WHAT SHOULD BE IN YOUR CONTRACTS

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I. UNDERSTANDING THE IMPORTANCE OF CONSTRUCTION CONTRACTS

This Article was originally published in 2010 and revised in 2012. While change is constant, there are many considerations related to residential construction contracts that continue to be relevant. Therefore, much of the discussion that follows remains unchanged from the initial version of this Article.

The purpose of this Article is also unchanged -- that readers gain some insights about the importance of a well-written construction contract and its impact on the health and welfare of a Builder's business. Not only will a good contract reduce risks of disputes, but it will also enable the Builder to create stronger, long-lasting relationships with customers. There will be a discussion of the overall purpose of contracts, and some legal and practical perspectives will be offered on various provisions that may be found in your construction contracts. The scope of this discussion is limited, and will not include all the provisions that may, and in some cases should, be in a construction contract.

When examining some of the various provisions that find their way into a contract, those provisions will be better understood if they are viewed in an explanatory context. To do that, this Article will identify the basic purposes contracts serve. These include the need for the parties (a) to formulate a detailed agreement (b) to understand their agreement; and (c) to fairly allocate risks and control liabilities. Understanding these basic purposes will give you a frame of reference to better appreciate and understand the purpose of specific provisions found in a construction contract. Additionally, contracting parties will be more likely to achieve their legitimate goals if they (1) understand their respective responsibilities and rights under the contract, and (2) appreciate the interplay between each party's interests and the risk-shifting that occurs through contractual relationships.

II. FIRST GOAL — MEMORIALIZING THE AGREEMENT

A contract is simply intended to be an expression of a common understanding — a "meeting of the minds" — between two or more parties. The problem is, however, that our memories about that common understanding are often imperfect. It only makes sense that a complex or detailed agreement be reduced to writing so that the contracting parties have a clear statement (or a reasonable assurance) of their common understanding without having to commit the terms of the contract to memory. And, moreover, many states *require* that agreements related to the transfer of real estate be in writing and signed by the party who is charged with performing

the agreement for the contract to be enforceable. It is important, therefore, to put the agreement down on paper — *even a napkin, if need be.* Without some way to establish there has been a meeting of the minds, *there is no contract.*

A. Describing the Scope of Work

Assuming the contract properly identifies the parties to the agreement, a good description of the work to be done or the services to be performed is the logical next step to take. But what *is* a good description? Well, often we see language used that focuses on *how* the work will be performed, as well as *what* work will be performed. From experience, **subjective descriptions invite controversy.** Therefore, terminology like "good and workmanlike" or "best efforts" can be problematic because those terms do not provide any definitive insights about how the work should be performed. There are similar uncertainties with words such as "diligent" and "first class."

Instead, contracting parties should use objective standards that focus on the end-result of the work. Logically, this can be accomplished through a reference to and incorporation of detailed plans and specifications into the contract. A detailed and objective description of what the Builder will build and what the Owner will receive is the goal. An example:

> The Improvements will be constructed in substantial compliance with certain schematic drawings that have been prepared by _____, dated _____, ___, and consisting of ____ pages, which have been initialed by the parties for purposes of identification and which by this reference are incorporated into this Contract (the "Plans"). In addition to the Plans, construction of the Improvements shall incorporate certain materials and equipment, and comply with certain standards, procedures and requirements (collectively referred to as the "Specifications"), which are detailed in the attached Exhibit "A". If the Plans and Specifications conflict, the Specifications shall control.

Notice that the provision above calls for *substantial — as opposed to strict — compliance* with the plans and specifications. Substantial compliance is a more appropriate standard because the construction process does not take place in a controlled, sterile environment with highly engineered components and precise measurements. Natural materials (wood, stone, *etc.)* are fashioned and assembled by a variety of independent trades in an environment subject to natural elements (moisture, heat, biological contaminants, *etc.).* In addition to these environmental considerations, we have the human element. Construction, like most other human endeavors, will not reflect perfection. And, importantly, the value and usefulness of a building is rarely compromised by minor deviations from the plans and specifications.

