A TACTICAL GUIDE TO AVOIDING CONSTRUCTION CONTRACT DISPUTES.

By:
Wally Zimolong, Esquire
Sigman & Zimolong, LLC
Philadelphia, PA

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I. INTRODUCTION

As a construction attorney, I am often asked to review construction contracts. Clients ask for my review both before a contract starts and after a dispute arises. Unfortunately, the latter is much more common. My clients are often disappointed to hear that contract language limits or even prohibits their right to recover an otherwise justified claim or that the contract shifts certain risk to them in a manner that "just does not seem fair." Arguments over the application of contract language typically ends up in expensive litigation where attorney fees and cost diminish any recovery a contractor ultimately receive.

Numerous construction disputes could be avoided if the more common practice among contractors was to have their attorneys review their contracts *before* signing them. The written language that is contained in a contract is so critical because courts will treat the written agreement as the best manifestation of what the parties agreed to, not what was verbally said or promised before, during, or after the contract was signed.

This guide is a collection of the seven construction contract clauses that are the most common causes for disputes ending up in litigation. It is not an exhaustive list. Rather, it is an attempt to identify those clauses that most typically are the subject of litigation based on my experience of litigating hundreds of construction disputes. It is also not a legal treatise or brief and is written (hopefully) in a way the average contractor can understand. Finally, it is also not a substitute for the judgment of counsel. Rather, it is a roadmap of what to look out for as the first set of eyes that review the contracts that

your firm ultimately signs and what you may want to ask your attorney further questions about, which we recommend you do.

A. SCOPE, PRICE, AND TIME.

Contract language that states what work you will be required to perform; what you will be paid for it; and how long you have to do it seems so fundamental to the basis of a construction contract it would hardly seem possible to overlook. However, issues regarding scope, price, and time are omnipresent. Moreover, vague language concerning scope, price, and time can be just as bad as no language at all.

1. Scope.

You think you know what work you agreed to perform. You discussed it with the party with whom you are contracting. You also stated it in your proposal or bid. However, have you carefully reviewed your contract to see what the contract says you have agreed to do?

The most typical mistake we see in the area of terms of contract scope is the attaching of the contractor's proposal to the contract under the mistaken belief that it controls the scope of the contractor's work. A careful reading of what the written contract defines as "scope" is often quite different and the contract's definition of scope is usually much broader than a contractor realizes. Most contracts will require a contractor not only to perform the work specifically listed on its proposal but also any work that is necessary the objective or is merely "implied" by the drawings.

Does the scope of work as set for on your proposal conflict with the scope of work as defined in the contract? If so, this could create the potential for disputes over scope related change orders.

2. Price.

Closely related to the scope of the work is the price of the work. Just as you need to make sure the contract's definition of scope is consistent with what you agreed to perform so must you confirm that the contract says what is included in your price.

Is your price for labor, material, and supervision only? Or, have you included in your price charges for taxes, bonds, insurance, permits, and fees? Typically, contracts will require that these items be included in your price. While you may have stated that these items are excluded from your price in your proposal, you need to make sure that the final contract incorporates those exclusions. Otherwise, you could end up on the wrong end of an unprofitable job.

3. Time.

Does the contract say how long you are expected to be on the job? Do not assume that there is an understanding that your work should only take a certain amount of time. More time on the job equals more man hours. More man hours equals more money. If the contract does not clearly state your anticipated completion date, you could be required to stand ready to perform indefinitely because of delays that have nothing to do with your work.

What if your contract contains no completion date? It is the general rule that where no time is agreed upon for the completion of a contract, it must be completed within a

reasonable time. 8 P.L.E. Contracts, § 245; 17A Am.Jur.2d, §§ 202, 479.

B. FLOW DOWN CLAUSES

Subcontractors need to make sure that they are aware of all of the terms they are agreeing to in the subcontract. Many subcontracts contain so called "flow down" or incorporation by reference clauses, which incorporate the terms of the general contractor-owner agreement and bind the subcontractor to the general contractor to the same terms that the general contractor is bound to the owner. Plum Creek Wastewater Auth. v. Aqua-Aerobic Sys., Inc., 597 F. Supp. 2d 1228, 1233 (D. Colo. 2009)("Flow down clauses are designed to incorporate into the subcontract those provisions of the general contract relevant to the subcontractor's performance.")

