K&L GATES

CAREFUL WHAT YOU ASK FOR: TEN CONSTRUCTION AND DESIGN CONTRACT PROVISIONS THAT MAY BE UNENFORCEABLE[1]

Josh M. Leavitt, K&L Gates LLP and Daniel G. Rosenberg

It is not unusual to see contracts in the construction industry that shift risks downstream. Especially in markets where new projects are scarce, contractors and design professionals often have little leverage beyond their particular expertise or their relationships to modify contract provisions that shift significant risk to them.

Legislatures have responded by passing a variety of construction specific statutes designed to "level the playing field." Examples of such legislation include Prompt Payment Acts (which are designed to protect contractors from slow payers), anti-indemnity acts (which limit the effectiveness of contractual indemnity clauses) and other construction "fairness" legislation.

Additionally, in individual cases, courts have imposed exceptions to the enforceability of specific types of clauses limiting certain types of liability risks. Examples include no damages for delay clauses and conditional payment clauses. The practical impact has been to limit the effectiveness of such clauses in certain jurisdictions but at the same time increase litigation costs. For example, whereas ten to twenty years ago it may have been possible to obtain outright dismissal of most contractor delay claims because of the bars of no damages for delay clauses, today in some jurisdictions the legislative or judicial exceptions to the enforceability of those clauses can be so wide that obtaining dismissal of delay claims even on summary judgment may be difficult, especially without well-drafted clauses that anticipate the recognized exceptions.

---

[1] Josh M. Leavitt is a partner in the Construction and Engineering Group of the Chicago office of K&L Gates LLP (312) 372-1121. Daniel G. Rosenberg is a former partner in the Construction and Engineering Group of the Chicago office of K&L Gates LLP. This paper is not intended as a substitute for legal advice or individual analysis of a particular legal matter. Readers should not act without seeking professional legal counsel. Transmission or receipt of this publication does not create an attorney-client relationship.

Adding to the problem is that enforceability rules can change from state to state, from court to court, and from situation to situation, making it difficult for counsel to draft clauses that would be generally enforced. Furthermore, in some situations state law protections can be waived and in others they cannot. In some situations a "savings clause" may be used to "save" an otherwise unenforceable clause to the extent it is enforceable and in others it cannot.

The effect of including a void or unenforceable clause also varies. In some situations if a contract includes a clause that is invalid under the applicable state's law, the clause could void an entire contractual section or provision or even, in an extreme case, the entire contract. Confusing things further, in many states the various statutes and case law addressing these clauses is new and unsettled and thus the effect of "void" clauses is not completely known.

In short, knowing these rules and their trends can be critical to proper contract drafting. Ten types of critical clauses and related evolving case law are discussed below.

1. <u>Contingent (Pay-When-Paid or Pay-If-Paid) Payment Clauses</u>

There are two different types of conditional payment clauses: (1) "pay-if-paid" provisions and (2) "pay-when-paid" provisions. Such clauses provide that the general contractor is under no obligation to pay its subcontractor or supplier unless (or until) the general contractor is paid by the owner.

The practical effects are apparent. If, for example, subcontractor A is not paid because of a dispute that has nothing to do with subcontractor A, such as the owner's holding back payment from the general because of subcontractor's B defective work or because of the owner's insolvency, subcontractor A may never receive payment. Therefore, some subcontractors try to modify the clause to require that they be paid as long as the reason for the owner's refusal to pay

the general contractor does not stem from inadequacies in the subcontractors' work. Often though subcontractors lack the leverage to negotiate these clauses.

Some states' courts disfavor and/or will not enforce such clauses. Other courts will reinterpret such clauses and hold that they are merely provisions that require the subcontractor to wait a "reasonable period of time" for payment. In other words, if the general contractor does not receive his payment from the owner or does not make the payment to the subcontractor within that reasonable period of time, the general contractor is obligated to make the payment to the subcontractor. But some states' courts enforce these provisions and make the subcontractor the ultimate banker. Other courts inquire whether the parties intended by these clauses to cover certain risks of non-payment such as owner or general contractor insolvency. In many states, pay-if-paid clauses are enforceable if clearly worded in condition precedent type language. However, a growing minority of states have held pay-if-paid clauses to be unenforceable, declaring that by preventing payment to the subcontractors these clauses go against the public policy established by the legislature in the state's mechanics' lien statute.