In addition to describing the scope of the work as it is presently known, one should also consider future changes to the scope of the work. The contract should introduce the concept of, and procedures for, change orders and should address what is to be done if a hidden or previously unknown condition is found.

B. Describing the Amount of and Procedure for Payment

Clarity and simplicity are the hallmarks of a good payment provision within a contract. As we know, nothing seems to bring a construction project to a halt more quickly that a payment dispute. And, payment problems are more likely if the contract fails to outline a simple and clearly described methodology for payment. Again, objective procedures and requirements are more workable compared to payments premised on subjective considerations and vague procedures.

Using a series of milestones or benchmarks relating to completed elements of the work is often seen, to be coupled with a specific set of requirements (or forms) for presenting a draw request or payment application. And, a specified timetable within which draw requests must be paid is a must. *The parties should look at the payment process as a step in moving the work along-- not as a decision-making process about the continuation of the contract.*

Accordingly, the payment process should specifically delineate a clear procedure that results in payment (once reasonable, objective, criteria have been met). **Tying payment to the "satisfaction" of the party who will fund or approve the draw or payment application can be dangerous.** If funds are to be withheld for re-work or repair, the sums should bear a reasonable relationship to the cost of the work that needs to be done, and provide a second, clearly delineated procedure for securing the payment of any retained funds. Typically, funds are paid on the basis of progress of the work, and not an approval of the work and corrective work (*i.e.*, punch lists). Corrective work can be addressed throughout the construction process without slowing the funding of the project.

The Builder should not be responsible for or should the risk of financing for the construction project. It is imperative that the subcontractors be paid promptly if a Builder is going to be able secure the necessary labor or materials to complete the project, or even complete any re-work. This simply acknowledges the fact that when one has in good faith performed work with the expectation of being paid, the withholding of payment undermines the trust which enabled the work to be done in the first place.

Often, however, payment of the Builder's draw request is premised upon the presentation of releases from subcontractors and suppliers. The better approach would be to present releases secured with the *prior draw*, not releases for work and materials that are the basis for the *current draw*. This relieves the Builder from financing the construction, and keeps the project moving forward.

The Timing of the final payment can be a significant issue and needs to be carefully addressed. Often an Owner attempt to hold on to monies that are payable to the Builder as "insurance" or a negotiating tool to re-trade the contract price. This effort by an Owner to "ensure" the final completion of the Project, however, can undermine the entire relationship and lead to disputes.

One benchmark for final payment could be when the Builder has achieved "substantial completion" of the work, *i.e.*, when the project has been completed to the point where it can be used for its intended purposes. This does not necessarily mean "final completion," since punch list items (minor corrective and finishing work) may still exist. Final payment can also be premised on receipt of required governmental approvals and certificates. The problem with funds being unfairly withheld can be addressed in part by a contractual provision that prohibits the Owner from occupying the improvements until the Builder has been fully paid. The Owner should therefore honor the Builder's expectations of prompt payment and provisions that support this expectation should find their way into the contract.

C. Limiting Extraneous Agreements

The contract should represent the *only* agreement between the parties. That does not mean the contract must include within its four corners all related documentation. Any other documents to be made part of the agreement should be clearly referenced in the contract, as well as having the parties initial or sign and date the referenced documents.