Because flow down clauses incorporate language appearing in a separate document – the general contract – it is important for subcontractors to review the general contract in addition to the subcontract to fully appraise itself of the terms to which it is agreeing. A subcontractor is bound to obligations relating to the subcontractor's work which appear in the general contract, although the terms do not necessarily appear in the subcontract itself.

Article 2 of AIA Form 401-2007, "Standard Form of Agreement Between Contractor and Subcontractor," provides an example of a typical flow down clause.

> The Contractor and Subcontractor shall be mutually bound by the terms of this Agreement and, to the extent that the provisions of AIA Document A201-2007 apply to this Agreement pursuant to Section 1.2 and provisions of the

> Prime Contract apply to the Work of the Subcontractor, the Contractor shall assume toward the Subcontractor all obligations and responsibilities the Owner, under such documents, assumes toward the Contractor, and the Subcontractor shall assume toward the Contractor all obligations and responsibilities which the Contractor, under such documents, assumes toward the Owner and the Architect. The Contractor shall have the benefit of all rights, remedies and redress against the Subcontractor that the Owner, under such documents, has against the Contractor, and the Subcontractor shall have the benefit of all rights, remedies and redress against the Contractor that the Contractor, under such documents, has against the Owner, insofar as applicable to this Subcontract. Where a provision of such documents is inconsistent with a provision of this Agreement, this Agreement shall govern.

By not reviewing the general contract, a subcontractor through a flow down clause, may unwittingly agree to terms that arguably have nothing to do with its work. Terms that an unsuspecting subcontractor may be agreeing to via a flow down clause include termination clauses, claims processing clauses, indemnification clauses, and dispute resolution clauses.

Therefore, before signing a subcontract that contains a flow down clause subcontractors should insist on reviewing the

general contractor agreement, which the flown down clause is incorporating by reference.

C. Pay-When-Paid v. Paid-if-Paid Clauses.

Terms and timing of payment are critical. A subcontractor that cannot manage cash flow is doomed. For terms of payment, most construction contracts use either a pay-when-paid or a pay-if-paid clause. Understanding the often subtle difference between the two is important for understanding when a subcontractor can expect payment.

1. Pay-when-paid.

A pay-when-paid clause is a timing mechanism that states that payment is due to a subcontractor within a certain time period after a contractor receives payment from the owner. A pay-when-paid clause, however, does not condition payment to a subcontractor on the contractor's receipt of funds from the project owner. Sloane Co. v. Liberty Mutual Ins. Co., 2009 WL 2616715 (E.D.Pa. 2009)("pay-when-paid" clauses "merely create a timing mechanism for a contractor's payments to a subcontractor and do not condition payments to a subcontractor on the contractor's receipt of those payments from the project owner.")

2. Pay-if-paid.

Conversely, under a paid-if-paid clause a contractor's receipt of payment from the owner is a strict condition precedent on payment to a subcontractor. Courts hold that a pay-if-paid clause in a subcontract shifts the risk of loss, from

non-payment by the owner, to the subcontractor. Id.; Fixture Specialists, Inc. v. Global Construction, LLC., 2009 WL 904031 (D.NJ. 2009). Depending on the jurisdiction, a contractor may have to wait indefinitely for payment to a contractor to happen before it is paid, or it merely must wait only a "reasonable period" of time before it pursues payment from a contractor.

3. Telling the difference between the two.

The differences in the language used in a pay-when-paid verse a pay-if-paid clause are often subtle and requires careful analysis of the subcontract's language. Most courts agree that in order for a payment clause to be construed as the more onerous pay-if-paid clause, whereby payment to the contractor is a condition precedent to payment to the subcontractor, there must be clear language showing the intention of the parties to shift the risk of non-payment. Id.; Seal Tite Corp. v. Ehret, Inc. 589 F.Supp. 701 (D.NJ.1984); Lafayette Steel Erectors, Inc. v. Roy Anderson Corp., 71 F.Supp.2d 582, 587 (S.D.Miss.1997); Mrozik Constr., Inc. v. Lovering Associates., Inc., 461 N.W.2d 49, 51 (Minn.Ct.App.1990) ; Watson Constr. Co. v. Reppel Steel & Supply Co., 123 Ariz. 138, 598 P.2d 116, 119 (Ariz.Ct.App.1979).