Some states have approached the issue of conditional payment clauses by means of statutes. The language of these statutes may vary, but the general purpose is to render pay-if-paid provisions unenforceable, or significantly more difficult to enforce. Some states have passed statutes stating that pay-if-paid clauses cannot be used as defenses to valid mechanics' lien claims.

2. <u>No Damages for Delays or Disruption Clauses</u>

Customarily, a "no damages for delay" clause provides that a contractor or designer is not entitled to a claim for delay damages, and will only be entitled to a schedule extension. An extension of time remedy may well be an inadequate remedy; and thus, combined with a no-

damages-for-delay clause, can shift substantial risk. While the extension of time remedy (if granted in a timely fashion) may help avoid acceleration costs, it will not help avoid extended overhead costs, labor inefficiency costs, and costs due to escalated material prices.

Some owners', general contractors' and architects' counsel try to tighten these clauses further by adding notice and time deadlines and requiring that claims be supported by critical path analyses or other damages methodologies. They have also learned to attempt to extend the limitations on "delay damages" to "disruption," "acceleration," "out of sequence work," "efficiency loss" and other types of damages that courts might consider different than "delay" damages.

Over the last ten or more years, courts and legislatures in many states have carved out numerous exceptions to the enforceability of such clauses such as where the upstream party "actively interfered" or where the delays where due to "unforeseeable circumstances" -- exceptions which in some cases have been interpreted so broadly so as to threaten to swallow the rule of general enforceability of such clauses. Some states recognize certain exceptions but not others. Some states simply lack enough case law from which to draw any conclusion. Additionally, some states have enacted statues rendering certain types of no damages for delay clause unenforceable. Some such statutes differentiate between claims on public and private projects.

3. Requirements that Change Orders be Approved in Writing

One of the greatest sources of controversy are claims for additional compensation based on change requests that are performed and then subsequently denied by the general contractor, architect or the owner as not being required since the work performed supposedly was within the scope of the original project. Although some agreements make a distinction between the

"change order" and the "construction change directives," these same agreements often do not detail the procedures for obtaining additional compensation in both types of situations. Most agreements do however require that change orders be approved in writing in advance and impose a number of conditions, dispute resolution procedures and time limitations before claims for additional compensation by approved by change order.

Despite the generally enforceability of such clauses, some courts recognize the difficulties that contractors face in the real world when they are directed to perform extra work and told not to wait for formal owner approval. Such courts do recognize that the requirements for written agreement to change orders in advance can be waived by conduct and allow claims for extras for orally directed work, but as a type of *quid pro quo* require elevated burdens of proof such as proof by clear and convincing evidence rather than by a preponderance of the evidence. Depending on the circumstances, some courts may look closely at whether the contractor sent or obtained a written confirmation detailing an oral directive to proceed and the basis for compensation. Thus, practically speaking, while such clauses are often included in contracts, in many instances it becomes a question of fact as to whether or not such clauses are enforceable.

4. <u>"No-Lien" Clauses and Broad Lien Waiver Forms</u>

In no-lien clauses, the contractor waives its claims for mechanics liens in advance of construction. Those seeking to enforce such clauses will argue that since the mechanics liens claims are derivative, all parties claiming by, through or under the general contractor have implicitly waived their respective mechanics lien rights.

Additionally, in lien waiver forms, upstream parties seek as a condition of payment broad waivers of all claims for additional compensation relating to work performed through the end of

the applicable pay period. Often contractors are asked to pre-sign such clauses even before they receive payment. Contractors are also often asked to disclose in sworn statements all their subcontractors, their subcontract amounts, the amounts paid to each subcontractor and all amounts due and owing.