There can, however, be a problem presented by prior negotiations and contemporaneous oral statements or assurances made around the time the contract is signed. These "understandings" can undermine, and even modify the written contract under certain circumstances. To guard against this, it is helpful to have what is known as an "integration paragraph." Below is an example:

> This Contract, together with all attachments, contains the entire understanding between Builder and Owner with respect to the construction of the Home, and replaces all prior agreements or understandings, if any. BUILDER IS NOT BOUND BY ANY STATEMENT, PROMISE, CONDITION OR STIPULATION NOT SPECIFICALLY SET FORTH IN THIS CONTRACT. No representative of Builder has authority to make any oral statements that modify or change the terms and conditions of this Contract.
>
> OWNER REPRESENTS THAT OWNER HAS READ AND UNDERSTANDS THIS ENTIRE CONTRACT. OWNER ALSO REPRESENTS THAT OWNER IS NOT RELYING ON ANY VERBAL STATEMENT, PROMISE OR CONDITION NOT SPECIFICALLY SET FORTH IN THIS CONTRACT. IT IS ACKNOWLEDGED THAT BUILDER IS RELYING ON THESE REPRESENTATIONS AND WOULD NOT ENTER INTO THIS CONTRACT WITHOUT THIS UNDERSTANDING.

This language makes it difficult for a party to the contract from claiming that oral misrepresentations were made in conjunction with the execution of the contract. As well it should, for significant hurdles should exist to prevent one from an Owner attempt to get around the written word.

III. SECOND GOAL — MANAGING EXPECTATIONS

It seems to be a well-settled proposition that unfulfilled expectations (a/k/a surprises) give rise to disputes. How does one address this situation in connection with drafting a contract? A comprehensive agreement is certainly one ingredient. A contract that is also organized in a logical manner is another, as is its readability. But the key ingredient in managing expectations is to address the role each party will play in carrying out the contract and ensuring the Owner has reasonable expectations regarding what the Builder will (and *can*) do, and when.

A. Identifying the Builder's Role

It is important to confirm in the contract that the Builder will be hiring, scheduling and monitoring the work by the subcontractors — in short, the *administration* of construction activities. **The Builder, however, is not the repository of all knowledge about the construction process, nor the materials that will be incorporated into the project, or even applicable regulatory requirements.** There are others who have expertise in these and related areas, and the Owner should be asked to rely on those sources just as is done by the Builder.

Therefore, it is equally important to identify in the contract those elements for which the Builder will *not* be responsible. For example, in certain areas, such as the preparation of plans or specifications, the Builder relies on others for their expertise. Recognition of this reliance on others is especially important when the plans and specifications are prepared by others and/or provided by the Owner. Accordingly, this must be communicated to the Owner so that realistic expectations can be fostered. For example, with the plans and specifications, the contract could provide:

> It is specifically understood and agreed by the Parties that Builder is not responsible for and in no way endorses the accuracy or completeness of the Plans and Specifications to the extent they have been prepared by an independent architect, designer or other third party. Any extra Work or related costs incurred because of deficiencies in the Plans and Specifications shall be the Owner's responsibility.

Who is responsible for the accuracy or completeness of the plans and specifications? The Builder should not (and probably cannot legally) perform services of an architectural or engineering nature. Accordingly, a licensed, third-party professional is the appropriate party on whom the Owner should rely. The law in some states provides that unless a Builder specifically disclaims liability for the plans and specifications, the Builder will be liable to the Owner for deficiencies in the plans and specifications that are not discovered before work is commenced on any specific element of the plans that is improperly drawn or dimensioned.

The Builder's reliance on information from third parties goes beyond just plans and specifications. For example, the Builder is relying on third parties to identify flood zones, determine the appropriateness of materials and components incorporated into the project, provide information regarding soil conditions and the like. Indeed, placing the Owner on notice of specific information on which the Builder relies may afford protection under some consumer protection statutes. It is important that the reliance is reasonable and the particular goods and/or services involved are specifically referenced in the contract.

