

What to Look for Before Signing a Construction Contract

Many construction contracts are horrible. I have reviewed hundreds of them, drafted dozens of them, and litigated dozens of unnecessary disputes arising out of poorly drafted contracts. This article explains construction contracts and summarizes what contractors and owners should consider before signing one.

There are three main types of construction contracts -- (1) fixed price contracts, (2) cost plus contracts, and (3) time and materials contracts. There are many variations of these, but owners must understand the differences and be sure the written contract -- almost always prepared by the contractor -- reflects what the parties agreed to. Contractors must be sure they are on the same page as the owner about the type of contract being agreed to, otherwise a dispute is sure to arise after the contractor begins work.

THE THREE TYPES OF CONSTRUCTION CONTRACTS

Fixed Price Contracts

In a fixed price contract, the contractor agrees to complete the work for a fixed price. Many owners prefer a fixed price contract because it provides certainty. Problems arise when the contractor underestimates the labor and material costs the contractor will incur. Facing a diminishing profit margin, some contractors lose interest in the project or attempt to coerce the owner into paying more prior to completion of the work.

Cost Plus Contracts

A cost-plus contract requires the owner to pay the contractor for costs incurred in the project, plus a set amount for profit, usually a percentage of the total price. With these contracts it is important to specify what "costs" include. The most obvious costs are the contractor's payments for labor and materials, but some contractors will also include items such as their time managing the project, so it's important that the contract clearly define what "costs" means.

Time and Materials Contracts

Time and materials contracts reimburse contractors for the cost of materials and establish an hourly or daily labor rate. Many contractors don't like these because of the time involved in tracking costs and time spent on the project. From the owner's perspective the contractor has no incentive to complete the project early unless the contract provides for a bonus if the contract finishes the job ahead of schedule.

WHY MANY CONSTRUCTION CONTRACTS ARE HORRIBLE

Contractors are not in the business of drafting legal documents, and many don't want to pay a lawyer to draft a contract for them. Consequently, they frequently present the owner with templates that are not right for the project and/or not favorable for the owner. Some never present a written contract at all, thus opening the door to expensive litigation about what the agreement

was. Without a written contract, the contractor is at risk because the owner may claim the scope of work what broader than what the contractor asserts it was.

Contractors that present the owner with a written contract usually obtain them from one of three sources - (1) the American Institute of Architects (AIA), (2) the Associated General Contractors of America (AGC), and (3) templates they found on the Internet or copied from another non-attorney contractor.

AIA Documents

There are three problems with the AIA documents. The first is that contractors often use them when there is no architect involved or when the architect's role is far less significant than the role the AIA document describes. The second is that even when the AIA documents accurately describe the architect's role, they are drafted to benefit the architect. The third is they are written by lawyers, making them difficult for laypeople to understand, and they frequently refer back and forth to other AIA documents, some of which the contractor may not have provided to the owner because the contractor is not familiar with the proper use of AIA documents.

AGC Documents

The AGC documents suffer from many of the same defects the AIA documents suffer from. Not surprisingly, the AGC drafts its documents to favor the contractor.

Templates Found on the Internet

Templates found on the Internet or copied from another non-attorney contractor are dangerous. The contractor often has no idea what they mean, but doesn't think it matters and takes comfort in the money saved by not paying a lawyer. Many of these documents are missing necessary protections for both the owner and the contractor. For instance, I have had to tell contractors there was no point in filing suit to collect sums owed because the contract did not contain a provision requiring the owner to pay the contractor's attorney's fees if the contractor was forced to file suit to collect sums owed.

WHAT TO LOOK FOR BEFORE SIGNING A CONSTRUCTION CONTRACT

1. What type of contract is it?

It's vital to be certain the written document accurately reflects the type of transaction agreed to. I have seen contracted labeled "Fixed Price" contracts that contain language allowing the contractor to charge on a cost plus or time and materials basis. In one case I filed suit against a contractor claiming fraud and violation of consumer protection laws because the contractor had labeled the document a "Fixed Price" contract but inserted time and materials provisions into the body of the contract.