Sometimes it is easy to differentiate between the two clauses. If words such as "condition," "if and only if," or "unless and until" are used in describing when payment to a subcontractor is due, then the clause is most likely a pay-if-paid clause. Sloan Co., supra, at *5. However, courts have also construed payment clauses as pay-if-paid clauses when less obvious language is used. For example, one court held

that a payment clause that stated "disbursement will be processed as funds are received" constituted a pay-if-paid clause as payment was conditioned on the contractor's receipt of the funds. LBL Skysystems (USA), Inc. v. APG-America, Inc. 2005 WL 2140240 (E.D.Pa. 2005). Moreover, some courts have held that key words such as "condition precedent" are not alone dispositive and the courts must look to the entire subcontract in order to determine whether the parties intended to shift the risk of non-payment to the subcontractor. Sloan Co, supra, at * 6. Therefore, while a majority of courts give heavy weight to key words such as "condition precedent," it is important to review the entire subcontract before concluding that a clause is a pay-if-paid rather than the more forgiving pay-when-paid variety. Of course, if possible, the safest bet would be to not agree to any payment terms that use the words "condition," "if and only if," or unless and until."

Knowing what your rights to payment are is important. As you can see, the difference between waiting indefinitely for payment and being able to pursue payment immediately sometimes hinges on few key words. Therefore, you need to scrutinize each subcontract carefully.

D. Termination for Convenience Clauses.

The proposition that a contractor can be terminated for non-performance is unremarkable and well understood. However, nearly all public project construction contracts and many large private project contracts contain language that permits a general contractor or owner to terminate the contract at any time without cause. Clauses that grant an owner or general contractor the right to terminate the contract without cause are known as "termination for convenience" clauses. Termination for convenience clauses typically spell out the amount of damages a contractor is entitled to if the clause is invoked, which may or may not include lost profits and other consequential damages.

The idea that a party can terminate a contract without cause and without paying the full contract price traces its origins to the Civil War. The doctrine originated because it would be unreasonable for the government to continue wartime contracts after the war was over and continuing a wartime contract during peace time would be against the public interest. Concern for public interest has caused the doctrine to carry over into peacetime public works projects. As one can imagine, there are a variety of economic and political reasons that a government entity would terminate a public works project prior to completion. Generally, if a government contract is terminated for convenience recovery is limited to costs incurred, profit based on work done, and the cost of preparing the settlement proposal. Maxima Corp. v. U.S., 847 F.2d 1549, 1552 (Fed.Cir. 1988).

Termination for convenience clauses have found their way into many private project contracts as well. The amount

of damages recoverable when a termination for convenience clause is invoked on a private project is determined by the language of the contract. Contractors, therefore, should carefully review such clauses to see what damages will be recoverable in the event of termination. Often, the termination clause does not permit recovery other than the value of the contractor's work performed up to the date of termination. Therefore, a contractor will not be permitted to recover lost profits that would have been earned had the entire contract been completed. Finally, these clauses may not clearly state how a terminated contractor will be compensated for work performed off-site or for stored materials. Therefore, a contractor anticipating performing off-site work or storing large quantities of material or pre-fabricated items should consider amending the language of a termination for convenience clause to spell out how it will be compensated for such work and material.

Although termination for convenience clauses suggest a broad set of circumstances which would permit termination without cause, such termination must still be done in good faith. In other words, a party cannot enter into a contract with the intention of not honoring it and avoid liability for breach by hiding behind a broad termination for convenience clause. Torncello v. U.S., 681 F.2d 756 (Ct.Cl. 1982); Salsbury Indust. v. U.S., 905 F.2d 1518, 1521 (Fed.Cir. 1990).

Margins on a completed construction contract are tight. Therefore, it is critical to determine whether a contract contains language which permits a party to terminate a contract without cause and without compensating the contractor for lost profit.

E. No Damage for Delay Clauses.

Claims seeking compensation for delays in completion are a frequent source of litigation. Delays force a contractor to spend more money on manpower and material. Moreover, because a delayed contractor is forced to spend time completing the delayed project, it is unable to devote resources to other projects or potential projects. Therefore, the monetary value of delay claims is often significant. Because of this, many construction contracts contain "no damage for delay" clauses, which prevent contractors from recovering damages for delays encountered on a project.