B. Identifying the Owner's Role

The Owner does indeed have a role and explaining the role the Owner will play can be significant in managing expectations. One activity with which the Owner should be tasked is the inspection and suitability of aesthetic aspects of the work. This is of particular importance with the location of items not specifically provided for in the plans. In the context of a residential custom home contract, this would be placement of lighting, HVAC registers, tile patterns, the appearance of finishes, etc. The purpose of such a provision is to place on the Owner the responsibility to perform inspections that would afford the Builder notice of a problem the Owner saw, and hopefully allow the correction or adjustment of that item before the condition was covered or otherwise incorporated into other work. When the Owner does not take on that responsibility, the Builder may be faced with performing corrective work that is more expensive and time-consuming. A clause such as follows may help:

> Owner shall conduct periodic walk-through inspections of the Project (with due consideration being given to safety concerns) and agrees to promptly apprize the Builder in writing if any aspect of construction has not been completed in substantial conformity with the Plans and Specifications and this Contract. ***Failure by the Owner to reasonably object to aesthetic aspects of the Work performed within any phase of construction shall constitute an acceptance of that Work.***

The Owner should then expect that the Builder will rely on the Owner's silence as confirmation the work is acceptable. At the same time, the Owner is not expected to point out latent defects or problems that would require special knowledge or training to recognize: the Owner must only "reasonably object" to "***aesthetic aspects of the Work.***"

Managing the Owner's expectations about his or her role in the contract is not just about describing activities for which the Owner is responsible. The contract should also communicate

to the Owner what the Owner should *not* do. For example, it is important for the Builder to serve as the focal point for coordinating the construction activities taking place at the job site. A problem will result if the Owner intervenes to direct subcontractors and suppliers. It is like having two quarterbacks on the football field calling different plays and signals at the same time. To avoid this situation, the contract might include a provision that provides as follows:

> The Owner agrees not to instruct, direct or otherwise communicate with the subcontractors retained by the Builder as to the scheduling of or details about the Work (including additions to or deletions), nor shall Owner do or cause any Work to be done, or alter or cause the alteration of any portion of the Project, whether complete or incomplete, before Final Completion and Final Payment. Owner shall not independently contract for or sublet any portion of the Work without Builder's express written consent.

In addition, the Owner should not control which subcontractors and suppliers the Builder hires, nor should the Owner interfere with scheduling of the work. Typically, an Owner contracts with a specific Builder based on the quality of prior projects completed by the Builder – projects for which the Builder had used its typical cadre of subcontractors and suppliers. The Owner should not, therefore, attempt to modify this, if the Owner wants similar results. If, however, the Owner wants to approve of who the Builder hires, wants to control how the job site is administered through the imposition of procedures and policies, the Builder's efforts to construct the project may be hampered and the project administration complicated. *Note: Your subcontractor agreement should also include provisions to address this problem.*

The Owner's employment of the Owner's own forces can also give rise to significant problems. Conflicting scheduling and the interaction between the Builder's subcontractors and those employed by the Owner can result in one trade's work being damaged by another subcontractor, or the creation of delays in completing the construction. The risk of job site injuries also increases. The contract should therefore place upon the Owner the responsibility for any losses or damages caused by the Owner's personnel, as well as make clear that the Builder will not warrant the work performed by the Owner's subcontractors.

C. Managing Expectations — the Work

One expectation that often leads to misunderstandings and disputes is the time of completion. In reality, however, the interests of the Builder and the Owner are aligned on this issue. From a pragmatic viewpoint, the Builder will be motivated to complete the construction project as quickly as possible (so that full payment can be obtained and projects with other customers can be bid and constructed). If the parties have executed a fixed-price contract, the Builder will want to avoid price increases that proliferate the longer a project takes. And, if the project is on the Builder's property, the Builder is faced with the carrying costs (taxes, interest accrual, etc.) that are unrelenting until the Owner takes Ownership. Therefore, the risk that a Builder will purposefully allow a project to languish seems remote.

Accordingly, tight restrictions on when a construction project will be completed are usually unnecessary. Furthermore, the ability of the Builder to guarantee a specific date for completion is problematic at best. This is the case because many factors outside of the Builder's control can slow down or stop the progress of building. Those factors include inclement weather, shortage of materials, change orders that enlarge the scope of the project or require the

elimination of prior work, failure of the Owner to provide input when needed, *etc.* The parties may be well-served with an estimated date of substantial completion, and there would be no reason why that estimate could not be updated and refined as the job progresses. A cooperative approach to this issue will serve the purposes of both parties, and this involves managing the Owner's expectations through contract provisions that acknowledge the Builder's inability to ensure completion of the project on a date certain.

