DELIVERING STRATEGIC SOLUTIONS ACCA'S 2000 ANNUAL MEETING

A QUICK PRIMER ON CONSTRUCTION RISKS AND CONTRACTING PRACTICES

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Introduction

It has been said that "[n]o business is more exacting or requires greater effort and determination than construction." Indeed, construction is a complex and challenging process. Among other things, it requires interpretation of and conformance with myriad laws, codes and regulations, marshalling of considerable resources, including labor, equipment and material, and communication with and coordination among multiple parties, such as the design professional, contractor and subcontractors, all of whom may, at times, have different, even conflicting, purposes and goals. Moreover, many factors are unknown or unknowable at the start of any project. Not surprisingly then, risks are an inherent and expected part of this process.

Definition of Risk

A construction risk can be defined as any exposure to possible loss. Because every construction project is unique, each offers a multitude of different risks. To ensure the success of its undertaking, a company/corporate owner embarking on a construction project must be able to *recognize* and *assess* these risks.

Identifying Risks

Typical construction risks that may impact the project cost or schedule include the following:

Project Site

- Acquisition of necessary easements
- Archaeological discoveries
- Coordination with other on-site contractors
- Related activities not under the control of the general contractor or construction manager
- Delays in presenting, addressing and resolving site construction problems
- Encountering hazardous wastes, buried tanks, or other environmental conditions
- Environmental permitting and monitoring
- Permits and licenses
- Site security
- Varying subsurface conditions encountering difficult soils, rock and groundwater
- Worker and site safety
- Identification of underground site features (utilities, old building foundations, etc.)

Owner and Design/Construction Team Relationships

- Inadequate compensation/late payment

- Adequacy and availability of owner representation to facilitate prompt decisions
- Lack of appropriate involvement of design professional during construction
- Lack of coordination/communication program among owner, design and construction teams
- Late or unsuitable owner-furnished material and equipment
- Post-bidding design changes

Contract/Specifications

- Force majeur/acts of God/extreme weather or natural disasters
- Imposition of unreasonable site performance requirements by owner/design professional representatives
- Overlapping insurance coverage
- Lapsed insurance coverage
- Sufficiency of plans and specifications
- Unrealistic performance schedules
- Unreasonable systems performance guarantees

Other

- Adequacy of labor force
- Insolvency
- Civic/community activism
- Cost escalation
- Changes in legal requirements/codes/taxes
- Delays in delivery of critical equipment and supplies
- Inadequate project funding/inadequate contingency funding
- Labor strife/jurisdictional disputes
- Political involvement and interference
- Subcontractor capability
- Protracted disputes
- Malicious acts/arson/theft
- Third-party litigation
- Contractor's level of commitment to complete the last five percent of the project

Allocating Risks

After identifying each risk, the company/corporate owner next must decide whether to *share* or *transfer* each risk. Although adopting an "all-or-nothing" or "take-it-or-leave-it" approach to allocating construction risks (i.e., transferring all risks to the design and/or construction teams) may be tempting to some companies, companies that adopt a "reasoned" approach to risk allocation will find that they benefit as well as the design and construction teams. A "reasoned" risk allocation strategy is a "win-win" proposition for all project participants. *Such a strategy seeks to allocate specific risks based on an analysis of which party is best able to evaluate, control, manage and assume the risk*. It also seeks to more closely align the interests of the owner with those of the design and construction teams. In many instances, the parties may find that they share construction risks; in other instances, one party may accept risks that are foreseeable and that are primarily or exclusively within its control. If neither contracting party is in position to control or manage a particular risk effectively, and that risk cannot be transferred to a third-party, such as an insurer or surety, the risk should remain with the company/corporate owner as the originator of the construction project.

