Chapter 1 Contracts: Basic Training

What Is a Contract?

This isn't a trick question, and it doesn't have a complicated answer. For the purposes of this book, the following definition will be used:

A **contract** is a written agreement that clearly defines the responsibilities and obligations of each included party, is legally enforceable, and is dated and signed by an authorized representative of each party.

A contract may also be called an agreement. The term contract will be used throughout the book.

The Steps to a Contract

1. Receive an inquiry or request for proposal (RFP) from the owner.
2. Prepare a proposal for the work and submit it to the owner.
3. Negotiate all the details of the contract with the owner.
4. Sign the contract.

Understanding and Negotiating Construction Contracts: A Contractor's and Subcontractor's Guide to Protecting Company Assets, Second Edition. Kit Werremeyer.

It doesn't appear to be too complicated, does it? However, there are hundreds of issues—small and large—to consider and things to do during the process of responding to an owner's RFP. The contractor must:

- Review and analyze all the written bid documents, including any attached plans, drawings, and specifications.
- Resolve questions about the scope of work.
- Visit the site.
- Assess the physical and commercial risks.
- Select subcontractors and suppliers.
- Prepare an estimate and proposal.
- Review and comment on the commercial terms and conditions.
- Sort out insurance details.
- Negotiate improvements to the contract.

This chapter covers the basic concepts of contracting and explains some of the terminology contractors most often encounter.

Coming to the Party?

So who is a party to a contract? In almost all construction contracts, there will be at least two parties. One is the contractor (who is going to build something), and the other is the owner (who has a need for what is being built). If the owner hires a project manager to manage all the contractors on the project, then the owner's project manager would also be considered a party to the contract.

All persons or organizations that have not signed the contract are called third parties.

Some typical third parties a contractor might see at or near the project job site are:

1. The owner of the commercial property and buildings adjacent to the project site.
2. An OHSA safety inspector making a visit to the job site.
3. Another contractor, his subcontractors, and their personnel who are also working for the owner on the project site.
4. Subcontractors working for the contractor who are not signatory to the contract with the owner.
5. Local private homeowners or small business owners and tenants adjacent to the site.
6. Environmental protection groups.
7. The general public, who may wander onto the job site.

The Risk Associated with Third Parties

What's all the fuss over this business of third parties? The actions of these people or organizations can create serious commercial risks and potential financial liability for both the contractor and owner. Contractors must manage a multitude of job site safety issues in order to avoid employees' injuries.

Damage to a third party's adjacent property or injury to a third-party individual, such as a member of the general public, exposes both the owner and the contractor to lawsuits, legitimate or otherwise, that could financially ruin either or both of them.

Much of the concept of **commercial risk transfer** involves transferring risk from the owner to the contractor. Risk includes potential financial liability associated with damage to property belonging to third parties and injury to or death of third-party individuals, regardless of any contributing fault or negligence of the owner. This transfer of risk is accomplished mainly by the use of indemnity and additional insured clauses. (These topics are covered in detail in Chapters 7 and 8 of this book.) So although the contract is between the contractor and the owner, the contractor has to recognize that individuals or organizations not associated directly with the contract—third parties—may have an impact on the contract risk.

The Starting Point

The starting point for a construction contract is when an individual or company decides to construct a new facility to meet its needs.

An Example

Wilson Properties conducts a search of local building contractors and finds several that are qualified, including National Construction Company.

Wilson Properties prepares a written inquiry, or as it is commonly called, a ***Request for Proposal*** *(RFP), and sends it out to several contractors for competitive bids. The RFP would typically include:*

- *A description of the scope of work*
- *Some idea of a schedule*
- *The plans and specifications prepared by a design team and approved by the building department*
- *Applicable codes and standards*
- *Commercial terms and conditions the owner expects the contractor to accept*

The RFP might also require the contractor to indicate in writing whether he will provide a proposal for the work by the time specified in the inquiry, or whether he will decline to bid.