Many states will not enforce "no-lien" clauses. Some states permitting "no-lien" contracts have strict requirements as to recording and notice provisions. Additionally, some state courts have carved out protections from broad lien waivers. Examples in some states include invalidation of waivers where owners were separately put on notice of claims or where owners were supposedly aware of the existence of subcontractors whose names did not appear on general contractors' sworn statements.

5. Contractual Statutes of Limitation and Repair and Replace Clauses

Many construction contracts specify that all claims related to the construction project must be made within a certain period of time. Other related provisions state that all claims relating to the construction accrue upon substantial completion and the owner must assert the claim within a certain number of years from substantial completion. Another variation of such provisions is to offer limited warranties, which call for repairs within certain periods of time (known as "repair and replace clauses"). Downstream parties often advocate for these types of provisions by asserting that such clauses take the uncertainty out of calculating time periods for claims and by asserting that without these provisions the price of the bidding party will have to increase its price to do the work.

These types of provisions can face a variety of hurdles to enforceability. For example, in many states a clause that simply gives a party a limited period of time to bring a claim but does not address accrual of claims will be subject to a state's "discovery rule." A discovery rule

specifies that the time period to assert a claim does not begin until the claimant "discovers" the claim. Even where accrual is addressed, for example by stating that all claims related to the construction accrue at substantial completion, such provisions are not always enforceable. Some states' legislatures or courts have barred waiver of the discovery rules or limited or rendered unenforceable attempts to define contractual statutes of limitations.

Similarly, repair and replace clauses that provide that an owner's remedy in the event of a construction defect is for the contractor to repair the defect for some period of time, often do not have the effect many understand such clauses to have. Typically downstream parties, the constructors, argue that such provisions limit an upstream party's remedy to repair and replacement of defective work brought to the constructor's attention within the proscribed time period. Many courts, however, take a much broader view of such provisions. Unless the language of the provision is very clear, many courts find such provisions only provide one remedy, but do not eliminate other remedies.

6. Indemnification Clauses

Typically construction contracts require downstream parties to indemnify upstream parties in the event of a lawsuit. Such clauses are designed to protect the indemnitee mostly from personal injury and property damage claims when something goes wrong on a project. Upstream parties seek such clauses typically by arguing that they should not be responsible where something goes wrong due to events primarily controlled by the downstream party. For example, the argument goes, the subcontractor that built the wall that collapsed should be responsible for the resulting liability from the collapse, not the owner or general contractor. It is not unusual, however, for construction indemnification clauses to require the downstream party

to indemnify the upstream parties for any claim resulting from the downstream party's work – even where the downstream indemnitor had nothing to do with the acts giving rise to liability.

Many, but not all, state legislatures have responded to perceptions that upstream parties have inordinate leverage in these situations by passing what are known as "anti-indemnity" acts. These acts limit or void the effect of certain contractual indemnity clauses. The scope of the various anti-indemnity acts varies greatly. Some acts – known as "sole negligence" acts -- void indemnity clauses that do anything more than making a downstream contractor responsible for its own sole negligence. Other anti-indemnity acts – known as partial negligence acts – are narrower and allow the contract to specify that the downstream party is required to indemnify the upstream parties if the indemnitee was a partial cause of the injury at issue. While anti-indemnity acts may not affect an upstream party's ability to demand indemnity for a third-party's actions, by including a void indemnity provision, the parties could be left in some jurisdictions with an indemnity clause that is entirely unenforceable because it is too broad.

7. Additional Insured Clauses

Closely related to indemnification clauses are "additional insured" clauses. These clauses typically require the downstream party to include the upstream party as an "additional insured" on the downstream party's insurance – in particular on the party's commercial general liability insurance. Thus, if an injury occurs, the theory goes, the upstream party can seek insurance under the downstream party's policy. In their broadest form, these clauses are not limited in any way. Thus, in theory, if anything goes wrong on a project the owner could seek coverage for any event under the general contractor and all subcontractors' policies regardless of whether or not the subcontractor, for example, had anything to do with causing the liability.