Benefits of Proper Risk Allocation

Proper risk allocation can yield tremendous benefits. Just as improper, one-sided risk allocation likely will impact total project costs negatively, proper risk allocation— and proper compensation for assumed risks— almost always will have a salutary effect on the project. It will frame positive project relationships, thereby reducing the adversarial mentality characteristic of an "all-or-nothing" or "take-it-or-leave-it" approach and the opportunity for misunderstandings and claims. Because of the absence of uncertainties imposed by unfairly allocated risks, contractors can avoid the addition of cost contingencies in the pricing of project bids and estimates and schedule contingencies in the time for contract performance. In short, by advocating fair risk allocation, companies/corporate owners can expect that their projects will have fewer claims, reduced costs and timely completion.

The benefits go beyond the immediate project, however. By building a reputation for fair dealing, corporate owners will reap the benefits of a larger pool of qualified contractors bidding on their next project, which will translate into more competitive bids. Conversely, corporate owners that routinely proffer onerous contracts will reap an ever, shrinking pool of qualified bidders for subsequent projects.

Recording Shared & Transferred Risks: The Construction Contract

The construction contract expresses the intent of the parties and memorializes their principal risk allocation decisions. The term "construction contract" is somewhat of a misnomer. Rather, each "construction contract" is actually a series of different documents, which, when taken as a whole, set out the entire understanding between the owner and the contractor. The contract typically is composed of an agreement, drawings, specifications, general conditions, supplemental conditions, addenda, and contract modifications made during contract performance. Within the general conditions of the contract are found usually the highest concentration of provisions addressing construction project risks. The general conditions typically address such matters as:

- the respective responsibilities of the owner and contractor,
- the administration of the contract by the owner and/or design professional

- the administration of the contract by the owner and/or design professional,
- terms relating to separate contractors and to the contractor's subcontractors,
- procedures for initiating changes in the work of the contractor,
- procedures for resolving claims and disputes,
- provisions addressing delays and time for performance,
- procedures for payments,
- requirements for indemnity, insurance and bonds,
- procedures for contract suspension and termination,
- procedures for project close-out, and
- miscellaneous terms, such as assignment and governing law.

"Good" Construction Contracts

The proper allocation of risks and responsibilities is a crucial factor in determining whether a particular construction contract should be considered a "good" contract. What is meant by a "good" contract? One legal commentator characterizes a "good" construction contract in the following terms:

> A *good* contract clearly informs each party what it must do and to what it is entitled. It also informs each party of its rights if the other party does not perform as promised. It anticipates the likely problems and resolves them clearly and in a way that *strikes the parties as reflecting a proper allocation of risks and responsibilities* [emphasis added]. A good construction contract, of course, includes well-drafted drawings and specifications that inform the contractor what it must do to earn the promised compensation and provides a method of determining whether the objective has been reached. A good construction contract also reflects the realities of contract administration and *does not require procedures not likely to be followed* [emphasis added]. A good contract principally provides a set of working rules for the parties and secondarily addresses judges or arbitrators who may be called upon to interpret it.

Standard Form Contracts: Are They "Good" Contracts?

Standard form contracts have been an essential part of the construction industry's business practices since the nineteenth century. Produced by the professional and trade associations for architects (American Institute of Architects), engineers (Engineers Joint Contract Documents Committee) and commercial contractors (Associated General Contractors of America), among others, standard form contracts have served the vital function of stabilizing construction transactions in the private sector by imbuing such transactions with predictability and efficiency. Unlike many other business endeavors or industries, construction is not governed by a "comprehensive or consistent set of laws like the Uniform Commercial Code or a federal statutory scheme." As a result, the standard form contracts published by construction industry associations have, in many respects, provided the "rules-of-the-road" for private construction transactions and the underpinnings for the development of construction law in the United States. Further, most legal commentators and most in the industry perceive them as being fair and advantageous, and their prevalence and frequency of usage serves to validate this perception.

Because most industry-drafted documents (specifically those produced by the principal organizations of AGC, AIA and EJCDC) are developed through a process in which other industry groups and organizations participate or are given opportunities to provide comment and feedback on specific proposed terms and conditions, these documents fairly represent prevailing customs and practices and can be considered good sources of industry best practices. For that reason, even if the parties choose to draft their own contract forms, industry standard forms serve as invaluable references and benchmarks for the parties' forms drafting and negotiation efforts.

