



THE MOST COMMON COMMERCIAL CONSTRUCTION CONTRACT ISSUES - PART I

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THE MOST COMMON COMMERCIAL CONSTRUCTION CONTRACT ISSUES: PART I

Written by Charles B. Jimerson, Esq. and Edgar Sanchez, JD Candidate – 3/31/17

When entering into a commercial construction contract to build a commercial building, landowners should be aware of certain contract issues that can cause future legal problems. This article is designed to address some of the more common issues seen in commercial construction contracts, and what landowners should pay attention to before entering into any contracts for the construction of a commercial building.

COMMERCIAL CONSTRUCTION CONTRACT ISSUES

The great majority of commercial construction contracts are tailored to benefit contractors and builders by shifting most of the project's costs to the landowner. Due to this, it is important that you understand the provisions of a commercial construction contract that are most commonly at issue, and how with the help of independent counsel you can negotiate more agreeable terms that will better allocate risks, diminish the likelihood of litigation, and equally spread financial burdens.

Although a commercial construction contract has innumerable provisions, not all of these provisions have an effect on your—or the builder's or contractor's—rights. That being said, some of the most prominent provisions that may affect the construction process of your commercial building are:

- 1) Scope of Work/Performance Duties Provision
- 2) Securing the Parties' Performance Provision
- 3) Payment Provision
- 4) Project Changes and Change Orders Provision
- 5) Delays Provision
- 6) Indemnification Provision

(1) The Scope of Work/ Performance Duties Provision

A Scope of Work, also commonly referred to as a Performance Duties Provision, is meant to provide you and the builder or contractor with a clear description of the work that is to be performed.

What the Scope of Work/ Performance Duties Provision Includes:

This provision describes your duties and responsibilities, the work that is going to be undertaken by the builder or contractor and how that work is to be completed, and other

duties and responsibilities of the builder or contractor. Additionally, this provision may describe how you and the builder or contractor will handle unforeseen events; what quality of work and completeness is expected; and how the commercial building design documents are going to be handled and interpreted.

Most Common Issues With the Scope of Work/ Performance Duties Provision:

The most common issue with this provision is that it will contain incomplete descriptions. The consequences of which are usually incomplete or defective work, problems with coordinating responsibilities during the construction phase, and disputes concerning the quality of the work.

If these issues arise during the construction of your building, usually litigation will be required to resolve them. This need to wait for courts to handle the dispute will inevitably delay the construction of the building or in some cases, may result in the building never being completed.

Preventative Measures:

It is possible for you to entirely prevent these disruptions or at least streamline their resolution before work on your building even commences. To do this, it is imperative that you and independent counsel diligently review and cooperatively work with the builder or contractor to develop a Scope of Work/ Performance Duties Provision that is mutually agreeable and includes things such as:

- a) Incorporation by reference to the project's design documents and specifications;
- b) Assurances that your design documents and specifications are complete and clearly drafted;
- c) Assurances that the builder or contractor will meet the standards and specifications set out in your design documents;
- d) Descriptions of express warranties by the builder or contractor that the work they will be performing will meet the requirements set out in the design documents and specifications;
- e) Descriptions of dispute resolution systems that will quickly and effectively handle any issues that arise during the construction phase;
- f) Descriptions of heightened standards of workmanship that you expect the builder or contractor to meet; and
- g) Clear descriptions of how risk is allocated between you and the builder or contractor.

(2) Securing the Parties' Performance Provision

The Securing the Parties' Performance Provision is meant to detail the credit relationship between you and the builder or contractor.

What the Securing the Parties' Performance Provision Includes:

This provision describes the monetary assurances that you and the builder or contractor make in order to assure performance of the commercial construction contract. Specifically, it details the post payment and performance bonds that you will use to ensure that the builder or contractor will continue to perform the work.

Likewise, builders and contractors use this provision to assure that you have the necessary capital to fund the project, and to insure their work against possible non-payment. Typically, builders and contractors will use this provision to list the various methods that they can employ to secure a monetary payment from you. In case of non-payment, some methods builders and contractors may be able to insure themselves through pre-payment clauses for the work and mechanic's liens.