"Here's My Proposal"

The written proposal, such as prepared by National Construction Company, to perform the work is called an **offer** and is the first half of the contracting concept of **offer and acceptance**. The offer will include the contractor's price and schedule to perform the work and may contain responses to information requested by the owner's inquiry. It may also address specific work scope and commercial clarifications, as well as any other concerns of the contractor.

An Example

National Construction Company may propose a different completion schedule than required by Wilson Properties' RFP documents, technical substitutions, or other cost- or time-saving alternatives. National Construction Company may also propose changes to the commercial terms and conditions that were included in the Wilson Properties' RFP documents.

"And I accept, but…"

Wilson Properties receives the proposal (offer) to perform the work from National Construction Company, reviews it for general compliance with the RFP, and decides that it is a good offer and that they would like to award the project to National Construction Company.

However, Wilson Properties has some issues with the schedule, the price, and the clarifications to the commercial terms and conditions proposed by National Construction Company. Wilson Properties has National Construction Company come to their office to negotiate and tells them, "We would like to accept your offer, but…" The two companies then proceed to negotiate a mutually agreed-on schedule, price, and set of commercial terms and conditions.

The acceptance of the offer in this instance is actually a process. Wilson Properties and National Construction Company negotiate back and forth until they reach a mutually-agreeable deal. The final offer is defined through the negotiations, and both parties say, "Okay, we agree. We have a deal." This back and forth negotiation is the contract negotiation process.

All of the negotiated changes to Wilson Properties' original RFP are documented in writing. The best way to do this is to make the appropriate changes in the body of the signed contract. An alternate way is to document all the changes in a separate letter signed by

Offer and acceptance is the technical term used to test whether a contract has been arrived at or not. A more workable and practical definition of the offer and acceptance process is successful contract negotiations.

both parties noting that the changes agreed on supersede and take precedence over the contract and any similar or conflicting provisions.

Wilson Properties then advises National Construction Company in writing that they have been awarded the project, referencing the original RFP and the letter documenting all the negotiated changes to the RFP.

This written notification by Wilson Properties signifies their acceptance of National Construction Company's offer, as was revised and agreed on through the two companies' negotiations.

These are the first two key steps taken in the process of arriving at a contract: offer and acceptance.

"Consideration," or Something of Value

Each party to the contract must receive something of value in order for the contract to be legally enforceable. In the previous example, the contract calls for Wilson Properties to receive a new office building that will be built in accordance with the RFP—and the changes to the RFP mutually agreed to in writing by both parties. The finished building that Wilson Properties will receive is referred to as **something of value.**

National Construction Company receives the agreed-on contract price to construct the building for Wilson Properties. The money—contract price—that National Construction Company receives is also considered something of value. Both parties to the contract receive something of value, also known as **consideration**.

The "Happy Test"

Both parties must mutually and freely agree to all the conditions spelled out in the contract. In order for the contract to be legally enforceable, neither party can use coercion to get the other party to sign. A contract cannot obligate one party or the other to do something illegal. An illegal obligation would cause the contract to be unenforceable.

For example, if one party to a contract brings in a group of armed thugs and says to the other party, "sign, or else," then that clearly is coercion, and the resulting contract would not be legally enforceable. This is an extreme example, but it makes the point.

If the written conditions in the contract require one of the parties to have the responsibility of periodically bribing the local customs official (an illegal act) in order to have him under-apply import duties, then the contract would not be enforceable. There can be nothing in a contract that requires one party or the other to do something illegal. The best advice is: when in doubt, don't agree to do it.

"Can That Person Sign This Contract?"

There are two issues here: the first one involves the competency of the person signing the contract, and the second one involves whether that person has the authority to sign. Both parties signing the contract must be competent. If the person signing the contract is under the influence of drugs or alcohol, or has a serious mental incapacity, then that person probably does not have the competency to sign the contract. The contract would likely be legally unenforceable. A more common concern is whether the person signing the contract for one of the parties has the authority to do so.

An Example

A young employee of the owner who has just graduated from college is getting ready to sign a high-value EPC contract on behalf of the owner for a major expansion to a complex petrochemical plant. The contractor for the expansion questions the young person's authority to sign the contract. The contractor is accustomed to having much more senior representatives of the owner sign contracts for such major projects.

