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Risk Management Tools for the Design Professional

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The Construction Contract: 3 Essential Rules

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In the construction world, the contract rules the parties. It is the blueprint (pun intended) that says what you can be sued for, when you can sue the other party, and what your damages will be. If you do not have any written contract, the law presumes certain things that you may not want it to presume. Therefore, you must treat the contract seriously, and consider these three essential rules.

(1) Put all agreements in writing

Design professionals who rely on “handshake” or “gentlemen’s agreements” are playing a game of Russian roulette. One bad project, and you’ll wish that you had a well-written, reviewed and negotiated contract.

Written contracts are crucial to enforcing binding agreements once the dirt begins to turn. Memories fade, records are lost, and key employees leave. Having all the crucial terms in writing eliminates the need to argue over how changes are handled, how compensation issues are dealt with, and how disputes are decided.

(2) Negotiate or strike through unfair or one-sided terms

While a written contract is important, it is almost better to have no written contract than to have a poorly negotiated, unfair, or unclear written contract.

Read the contract, and negotiate the terms before signing on the dotted line. I myself will admit to signing the occasional contract (gym membership, anyone?) without reviewing it, but I know better. And so should you. If you are presented a contract by the owner/client, you may think that you cannot afford to make trouble in today’s bad economy. However, almost all owners are willing to negotiate, at least to some extent. If you run into an owner who will not budge even an inch on the contract at the beginning of the project, when the parties should all be working well together, it does not bode well for the relationship down the road. You might be better off without such a project.

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There is some built in level of protection if you use one of the standard form contracts discussed below. Even so, you need to look at the contract closely, particularly those changes and modifications to the default terms. Standard terms can cause problems if they will not work for your project and circumstances.

If your contract is not a standard contract, which is very often typical of and appropriate for smaller projects, you must examine the proposed contract even more closely. Contracts drafted by one party can often be extremely one-sided. You must carefully read the contract from top to bottom to make sure everything discussed is accounted for in the document.

Three of the biggest unfair provisions you may encounter are indemnity, duty to defend, and consequential damages.

a. Indemnity

Indemnity is the agreement, in advance, of a party to assume the liability of another party. Project owners sometimes have one-sided indemnity clauses in their contracts stating that your firm will indemnify them from any claims. Some of these provisions state that you are even required to indemnify the owner from the owner's own negligence. In North Carolina and some other states, such a provision purporting to give someone else liability for your own negligence is void as against public policy. If an indemnity provision is properly worded, however, it can still be valid. There are pros and cons to indemnity, and the area is fraught with legal issues. For example, most Errors & Omissions (professional liability) policies do not provide coverage for liability assumed under contract, such as indemnity clauses.

If there is to be indemnity in the contract, the least you should do is to push for a mutual indemnity provision, where each side agrees to indemnify the other, and *only to the extent the claim is based on that party's negligence*.

b. Duty to defend

The duty to defend can exist in a contract even if the indemnity clause is stricken. If a duty to defend is stated, it requires you to pay for the owner's defense of the specified types of claims, whether or not your firm is negligent or even named as a defendant. Usually, the duty to defend is tied to the indemnity provision, but it does not have to be.

In addition to insurance coverage issues here, there is the likelihood that the owner will pick a law firm that is top of the line, leaving you no say, yet stuck with the legal bills. At the minimum, if a duty to defend clause cannot be stricken, you should attempt to insert clauses to modify it by including language to allow your firm to hire, direct, or be consulted on the litigation defense.

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c. Consequential damages

Another area where you need to pay careful attention is consequential damages. Consequential damages include everything that is not a direct damage. These are indirect sources of loss, such as loss of use, loss of profit, or even loss of bonding capacity. The standard construction agreements by AIA, EJCDC, and ConsensusDocs all have at least a partial mutual waiver of consequential damages. However, if this provision is modified, it should be done with full knowledge of the increased risk. Non-standard, owner-written contracts sometimes provide for consequential damages for the owner, but not for the design professional. Again, if the provision is included, you should insist that it be mutual.

(3) Deal with discrepancies between the Proposal for Services and the Contract

You have a written contract, which you've both read and negotiated. Great. However, your work is not done yet. You must compare your Proposal for Services to the Contract, and decide up front how to deal with any discrepancies. If you do not do this, you may find that, due to what's called a "merger clause," you may have waived some of the Proposal terms without even realizing it.

A merger clause (also called an "integration clause") is a statement that the contract is a complete statement of the agreement and replaces, or supersedes, prior terms, oral or written representations, or any side agreements. All of those negotiations are deemed merged into the written document, and the written contract has the (rebuttable) presumption that it represents the final agreement between the parties.

An example of such a clause:

This Agreement contains the entire agreement of the parties, and supersedes all prior negotiations, agreements and understandings with respect thereto. This Agreement may only be amended by a written document duly executed by all parties.

The purpose of such a clause is to ensure that the contract is a complete agreement, and that there will be no claims made later of additional terms or that existed. The merger clause effectively takes all those side agreements, representations, and statements and says: "If the terms are not in the contract, we don't care: they don't exist."

While there are certain exceptions to the application of the merger clause (as, for example, when application of the clause would frustrate the parties' true intentions), as a general rule, such a clause will be enforced.

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For example, if your proposal has a limitation of liability clause, but the contract does not, the contract will prevail. You might think that, if the contract does not address an issue, but your proposal does, the proposal term can still apply. Unfortunately, you would be wrong. The merger clause typically makes any side or prior agreement null and void. This is another reason to treat the contract seriously, and to make any changes necessary so the contract reflects the important points of your proposal.

Saved by the Rules

It should be clear that stepping into a project with either no contract, or an unexamined, unfair or one-sided one, can lead to unforeseen consequences that can devastate your firm. By spending a little time up front negotiating fair, clear, and complete contracts, you may save yourself time and other valuable resources later, if the project goes to the dogs.

Broker's Notes