1. Spotting a "No Damages for Delay" Clause.

An example of typical no damage for delay clause language appears at Section 8.3.1 of the AIA 201-1997 general conditions that state:

> "If the Contractor is delayed at any time in the commencement or progress of the Work by an act or neglect of the Owner or Architect, or of an employee of either, or of a separate contractor employed by the Owner; or by changes ordered in the Work; or by labor disputes, fire, unusual delay in deliveries, unavoidable casualties or other causes beyond the Contractor's control; or by delay authorized by the Owner pending mediation and arbitration; or by other causes that the Architect determines may justify delay, then the Contract Time shall be extended by Change Order for

such reasonable time as the Architect may determine."

2. Enforceability of "No Damages for Delay" Clauses.

Ordinarily, "no damages for delay" clauses are enforceable. James Corp. v. N. Allegheny Sch. Dist., 938 A.2d 474, 484 (Pa. Commw. Ct. 2007). However, the extent of enforceability often depends on state specific statutory law and common law. Under federal law, a contractor can only recover delay damages against the government when the government agency actively interfered with the contractor's work. Cite.

a. Pennsylvania and New Jersey law.

Pennsylvania law recognizes that exculpatory provisions in a contract cannot be raised as a defense where (1) there is an affirmative or positive interference by the owner with the contractor's work, or (2) there is a failure on the part of the owner to act on some essential manner necessary to the prosecution of the work. Henry Shenk Co. v. Erie County, 319 Pa. 100, 178 A. 662 (1935). Thus, affirmative or positive interference sufficient to overcome the "no damages for delay clause" may involve availability, access or design problems that pre-existed the bidding process and were known by the owner but not by the contractor. Coatesville Contractors & Eng'rs, Inc. v. Borough of Ridley Park, 509 Pa. 553, 506 A.2d 862 (1986).

Similarly, an owner cannot insulate itself from a delay damage claim where it fails to perform an essential contractual duty. Gasparini Excavating Co. v. Pa. Tpk. Comm'n, 409 Pa. 465, 187 A.2d 157 (1963) (owner with contract responsibility

for contractor cooperation pursuant to "predetermined program" directed contractor to proceed, but contractor prevented from accessing work area for five months because of another contractor); Commonwealth of Pa., State Highway & Bridge Auth. (Penn–DOT) v. Gen. Asphalt Paving Co., 46 Pa.Cmwlth.114, 405 A.2d 1138 (1979) (owner assumed responsibility for negotiating relocation of water line, but failed to do so expeditiously, resulting in denial of access while water line relocated by others); Guy M. Cooper, Inc. v. E. Penn Sch. Dist., 903 A.2d 608, 614 (Pa. Commw. Ct. 2006).

In New Jersey, the no damage for delay clauses are legal but, are "generally construed strictly against its draftsman," and "special exceptions are often read into it" *Ace Stone, Inc. v. Wayne Township.,* 47 *N.J.* 431, 434, 221 *A.*2d 515 (1966).

Like Pennsylvania, New Jersey recognizes the active interference exception. A. Kaplen & Son Ltd. v. Housing Authority of Passaic, 126 *A.*2d 13 (App.Div.1956). New Jersey also recognizes an exception to no damages for delay clauses when a party's "conduct indicates bad faith or some other tortious intent." Edwin J. Dobson, Jr., Inc. v. State, 218 N.J. Super. 123, 128, 526 A.2d 1150, 1153 (App. Div. 1987).

Therefore, under both Pennsylvania and New Jersey law, a contractor can still recover damages for delays encountered on the project when the delays were caused by the active interference of the owner or counterparty to the contract.

b. Federal law.

Contractors performing work on projects owned by the Federal government must look to Federal law to see if they can

recover monetary damages for delays. Under Federal law, a contractor may only recover if it can establish that the government alone delayed the work by actively interfering with the contract or by failing to prefer an act essential for the work to proceed, such as issuing a timely and necessary change order. P.R. Burke Corp. v. United States, 277 F.3d 1346, 1359-60 (Fed. Cir. 2002).

F. Performance and Design Specifications.

The contract specifications will often instruct the contractor to do more than simply build a particular building element using certain materials. While sometimes the specifications will simply instruct the contractor to build an element in a particular fashion, other times the specifications will instruct the contractor to construct a building element in a manner that achieves certain objectives. The difference between these two types of specification is important because it dictates the level of risk a contractor is assuming.