A contract may be unenforceable if it is signed by someone who does not have the proper authority to commit the party he represents to the requirements in the contract.

In a situation like this, the contractor might request that the proposed signer of the contract produce a power of attorney document from the company president, or some other senior officer, granting specific authority to sign the contract. This is a simple solution to resolving the issue of proper authority.

It's not too unusual for the owner's RFP to require the contractor to have an officer of the company sign the contract. If someone other than an officer of the contractor's company plans to sign the contract, then he must present to the owner an appropriate power of attorney document giving the signer the authority to sign contracts and commit the resources of the contractor.

Call in the Enforcer to Close the Breach!

What does the term **legally enforceable** mean? A legally enforceable contract exists when:

1. A written contract has been negotiated (offered and accepted), without any coercion, between the owner and the contractor.
2. There is nothing illegal contained in the contract.
3. The contract has been signed by representatives of the owner and the contractor. The contractor and owner (or representatives) have the authority to commit the resources of their companies.

If a contract is legally enforceable, the owner can, if necessary, sue the contractor in court to make him live up to his agreed-on obligations as defined by the contract. Likewise, the contractor can, if necessary, sue the owner in court to make him live up to his agreed-on obligations. The court can act as an enforcer of contract obligations.

Into the Breach!

If the owner or the contractor does not abide by his respective obligations as contained in the contract, then he may be determined to be in **breach of contract**. This just means that someone who is party to the contract is not living up to what he has contractually agreed to do. Breach of contract is also commonly called **failure to perform**. It's mentioned here only because the issue rears its head all the time. How many times have contractors heard it said that, if you don't do this or that, you are in breach of the contract?

There is no reason to get excited; the term is overused to exert leverage on the contractor and is subject to far too many personal interpretations.

An Example

> *If an owner agrees in the contract to pay the contractor's payment invoices 30 days from the date of each invoice, and does not pay until the 32nd day, then the owner technically has committed a breach of contract. The owner may have a variety of reasons—legitimate or otherwise—why he didn't pay the contractor on time as required by the contract, but he is still technically in breach of contract. Unfortunately, the contractor would have to go to court to have it determined that the owner was actually in breach of contract. It's always better to find a way to resolve the issue with the owner to get him to live up to the terms of payment he agreed to accept.*

The court acts as an enforcer in breach of contract disputes by compelling the party who has failed to perform to live up to his contractual obligations, or else pay monetary damages to the other party.

Sometimes a contractor will hear the owner use the term **material breach of contract**. Like many things in a contract, this term is open to much interpretation. In general, a material breach of contract is a failure to perform a contractual obligation, and the failure is extremely serious and damaging to one or both parties.

In the previous example, the owner paid the contractor on the 32nd day and so was two days late. That probably would not stand up to the test or interpretation of what constitutes a material breach of contract. However, if the owner paid the contractor 60 days late and did not have a legitimate reason for the delay, it would certainly have a much better chance of being deemed so.

A Contract Example

The following is an example of a simple "supply and install" construction contract that illustrates contracting basics.

An Example

National Construction Company responds to Wilson Properties' RFP for a new office building, negotiates the details (offer and acceptance), and enters into a construction contract, agreeing to supply and construct the office building (something of value for Wilson Properties) in accordance with the drawings and specifications contained in the RFP.

National Construction Company also agrees to perform the work within a fixed time period and for a certain fixed price (something of value for National Construction Company). National Construction Company is to receive a downpayment from Wilson Properties prior to starting the work, and will receive the balance upon satisfactorily completing the building.

No coercion was used by either party regarding the terms of the contract, and the contract does not include any illegal requirements. The contract document is signed by Wilson Properties' President and by National Construction Company's Project Manager (competent parties with authority).

In written form, the contract would look something like this:

Article 1 – Scope of Work and Price

National Construction Company agrees to supply and build a one-story office building on a site provided by Wilson Properties strictly in accordance with the attached Plans and Specifications for a fixed, lump-sum price of $250,000.