Most Common Issues With the Securing the Parties' Performance Provision:

The most common issue is that the builder or contractor will reach the credit limit amount that he allocated to you for the project and will stop all work until you make payments or further assurances to extend the credit relationship. Alternatively, the builder or contractor may reach the credit limit and instead seek the enforcement of a mechanic's lien before offering you proper time to extend the credit relationship.

Another possibility is that if the credit relationship is not clearly detailed, the builder or contractor may unexpectedly expand your amount of credit, and perform extra work without your approval. This inevitably will lead to you being responsible for paying for the extra work that you did not approve ahead of time.

These credit issues can usually be resolved between the parties, but will cause project delays during negotiations of how the project will continue to be funded.

In the event that the builder or contractor exercised their rights to secure a mechanic's lien ahead of time, litigation will be required. This need for courts to handle the dispute will inevitably delay the construction of the building, and in the case that the builder or contractor properly executed the mechanic's lien; the lien on your property may actually prevent you from acquiring further financing for the project.

Preventative Measures:

To avoid most of the issues listed above, it is best if you and independent counsel review and negotiate the terms and conditions of this provision in order to tailor them to your ability to finance the project. Furthermore, to protect yourself from the builder or

contractor overreaching and performing extra work at your cost and without your consent, you should also make sure to set clear standards as to when and how the credit limit can be altered. Last, in order to prevent a builder or contractor from exercising their rights to acquire a mechanic's lien before you can resolve a credit dispute, you and your independent counsel should create a system whereby the builder or contractor needs to fulfill certain notification conditions, and allow you enough time to correct the dispute prior to the filing of a mechanic's lien.

(3) Payment Provision

The Payment Provision is meant to detail how you will be paying the builder or contractor.

What the Payment Provision Includes:

This provision is usually drafted as a schedule of values assigning a line item value for each of the identified items of work. As the construction of your building progresses, the builder or contractor will periodically certify what amount of work has been completed in accordance with this provision.

Depending on how much of the work has been completed, the builder or contractor will then apply to you for payment by providing you with a detailed list of:

- 1) the line items that have been fulfilled;
- 2) their completion percentage; and
- 3) the item value for that percentage of completion.

Upon receipt of this application, you are then responsible to follow the steps set out in this provision and make the payment to the builder or contractor, minus any retained fees that the builder or contractor has already collected for a certain item of work.

Most Common Issues With the Payment Provision:

One of the most common issues with this provision is that it leaves out how the builder or contractor will certify what amount of the work has been completed. The issue with this is that it gives great freedom to the builder or contractor to make its own determinations as to what amount of the line items have been completed. This leaves you with no alternative but to accept their determination and make the requisite payments.

However, in the event that you believe that the builder or contractor has erroneously estimated the amount of work completed or that the work is defective and does not merit full payment, your withholding of payment may be viewed as a breach of contract.

The consequence of this is the builder or contractor is likely to cease performance and seek recovery for labor and materials already furnished or continue performing and seek a larger judgment for contract damages.

Although these common issues can be resolved between you and the builder or contractor, your withholding of payment is likely to cause a disruption to the building process. Additionally, it is likely to harm the business relationship between you and the builder or contractor.

In the event that the issue cannot be resolved directly between you and the builder or contractor, it is almost guaranteed that the builder or contractor will pursue litigation in order to recover any payments that you have not made. The builder or contractor is also likely to pursue subsequent monetary damages that they may have suffered as a result of your withholding of payment, and will ask the court to enter a judgment through which you will be responsible for paying the builder's and contractor's attorneys' fees and costs.

Preventative Measures:

To avoid these issues, the best thing you can do is make sure that this provision details how the builder or contractor will assess the completeness of a line item. Additionally, you and independent counsel can negotiate with the builder or contractor to include as part of the provision a method by which disputes over completion of line items, and payment of those line items, can be handled without resorting to litigation.