2. Does the contract define the scope of work?

Disputes often arise when the contract is unclear about the scope of work. With a fixed price contract, it's vital to know what work is included in that fixed price. Even with cost plus or time and materials contracts, the owner wants an accurate statement of what work will be done and an accurate estimate of the cost. One way contractors get more money is by charging the owner for work they believe was not within the scope of the original contract, so it's vital to be clear about the scope of work.

3. What does the contract say about cost overruns?

Some contractors attempt to limit their risk of a fixed price contract by including a provision allowing them to charge a higher price if there are cost overruns. In such cases, it is vital that the contract include a line-item budget showing the time and material costs projected for each item. An owner that agrees to a clause that allows an increased price due to cost overruns should insist on some limitation, such as provision that in no event shall the fixed price increase by more than five or ten percent of the agreed price.

Contractors should take the time at the outset to prepare accurate cost projections. I have filed suits against contractors alleging they fraudulently or negligently induced the owner to enter the contract by underestimating the costs in their estimates.

4. Invoicing and Payment.

The contract should be clear about invoicing and payment. Many contracts require the owner to make progress payments during the project, but the contract is often vague. For instance, a contract might require a progress payment when the contractor has completed twenty percent of the work, but the contract leaves it to the contractor's discretion determine when twenty percent of the work has been completed. Problems arise when the contractor is asking for payment of fifty percent of the fixed price or fifty percent of the estimated cost, but it appears the contractor has only done thirty percent of the work. A good contract contains clear milestones for payment.

5. Record Keeping.

Many contractors are notoriously bad about keeping records of their costs and time. The contract should require the contractor to keep accurate records and provide all receipts and time records with each invoice. Contractors that fail to do this put themselves at risk if disputes arise during the project.

6. Change Orders.

Owners frequently want to add to or change the scope of work during the project, and the contractor understandably wants to get paid if these changes or additions increase the contractor's costs. Disputes arise when the contractor claims the owner asked for additional work or changed

the scope of the work and the owner denies it. For this reason, it is critical that the contract state that the owner is not liable for any changes in the scope of the work unless the owner approves it in a written change order.

Disputes sometimes arise when the parties don't follow the contract's change order process. For instance, the contractor might send the owner an email stating the contractor is going to use more expensive roof tiles than what was budgeted. If the owner does not respond, the contractor may construe that as an acceptance of the plan for more expensive tiles. Following the change order process protects both the owner and the contractor.

7. Warranties.

Does the contract contain any warranties as to the quality of work and materials? Are the warranties clearly defined? Some contracts attempt to disclaim all warranties.

8. Limitations on Damages.

Most contracts contain a clause that prevents the owner from collecting consequential, incidental, or special damages resulting from the contractor's breach. (For my purposes, those terms are synonymous). Not understanding what this means, the owners usually agree. This can be regrettable, particularly in commercial projects. For instance, suppose the contractor's unjustified delays prevent a business from opening for three months and the owner loses three months of anticipated profits. A limitation on consequential damages might preclude the owner from seeking to collect those damages.

9. Owners Should Avoid Arbitration Clauses.

Even though the Constitution establishes a court system, business is convinced that unethical lawyers are crouching behind each corner, eager to file frivolous lawsuits. Thus, they include mandatory arbitration clauses in the contracts. An arbitration clause requires the parties to surrender their right to go to court if one party breaches the contract and instead requires them to submit the dispute to an arbitrator. Discovery in arbitration is limited and there is no appeal from an arbitrator's ruling -- even if the arbitrator gets the facts wrong or misapplies the law. Moreover, many arbitrators are former contractors or lawyers that represent contractors. If the contractor insists on an arbitration clause, insist on these provisions:

a. A provision that the arbitrator must be former state court or federal judge. This is particularly important if the issue involves interpretation of a legal document or application of contract law principles. Better yet, agree on the arbitrator in advance and identify the arbitrator in the contract.

b. A provision that in any arbitration the parties will be allowed to conduct discovery consistent with the rules of civil procedure in your state.

c. A provision that requires the arbitrator to award attorney's fees to the prevailing party.