There are two potential problems with such additional insured clauses. First, increasingly anti-indemnity acts bar such clauses or severely limit their application. Legislatures in some states have determined as a matter of public policy that upstream parties should not be able to force downstream parties to provide insurance.

Second, and not surprisingly, insurers seek to limit and control their exposure and increasingly, the availability of such additional insured coverage is limited or costly in the marketplace. Some contractors or subcontractors may be unable to add parties to their insurance or may only be able to do so on a limited basis.

8. No Interest or Slow Pay Provisions

Contracts often contain clauses specifying when a payment is due – these clauses typically give the owner or general contractor or project architect a fair amount of time to process a payment application and then pay that application. Again, the result may be that the lowest tier subcontractors and subconsultants effectively become the project's bankers because they are often forced to wait months to be paid and have no contractual recourse to obtain interest unless they go to the expense and trouble of recording a lien and filing a lien foreclosure lawsuit. Governments are notorious for being slow payers, in particular.

Legislatures have recognized that prompt payment of amounts legitimately due is important to the industry. As a result, nearly every state in the country has passed some version of a prompt pay act, which requires payment within a certain number of days. Overall, such acts in many instances render unenforceable the timing of payment and interest on past due payment clauses included within contracts.

Again the scope of these acts varies. Some only apply to governmental construction contracts; some apply only to private contracts; other states have acts that apply to all types of

construction. Some prompt pay acts do nothing more than allow the contractor to collect interest for delayed payment. Others establish that for purposes of seeking payment under the act, if an upstream party fails to deny a properly submitted payment application in writing within a certain number of days, then that application is deemed accepted and cannot be later contested.

The penalties provisions of the prompt pay acts can be cumulative of other recoveries and can provide for significant interest and penalties if ignored. Importantly, whether a prompt pay act's protections can be waived by contract and what language must included to waive the applicable act varies significantly state by state and in many states has not been fully determined.

9. Choice of Law and Forum Selection Clauses

Parties with leverage often impose choice of law clauses that allow them the protection of state laws with which they are most familiar. Similarly they impose forum selection clauses in their home states which create cost and time impediments to claims and afford perceived "home court advantage" when claims are filed.

In some states, statutes have been enacted prohibiting construction contracts from subjecting disputes to the laws of a state other than where the project located. Similarly, mechanics lien acts and other statutes often specify what court is to hear a construction dispute.

10. Liquidated Damages Clauses

Many owners faced with extreme risks of lost profits and other losses, particularly with respect to project delays, seek to impose liquidated damages ("LDs") on their contractors and designers. The LDs are often calculable and expressed in terms of dollar per day charges. Other owners use a combined carrot and stick approach that combines LDs with early completion bonuses, but the effect of failure to meet schedule can still be the same: severe LD consequences.

Not every such clause is enforceable, however. Under the applicable case law of many states LD clauses are only enforceable if they meet a multi-part test that generally requires some version of the following test recognized in the authors' home state: (1) the parties intended to agree in advance to a settlement of damages that might arise from a breach; (2) that the set amount was reasonable at the time of contracting and bearing some relation to damages that might be sustained; and (3) that the damages would be uncertain in amount and difficult to prove. This test is arguably inconsistent and difficult to apply. For example, how are damages both capable of being estimated but at same be difficult to prove? Again, a contract drafter must walk a fine line in crafting an LD clause to make sure the clause is actually enforceable.

Conclusion

Some may find that when it comes to the construction industry, there is a surprising lack of uniformity in state laws applicable to fairly common contract provisions. Even within states, courts are less than uniform in their approaches, and many states' statutes and court decisions have left open critical questions about the enforceability of the provisions. To craft an effective and enforceable contract for clients doing business in multiple states, a drafter must be aware of state by state nuances and trends. Every situation is different, but one must also keep in mind the practical realities of what is required in a contract; including contract provisions to which no contractor or subcontractor can comply or which result in extreme price increases may not serve either the parties' interests nor the client's relationship or business interests.