A performance specification sets forth the standard of performance to be achieved. The contractor is expected to exercise it judgment in how best to achieve the performance standard. A basic example of a performance specification is if a specification states that the contractor shall construct a HVAC system shall maintain a certain level of temperature and humidity level, but leaves the design of the system necessary to achieve the required temperature and humidity levels up to the contractor performing the work.

Conversely, a design specification describes in detail the materials and equipment the contractor must use and the manner in which the work must be performed. As one court put it, "design specifications state how the contract is to be performed and permit no deviations. Performance specifications, on the other hand, specify the results to be obtained, and leave it to the contractor to determine how to achieve those results."

This distinction is critical because when a contractor agrees to design a system to meet a performance specification,

it warrants that the system will perform as promised. Conversely, a contractor that designs a system simply to meet the design specification guidelines makes no warranty that the system will perform in any particular way. In fact, under the so called Spearin Doctrine, which gets its name from a 1918 Supreme Court decision United States v. Spearin, a contractor who has constructed a system according to a design specification has a defense to any claim that the system is not performing as intended.

The Spearin Doctrine applies onto to design specifications. Often, determining whether a specification is a performance versus design specification is difficult as a specification may blend elements of both. In order to differentiate between performance versus design specifications, courts look to the level of discretion that exists within the given specification. A contractor arguing that a specification is a design specification – and thus subject to the Spearin Doctrine – must show that the specification "does not permit meaningful discretion."

Specifying a certain manufacturer of a product alone is not dispositive of whether a specification is design rather than performance, especially when a specification permits substitution of a specified product with "an approved equal." In determining whether a specification is design over performance, courts also look to how much oversight the owner exercised over the contractors work and whether the specifications lay out the contractors means and methods of contraction.

Additionally, the difference between design and performance specification and the liabilities each creates is of

particular importance to design builders because specifications in design-build contracts are performance specifications. Therefore, design-build contractors should not only confirm that the system is capable of being constructed to perform as required, but also that it can be constructed a price acceptable to the design-build contractor. A design-build contractor that learns after contracting that although the system is capable of construction, albeit at an exorbitant price, will not be entitled to an adjustment in the contract price. Moreover, if they are financially incapable of constructing the system at the price necessary for it to perform, it is at risk for a bond claim.

G. Change Order Clauses

Even on modestly sized projects changes are inevitable and a project is rarely constructed exactly as originally designed. The reasons for changes in the work are as numerous as the stars in the sky. However, one certainty is that entitlement to additional compensation for changes is a frequent battle ground for construction disputes.

Several areas of the contract will address changes. Of particular importance is how a contractor perfects a claim for compensation for a change. Pity the contractor that has performed work clearly outside the scope of his contract only to see his claim be lost because he failed to perfect his claim under the contract. Your lawyer cannot argue a claim for compensation because of a change if the claim was not perfected. Therefore, it is imperative that a contractor know how a change claim is perfected.

A contract should state the "who, when, and how" of change claims:

- Who is authorized to direct changes?
- When is the deadline for submitting claims for changes?
- How must those claims be submitted?

1. Who is authorized to direct change orders?

The contract should state who is authorized to direct changes in the work. In First General Construction Corp., Inc. v. Kasco Construction Co., Inc., the Federal District Court for the Eastern District of Pennsylvania held that verbal directives

to perform additional work from a person not authorized to approve extra work are insufficient to support a claim for additional compensation related to that work. In First General, the Court granted summary judgment in favor of the defendant on a subcontractor's claim that it was entitled to compensation for additional work directed at the behest of defendant's project superintendent. The Court held that the only person from defendant that was authorized to direct such work was the project manager and the directive in question came from the project superintendent.

Therefore, the contract should be clear as to which persons are authorized to direct the work. Contractors should follow directives only from those authorized persons and when the directive comes from a non-authorized person should confirm the directive from the person that is authorized.

2. When is the deadline for submitting claims?

Contracts will typically require written notification on claims for compensation to be submitted within a certain time period. The time period can range from between 7 to 21 days after a contractor is aware of an event giving rise to a claim. Failure to provide notice within the prescribed time period may result in a claim being barred. Therefore, contractors should be wary of any such notice provisions and deadlines for making claims for changes.