As an extra precautionary measure, it is advisable that you and independent counsel create an inspection system with the builder or contractor whereby a mutually agreed upon independent specialist will inspect the payment application of the builder or contractor before you are required to make any payments. By including this and similar precedent conditions, you may be able to assure that the builder or contractor is not making applications for payments of line items that they have not yet met, and that the work itself is free of defects.

(4) Project Changes and Change Orders Provision

The Project Changes and Change Orders Provision, which can be viewed as two separate provisions, is meant to detail how any changes you or your architect make to the plans and specifications of the building will be handled by the builder or contractor.

What the Project Changes and Change Orders Provision Includes:

The Project Changes portion of the provision includes the method by which you can notify the builder or contractor of any changes to the original specifications and plans. At its most fundamental point, this notification method is meant to allow the builder or

contractor time to reassess the costs that will be incurred as a result of the changed building plan.

The Change Orders portion of the provision prescribes the procedures that the builder or contractor may take in order to notify you of any changes to the original project, budget, and/or schedule that the builder or contractor will need to adjust as a result of the changed building plans.

Most Common Issues With the Project Changes and Charge Orders Provision:

The most common issue that arises involving this provision is that most commercial construction contracts will not include the Change Orders portion of the provision. The result of this is that most builders or contractors will inflate their contract price in order to cover any possible project changes that you or your architect may make prior to or during the construction of the building.

Although the builder or contractor commonly resolves this issue by inflating the contract price, it may lead to litigation if the builder or contractor underestimated the cost of possible project changes. The unfortunate result of this is that the builder or contractor will likely halt all construction once it has reached its contract price, and you will be required to litigate the builder's or contractor's breach of the contract in order to receive complete performance of the contract.

Preventative Measures:

The easiest way to circumvent this issue is to include the Change Orders portion of the provision. By you and independent counsel's careful negotiation of the Change Orders portion of the provision, you may benefit by:

- a) Receiving less inflated bids from builders and contractors because of your willingness to allow them to recalculate the costs they will incur as a result of any changed building plans;
- b) Save money in the long run because you will not be paying builders or contractors for construction contracts/bids that take into account possible project changes that may never actually occur; and
- c) Most importantly, have a respectful working relationship with your builder or contractor because of your willingness to acknowledge their concerns when bidding for commercial construction contracts.

(5) Delays Provision

The Delays Provision is meant to detail the procedures through which contractors can claim time extensions and/or damages for events over which the contractor bears no responsibility.

What the Delays Provision Includes:

This provision typically insures that builders and contractors will be compensated for compensable events that delayed work on the project. These compensable events are commonly referred to as “force majeure” and “Acts of God” events. The most common types of events for which a builder or contractor may receive compensation despite the project’s delay include labor disputes, material shortages, and actions taken by government agencies that resulted in delays to the project.

Similarly, this provision entitles a builder or contractor to monetary compensation for extra expenses the builder or contractor incurred as a result of the delay. These extra expenses may include material price escalations, project acceleration costs, and costs associated with extended project overhead costs.

Until recently, this provision also included what is commonly referred to as a “no-damage-for-delay” clause which was meant to restrict builders and contractors from being able to request compensation for non-compensable events. However, due to the potential monetary windfall to builders and contractors that this clause had, courts and legislatures have restricted their use in commercial construction contracts.

Most Common Issues With the Delays Provision:

Regularly this Provision is drafted in a way that allows builders and contractors great freedom to unilaterally extend a projects timeline, and still be compensated for both compensable and non-compensable delays. The consequence of this is that the project will take longer to complete than what was originally expected, and you will be paying extra for the services of the builder or contractor.

The most common resolution of this issue involves you and the builder or contractor negotiating over whether a certain event or delay to the project was caused by a compensable event. Depending on when this negotiation occurs, the project may be held at a standstill until you and the builder or contractor can resolve the issue.

In the alternative, if you decide to not compensate a builder or contractor for delayed work, you may find yourself in litigation with the builder or contractor. Inevitably, this will prolong the project if it is not yet completed and may cause you to incur otherwise unnecessary legal expenses.