IV. THIRD GOAL — SHIFTING RISK AND CONTROLING LIABILITY

A construction contract should both *shift risks* and *control the overall scope of risk (or liability)*. First, contracts may shift risks, burdens, and obligations to the parties who can best perform the specific obligation or shoulder the specific burden.

One example of this is found in a release/indemnification provision dealing with the personal safety of those who enter onto the property during construction. This clause, when should logically include the Owner and the Owners' business and social guests and other persons who the Owner controls. A release/indemnification provision should also be included in agreements between the Builder and its subcontractors. The risks of liability can also be addressed through practical dispute resolution procedures and limitations on remedies and types of damages.

This Section discusses the benefits of shifting risk through releases and indemnification provisions and goes on to discuss the advantages that can be achieved by crafting an appropriate and practical dispute resolution procedure.

A. Shifting Risk — Indemnification

Construction sites are dangerous places, even when all due precautions are taken. Dangerous conditions inherently exist where construction is taking place and where dangerous activities are performed. Risk of loss and injury on the job site, therefore, is a topic that should be included in a construction contract. **We begin with the concept that as the party "in control" of the property, the Builder may have a duty to warn business and social guests (the law calls them "invitees and licensees") who come onto the job site of any dangerous conditions.** This obligation may be difficult or impossible to fulfill, however, because it is unlikely that a Builder will be able to put in place comprehensive controls to ensure the job site is a safe place (even if the Builder were to be on site 24 hours a day). Moreover, even if the Builder could effectively control the nature and the details of the work being performed by its subcontractors, there are reasons why the Builder should not attempt this. It is also unlikely that a Builder could identify all dangerous conditions or warn those who come on the property about those conditions when the Builder is not continually on the job site. As a result, the Builder knows that a real prospect exists for someone to be injured at the job site, and that there is a strong prospect the Builder will be found to be responsible for the injury.

So how does the Builder address this risk of liability? With regard to subcontractors and suppliers, care should be taken to ensure that the Builder does not attempt to control the details of how the employees of subcontractors and suppliers perform their work; the Builder should be concerned solely with the end product. Additionally, the Builder should ensure that the contracts with its subcontractors and suppliers call for the Builder to be shown as an additional insured on the subcontractors' and suppliers' liability policies, if permitted under state law. Finally, the Builder's subcontracts should contain an appropriate release and indemnity clause relating to injuries to the subcontractors' employees and others.

But, what about the Owner, family members, and inspectors, who will certainly come onto the job site? They will be particularly susceptible to being injured, and any ensuing liability could be quite substantial (and easily exceed the Builder's liability policy limits) given the size of personal injury claims. *How can the Builder effectively manage these risks?*

The answer, again, is through contractual releases and indemnity. For the reasons discussed above, the Builder will want its contract to call for the Owner to assume the risks associated with unsafe conditions when the Owner chooses to come on to the work site or bring others there. This can be accomplished with the Owner's agreement to release the Builder for injuries that might be sustained by the Owner, and to indemnify the Builder for injuries sustained by the Owner's licensees and invitees, if applicable law permits this. The indemnification should extend even to losses that result from the Builder's own negligence (since that determination arises from the Builder's "control" of the job site). With regard to an indemnification of the Builder from its own negligence, the clause should be explicit, clear and conspicuous. The indemnification, however, should extend only to those persons the Owner can control, should not extend to invitees of the Builder or to trespassers, and should not attempt to cover the gross negligence of the Builder.