3. How must the claims be submitted?

Knowing how claims are submitted is just as important as knowing when they must be made. Typically, the contract will require claims to be made "in writing." Contractors

should take care to learn what the written notice must include in order to validate the claim. Moreover, to whom is the claim being made? Is it to the architect, the construction manager, the owner, or some combination of them?

Of course there are exceptions to these rules, but why make claims for entitlement more difficult to prove; especially, when the burden of proof in demonstrating the exception applies is on the party claiming the exception.

H. Honorable Mention Clauses

1. Differing site conditions.

"Differing site conditions" or "changed conditions" clauses come into play when a contractor encounters conditions at the site that were neither known, expected, nor disclosed to the contractor.

Generally, changed conditions are classified as either Type I or Type II. Type I are conditions that materially differ from the conditions that were disclosed to the contractor in the contract documents at the time of bidding. Type II are conditions that are "unusual, unknown, and unanticipated."

The standard for recovering increased costs associated with encountering Type I or Type II conditions is beyond the scope of this handbook. However, recovery under either standard is potentially thwarted by contract clauses that attempt to shift the risk for differing site conditions to the contractor.

a. Site investigation.

Contracts sometimes require the contractor to warrant that he has visited and inspected the work site; reviewed all of the documents and data about the site made available to the contractor; and become familiar with both. If the condition is one that would have been discovered during a reasonable investigation of the site or based upon a review of the available data, a contractor will not be able to recover for unknown or unanticipated site conditions. Therefore, if the contract contains a clause that requires a site visit and investigation and

a review of relevant data, then a contractor is best advised to do both.

b. Disclaimers.

Rather than simply requiring a contractor to investigate a site, contracts sometime require a contractor to broadly disclaim any claim for extras related to differing site conditions. These clauses will explicitly shift the risk of bearing the cost of differing conditions to the contractor. Contractors worried about differing site conditions should avoid signing a contract with a broad disclaimer at all costs.

2. Dispute resolution clauses.

A vast majority of construction contracts contain at least some form of an alternative dispute resolution clause that requires the parties to submit their dispute to mediation, arbitration, or both.

The Federal Arbitration Act and the accompanying state arbitration acts create a strong public policy in favor of compelling arbitration when the parties have entered into an agreement containing an arbitration clause.

Generally, mediation and arbitration are less expensive and more efficient than litigation in court and most contractors that are familiar with the arbitration process prefer to have disputes resolve by mediation and arbitration. But that is not always the case and in some circumstances arbitration can be as expensive as litigating a matter in court.

When reviewing a contract, contractors should be sure that an arbitration clause states that all disputes between the parties will be subject to arbitration.

For more information about the topics covered in this guide please contact Wally Zimolong, Esquire at (215) 665-0842 or email him at wally@sigzim.com.

ABOUT THE AUTHOR

Wally Zimolong is one of Super Lawyer Magazine's "rising stars" of construction litigation.

He represents general contractors, subcontractors, and developers, helping them face the challenges of the construction business. He has successfully litigated cases that resulted in published court opinions and changes in substantive law.

Wally is a frequent author and presenter on issues facing the construction industry. He has appeared in the Wall Street Journal, Construction Executive Magazine, ABA Construction Litigation Newsletter, Philadelphia Inquirer, Philadelphia Business Journal, and others.

Wally enjoys supply side economics and is a passionate conservative who actively supports the Republican Party. He is currently the elected Republican Committeeman for the City of Philadelphia's 2nd Ward, 10th Division. He also is a member of United States Senator Pat Toomey's Service Academy Selection Committee. In 2008, he was the elected Republican Candidate for State Representative for the (extremely liberal) 182nd District of Pennsylvania and received more votes than John McCain in the district. In 2008, he also acted as a surrogate speaker for McCain/Palin.

He enjoys trying not to embarrass himself on the golf course, trying not to shoot anyone while hunting, watching college sports, surfing and spending time at his Philadelphia home with his soon to be wife, Shannon, and their two children−a black

Labrador Retriever named Bubba and a Havenese named Rebel. They appear indifferent to his political opinions.

For more information about Wally please visit www.supplementalconditions.com .

Wally can be reached at wally@sigzim.com.