Article 2 – Schedule

National Construction Company agrees to complete the one-story office building within one year from the date of this Contract.

Article 3 – Terms of Payment

Wilson Properties agrees to pay National Construction Company $50,000 as downpayment immediately upon the signing of this Contract, and the balance of $200,000 immediately upon the completion of the one-story office building.

Dated: January 1, 2007

Signed:

Wilson Properties	National Construction Company
_____	_____
President	Project Manager

This is an example of a legally enforceable construction contract in its simplest form. But that's all that's actually required. It includes all the basics:

1. National Construction Company made an offer.
2. Wilson Properties accepted the offer.
3. National Construction Company provides something of value: the one-story office building.
4. Wilson Properties also provides something of value: the payment of $250,000.
5. The contract document is signed by a representative of each company who is competent, and who also has the authority to commit the resources of the company.
6. No coercion was used and no illegal activities are required.

This sample contract is extremely simple, but it would be perfectly legal and enforceable. However, almost all construction contracts will very likely be a lot more complex and will have numerous additional clauses to cover a variety of commercial terms and conditions, such as insurance, indemnity, performance and payment bonds, changes, dispute resolution, safety requirements, and schedule and progress reporting requirements.

This example could have been expanded to include an additional clause requiring National Construction Company to provide Workers' Compensation insurance and other types and amounts of insurance, which would read as follows:

Article 4 – Insurance

National Construction Company will provide statutory Workers' Compensation insurance in accordance with state laws, Comprehensive General Liability insurance in the amount of $1,000,000, and Automobile insurance in the amount of $300,000.

These insurance requirements are typical. Most states require contractors to participate in a Workers' Compensation insurance program, and owners typically require contractors to also provide General Liability and automobile insurance at a minimum.

All the clauses in a construction contract are collectively called the **commercial terms and conditions**. Commercial terms and conditions define all the responsibilities and obligations of each party to the construction contract.

Strange Words & Long Paragraphs

There are no requirements—legal, cosmic, religious, or otherwise—for Latin terms to be used in a contract. For example, the Latin term *inter alia*, which pops up all the time in construction contracts, simply means "among other things." It's perfectly okay to say "among other things" if necessary for clarity. Use English! Using only English terms in a simple and concise manner is a much better way to write a clear and understandable contract.

Also, there are no requirements, legal or otherwise, for the use of complicated and abnormally lengthy sentences or paragraphs, or any other confusing language that could lead to misunderstanding.

The following is an example of an unnecessarily wordy, complex contract clause stating that a contractor has to complete the work in accordance with the contract documents.

Article 25 – Contract Completion by Contractor

In consideration of all the mutual and independent agreements set forth on the part of the Owner in the Contract as contained herein, Contractor shall, without exception, construct, complete, and maintain the Work in absolute full conformity and in all respects with any and all the provisions of the Contract and Contractor will perform, fulfill, comply with, submit to, and observe all and singular the provisions, conditions, stipulations, and requirements and all matters and things expressed or shown in or reasonably to be inferred from the Contract and which are to be performed, fulfilled, complied with, submitted to, observed by, or on the part of Contractor.

Here's how this clause could be revised to simplify the usual obligation of the contractor to complete the work in accordance with the contract documents:

Article 25 – Contract Completion by Contractor

Contractor shall complete all the Work in full conformity with Owner's Contract documents.

Being clear, concise, and specific is the preferred way to write a contract, so that all those individuals responsible for executing the contract understand what they have to do.

Clear and concise English is the best way to write a construction contract! Being as specific as possible in writing the commercial terms and conditions is okay, too. Broadly worded commercial terms and conditions are subject to broad interpretation, usually to the detriment of the contractor. If there is a dispute over what the language in a particular commercial clause means, the more specific and concise the language, the better the chances are of resolving the dispute.

One thing to remember is that if a contractor ends up in a contract dispute, and a third party, like a court or an arbitration panel, reads the commercial terms related to the dispute, there is no assurance that they will interpret the clause the way the contractor believes it should be interpreted. Be as specific as possible so that the interpretation of the wording is clear to everyone.