A risk-shifting provision like this may seem, at first blush, to be unfair. In fact, however, a Builder simply cannot control the activities of independent subcontractors or keep a construction site entirely safe, either for the Owner and its representatives, or for employees of subcontractors. The Builder is simply not on-site 24 hours a day, seven days a week. A subcontractor or representative of the Owner who comes on the construction site is in the best position to control the risks that may be encountered, and to insure themselves against those risks (as do spectators at an athletic venue, or a patron who parks a car at a public parking garage).

B. Controlling Liability — Dispute Resolution

Another important aspect of controlling liability and placing reasonable limits on damages can be accomplished through formulating rational dispute resolution techniques. This includes the use of alternative dispute resolution methodologies such as mediation, bench trials, and arbitration.

The mediation process is one that has made a significant impact on dispute resolution, and many states have alternative dispute resolution statutes authorizing the training of mediators and calling for the courts to use mediation. The success ratios of mediators are quite high (65% to 80%) and provide a realistic and creative way to resolve disputes. And, mediations can be held at any time — pre-suit, during trials and arbitration, and even during the appellate process. Avoiding litigation or arbitration costs continues to be a significant motivator in the use of mediation, as is the need for businesses to be engaged in money-making activities rather than focusing on disputes, responding to discovery activities, and preparing for trials/arbitrations.

Arbitration has a long history within the construction industry and is intended to provide a streamlined and prompt resolution of disputes. And, in the dispute resolution process, less time generally equals less attorney's fees. The time usually seen to bring an arbitration proceeding to hearing (approximately six to nine months) is also considerably less than what is usually experienced in court proceedings. Parties who are opposed to arbitration, either because of concerns over payment of arbitrators' fees or the inability to appeal an unfavorable decision, may wish to consider bench trials. A bench trial is a trial before a judge, not a jury. Bench trials offer some efficiencies not customarily used in arbitrations (e.g., pre-trial motions that dispose of parts of a case), but litigation typically involves a greater range of discovery, and therefore expense to the parties.

Deciding on a preferred method of dispute resolution is something that should be done carefully under the advice of an attorney, who can explain fully the risks and benefits associated with each method. And whether arbitrations or bench trials are employed, it is prudent to make certain that the parties to the contract realize that they are waiving their right to a jury trial, and clarifying this point by specific and conspicuous language is important and may be called for by statute.

Finally, the parties to a contract should carefully consider the remedies that can be pursued and the types of damages that can be awarded if a dispute arises. The scope of available remedies and damages can be the subject of a contract, and the parties should attempt to fashion provisions that are pragmatic, realistic, and efficient ways to resolve disputes. An extremely useful approach would be to prescribe procedures that allow the Builder to inspect and repair problems, before the dispute can become the subject of a lawsuit or arbitration. Spending money on repairs is generally more efficient that paying legal fees and costs and accommodates the Owner's need to address the effects of construction defects. This approach (calling for inspection and repair) has also been adopted by statute in several states (*e.g.*, Arizona, California, Florida, Idaho, Indiana, Kansas, Kentucky, Montana, Nevada, South Carolina, and Texas).

V. CONCLUSION

The drafting of a comprehensive, objective, and easily understood construction contract affords the parties the opportunity to better know their rights and obligations, and to gain insights about each other and their respective expectations. If the parties are better able to comprehend the relationship they are about to forge, including an awareness of the perspectives and motivations held by each other, the less likely it is that the relationship will result in disagreements and dispute.

About the Author

Steve Paxson is a shareholder and President of PAXSON & ASSOCIATES, P.C. and has been practicing law in excess of forty-five years. For almost thirty years, Steve's practice has been focused on drafting contracts and handling construction defect claims related to residential and light commercial projects for property Owners, contractors, subcontractors, and suppliers, as well as providing general legal counseling and litigation-avoidance strategies. Steve's litigation practice has involved arbitrations and trials in state courts arising out of breach-of-contract actions, construction claims, real property disputes, consumer claims, banking and collection litigation, and employer-employee matters. Steve is a member of the State Bar of Texas and the Houston Bar Association and is an associate member of the Greater Houston Builders Association.