Preventative Measures:

With the use of careful drafting and negotiations with the builder or contractor, you and independent counsel can create a list of events that are both compensable and non-compensable. This list, which should be included in this provision, will not only guarantee that both you and the builder or contractor know exactly what delays or damages will be compensated for, but will insure that if a non-compensable event occurs, the builder or contractor will know that they are fully responsible for any expenses incurred as a result of it.

In the alternative, if you choose to include a general “no-damage-for-delay” clause, it is advisable that you seek independent counsel as the clause will need to meet state specific requirements or it will run the risk of being void and unenforceable.

(6) Indemnification Provision

The Indemnification Provision is meant to detail what responsibility you and the builder or contractor have for third-party judgments or liabilities.

What the Indemnification Provision Includes:

In essence, this provision accounts for third-party claims that might arise during the course of the construction of the building, and is meant to “indemnify” and “hold you harmless” from liability for these claims.

This provision customarily lists the most common third-party causes of action that may result during the course of the builders or contractors work on the building. Some examples of claims that are listed in this provision include: damage or injury to third parties, damage or injury to third parties’ property, and intellectual property infringement.

Most Common Issues With the Indemnification Provision:

The most common issue that arises involving this provision is that the builder or contractor does not indemnify you of all third-party legal actions that may arise during the course of the project. The result of this is that you may find yourself in litigation with a third-party for damages and harms that were caused to him or her by the builder or contractor.

Another common issue with Indemnification Provisions is that their terms are rendered void and unenforceable by state specific laws that deal specifically with the regulation of Indemnification Provisions in commercial construction contracts.

The only way to resolve any issues that involve this provision is through litigation. Typically, it will require you to present your case to the court and show that the commercial construction contract that you entered into with the builder or contractor indemnified you of the action that is currently being claimed by the third-party. In the

alternative, you may need to prove that the third-party should be pursuing damages against the builder or the contractor because it was their actions that caused them harm.

In either event, if a third-party claim does arise, and that third-party brings suit, lengthy litigation is likely to ensue, and you may find yourself owing large monetary damages for harms that you did not cause.

Preventative Measures:

One of the best precautionary steps to take in order to avoid a third-party claim because of a faulty Indemnification Provision is to review insurance policies. Specifically, with the help of independent counsel, you should review the claims listed in the Indemnification Provision, the possible claims that your insurance will cover, and what claims the builder's or contractor's insurance will cover.

After making a detailed assessment of all possible third-party claims, and more importantly which claims your insurance will cover, you and independent counsel can then create a possible list of other third-party claims that may arise as a result of the builder's and contractor's acts. With these extra claims in mind, you and independent counsel can then negotiate to include them in the Indemnification Provision in order to indemnify yourself from liability for these extra claims. Alternatively, you can negotiate with the builder or contractor to evenly distribute liability for claims that are not covered by your insurance, and even distribute the liability for claims that neither you, nor the builder's or contractor's insurance will cover.

The last, and possibly the best, precautionary measure is to review your indemnification clause with the help of independent counsel in order to make sure that its terms meet the standards laid out by state law, and that the clause will be held enforceable in court.

CONCLUSION

As the landowner and project financier, it is imperative to clearly set out your expectations prior to agreeing with a builder or contractor to construct your building. By doing so, you can assure that the finished building will meet your expectations; you can avoid disputes between you and the builder or contractor; and you can even save yourself a significant amount of money.

Although verbal assurances between you and the builder or contractor can help align your resources, at the end of the day a written commercial construction contract is absolutely necessary to detail the relationship that you will be entering into. Even with the numerous sample commercial construction contracts that exist today, at the end of the day you want to make sure that the one you use has provisions tailored to meet your financial needs, and that it protects your interests. Though it is impossible to

account for every unforeseen event that may arise in the future, with the information provided in this publication, and the help of independent counsel, you should now be able to begin negotiations towards a more favorable commercial construction contract.

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