10. Attorney's Fees.

In America, the rule is that in any lawsuit or arbitration each party pays their own legal fees unless the contract contains a "loser pays" provision. Some contracts contain a provision requiring the owner to pay the contractor's legal fees if the contractor wins, but don't contain a provision requiring the contractor to pay the owner's legal fees if the owner wins. Some contracts are silent on the issue, meaning a party must pay its own legal fees even if it wins. Without a "loser pays" provision, a party that has been victimized by the other party's breach may have no viable remedy because even if that party prevails in a lawsuit, that party will end up paying that party's lawyer more than the amount recovered.

11. Be Careful of LLC's.

Many small contractors operate as limited liability companies, making it difficult to sue the owner personally. A judgment against an LLC is often worthless since the LLC frequently has few assets. Few contractors will be willing to sign a personal guaranty of the LLC's performance, but one way to address this is to be sure the contract includes all representations the contractor is making to induce the owner to enter the contract. This allows the owner to sue the person signing for the contractor personally for any misrepresentations in the contract.

Similarly, a contractor doing a project for an LLC should insist that the owner of the LLC personally guaranty the LLC's obligations under the contract.

12. Insurance.

The contract should specify that the contractor must maintain errors and omissions insurance in a specified amount sufficient to protect the owner, general liability insurance in a specified amount sufficient to protect the owner, worker's compensation insurance as required by state law, and automobile liability insurance as required by state law. It should require the contractor to promptly notify the owner in writing if any coverage lapses.

13. Lien Waivers.

Contractors frequently invoice the owner for sums paid to subcontractors or material suppliers. Unfortunately, it sometimes happens that the contractor has not yet paid those subcontractors or suppliers, instead keeping the money. The result may be that the unpaid subcontractor or supplier puts a mechanic's lien on the owner's property after the owner has paid the contractor for sums allegedly already paid to the subcontractor or supplier. The contract should require the contractor to provide the owner with lien waivers from all subcontractors and suppliers before the owner pays the contractor for any claimed payments to subcontractors or suppliers.

14. Time of Completion / Damages for Delay.

Be sure the contract contains a deadline for completion and a provision for a penalty if the contractor fails to complete the project on time without justification.

15. Permits.

Be sure the contract is clear about who will obtain and pay for the required permits.

16. Future Agreements.

Be wary of contracts containing provisions stating that the owner and contractor will agree on certain items later. This is an invitation to litigation if the parties are unable to agree.

17. Modification.

Every contract should contain a provision stating it may not be modified, except in a document signed by both parties. Contractors frequently encounter trouble because the owner claims there was an oral modification to the contract after it was signed.

18. Indemnification.

Indemnification is the right of a party that is legally liable for a loss (the indemnitee) to shift that liability to another party (the indemnitor). The goal is usually to shift responsibility for any damages that occur from the party that is sued to the party that caused the harm. For instance, a contract might contain a provision stating that if a supplier sues the contractor to collect sums owed, the owner must indemnify the contractor. There is nothing wrong with that, but owners should make sure the duty to indemnify runs both ways. For instance, if a visitor sues the owner for an injury resulting from the contractor's negligence, the contract should require the contractor to indemnify the owner.

Indemnity provisions are complex and they must be consistent with other contract provisions, such as those that purport to limit liability or damages.

19. Termination.

Many contracts contain specific provisions that govern when a party may terminate a contract. Unhappy owners sometimes get into trouble by terminating the contract in a way that is not consistent with the contract's requirements.

If there is a dispute about the quality of the contractor's work, the owner must understand that Colorado has a statute - the Construction Defect Action Reform Act (CDARA) - that requires the owner to provide a notice of defects to the contractor and to give the contractor an opportunity to cure the defects. Failure to follow the required process can be harmful to any legal claims the owner may want to assert.