If a contractor does not understand a paragraph in a proposed contract because of its length, construction, or use of legal terms, then he should negotiate a revision to it so that everyone responsible for actually executing the contract can understand and interpret it, too.

Contracting Myths

One myth to dispel about construction contracts is that of the so-called standard construction contract. There is no such thing as a standard construction contract. There can't be. There's no such thing as a standard construction project.

This "standard construction contract" approach is sometimes used as a negotiating tool to get one party to the contract to accept unnecessary and/ or onerous commercial terms and conditions that are in favor of the other party. Owners will often insist on using their preferred, standard construction contract as a barrier, or stonewall, to try to stop the contractor from negotiating more favorable, less onerous commercial terms and conditions. Their tactic is something like this, "These standard terms and conditions are well established and can't be changed."

On the other hand, legitimate attempts have been made to try to standardize construction contracts so that the commercial terms and conditions they contain have some balance, are easier to understand and interpret, and are seemingly fair to all parties. This is admirable in its intent, but can lead to laziness in addressing issues unique to individual construction projects, and it may actually increase the commercial risk assumed by one or both of the parties to the contract. Caution should always be taken whenever a "standard contract" is suggested.

Examples of standard commercial terms and conditions for construction contracts are those published by the American Institute of Architects (AIA) and the Associated General Contractors of America (AGC). Other options include standard forms from the Engineers Joint Contract Documents Committee (EJCDC) in the U.S. and the International Federation of Consulting Engineers (FIDIC) in Switzerland.

There are certainly opportunities to use these standardized terms on construction contracts, but contractors must read them carefully and

understand how they apply to the specific project. If some of the standard terms don't apply, or tend to create excessive commercial risk, then the contractor should modify them or delete them. These standardized terms are not cast in stone, despite the impressiveness of the contract's appearance.

A Second Contracting Myth

Another myth to dispel is that only lawyers can write construction contracts. Once a contractor has an understanding of the risk and consequences of accepting certain commercial terms and conditions that can create a potential financial liability for his company, he can negotiate favorable changes to any offending commercial terms and conditions and better protect the assets of his company.

Contract Negotiations

One important thing to remember about construction contracts is this: all the wording of all the commercial terms and conditions in a proposed contract is negotiable. This is especially so if the contractor's proposal for the work contains a good price, an achievable schedule, and is technically solid. As long as what the contractor is trying to achieve by changing or modifying the language in a proposed contract is not illegal, then all the commercial terms and conditions that may create a potential financial liability for the contractor are fair game for change.

As noted earlier, many owners will have standardized wording for most all of the commercial clauses in a proposed construction contract. They would like for this wording to be accepted by all their contractors. That's fine, as much of the standardized wording can probably be classified as administrative terms, or, as it is sometimes called, **boilerplate**, and may not impose any additional or excessive commercial risk and potential financial liability on the contractor.

However, a conscientious and careful contractor needs to make sure he carefully reads the contract terms and conditions and understands all the commercial risk associated with accepting the owner's standard contract wording. If the commercial risk is unacceptable, then negotiations are necessary in order to change the wording to lower or eliminate the risk.

An unfortunate caution: some owners have been known to insert unrelated high-risk terms and conditions within what might be considered administrative terms, perhaps hoping the contractor will overlook them. A final waiver of mechanic's liens, for example, is a fairly normal requirement for the contractor to provide to the owner

There is no substitute for reading and understanding the contract. It is probably the most important part of the contracting process. Of equal importance is the ability to successfully identify and then negotiate changes to any commercial terms and conditions that can create unnecessary commercial risk and financial liability.

at the conclusion of a construction contract. The owner may even have a standard form for this. Sometimes that final waiver of liens also contains extra language that waives all of the contractor's rights to claim legitimate extras that are outstanding. This is unfair, but it does happen, so be careful.

After the basics of contracts are understood, the next step is developing an understanding of the general types and forms of contracts that contractors will commonly encounter. This is discussed in the next chapter.