[96] An owner has an implied duty to mitigate its damages; therefore, an owner may not be able to claim liquidated damages if it prevents or delays performance within the time stipulated by the contract.

[97] For instance, the Prompt Payment Act of 1982 (Title 31, USC, §3901) and the Prompt Payment Act Amendments of 1988 (Title 31, USC, §3902) require payment of all construction invoices within fourteen days of receipt and established a payment standard for construction subcontractor and supplier payments of seven days after prime contractor payment by the government. At the state level, the time period for paying subcontractors varies from state to state but typically does not begin until the contractor receives payment that includes payment for the subcontractor's work (pay-when-paid clause). The statutes vary in scope but generally require public entities to pay interest on late payments at a rate from 8 percent to 21 percent. Some states allow recovery of attorneys' fees.

[98] *See* Schoninger, *supra* note 1, at 15.