Industry standard forms are popular and find acceptance, in part, because they foster business expediency and are familiar to industry players. Familiarity with standard terms and conditions reduces drafting and review time. In a competitive business environment where "time-is-money," such as that of construction, reduced drafting and review time means lower overall transaction costs for each construction transaction. Familiarity with standard terms and conditions–and the consequences of those terms and conditions–also provides contractors and subcontractors with the necessary comfort to offer lower bids or negotiated prices.

A further reason supporting the use of industry standard forms is the simple fact that drafting a multi-part construction contract from scratch in a short span of time is an ambitious and daunting undertaking for the inexperienced. By contrast, industry standard forms are developed by construction law practitioners and construction industry experts typically over a period of several years after many rounds of receiving suggestions and feedback from construction industry constituents, such as owners, contractors, design professionals, specialty contractors, sureties and insurers.

Despite all their utility, construction industry standard form contracts should not be used without noting certain cautions.

- *Standard forms should not be used without modifications*. Since they are drafted for broad applicability, standard form contracts simply cannot account for all transaction-specific and jurisdiction-specific terms that the parties will need to insert into their agreement. For example, a particular state's laws may require that certain provisions, such as indemnities, be written in such a way as to be legally effective in that state.

- *When modifying a standard form, be wary of the "ripple effect."* Because standard form construction documents are complex documents

- *When modifying a standard form, be wary of the "ripple effect."* Because standard form construction documents are complex documents that often reference other parts of the contract, changes made in one may have repercussions in another. Pay particular attention when changing the definition of a word or term.
- *Do not become "contract complacent."* Read the contract, even if it is a standard form. New projects or circumstances may necessitate a "fresh look" at specific boilerplate language.
- *Custom-drafted and industry-drafted forms do not mix.* Industry-drafted forms usually are coordinated only with other industry-drafted forms from the same organization/publisher (e.g., AGC forms with other AGC forms). Unless the drafter of the custom form has attempted to coordinate the document with the industry-drafted form, chances are that they will not be compatible without great effort. Likewise, industry-drafted forms from different organizations/publishers usually are not compatible.
- *Every contract form, including those drafted by industry organizations, contains the bias of the drafter.* Bias is an inescapable element of any contract, whether drafted by the counsel for one of the contracting parties or by an industry organization. Turn that knowledge into advantage by knowing both the relative merits and features of and the circumstances under which to use the various standard forms published by different industry organizations.

Industry Contract Example: Matrix of Risk Allocation Choices in AGC Document No. 200, Standard Form of Agreement and General Conditions Between Owner and Contractor (Where the Contract Price is a Lump Sum), 2000 Edition

Contracting parties should note that the relative distribution of assumed risks will vary according to the compensation method chosen by the parties. For example, under a lump sum basis of compensation, where the contractor agrees to furnish all labor and materials and to perform all work necessary to complete the contract for a fixed-price, the contractor will assume more project risks than under a cost of the work plus a fee basis, where the contractor is reimbursed for the cost of the work plus receives a fixed fee or a percentage of the total cost as a fee. The matrix below relates to risks assumed under a lump sum basis of compensation.

Risk	AGC 200 Provision	Party Assuming Risk	
		Owner	Contractor

Furnishing labor & materials for Contractor's Work	3.1.1	1	1
Coordination & supervision of Contractor's Work; construction means & methods	3.1.2	1	1
Coordination of work of separate contractors/concurrent work	3.2.2	1	1
Reporting observed defects in work of separate contractors	3.2.4	1	1
Defects in work of separate contractors	3.2.4	1	
Comparison of drawings and specifications with Owner information and field measurements	3.3.1		1
Reporting known errors in drawings and specifications	3.3.2		1
Sufficiency of drawings and specifications	Implied warranty by operation of law		1
Acts & omissions/competence of Subcontractors	3.4.2		
Provision of skilled labor	3.4.3		1
Workmanship	3.5		1
Owner-furnished materials: delivery, quality	3.6		
Owner-furnished materials: installation	3.6		1
Tests & inspections: scheduling	3.7.1		1
Test & inspections: expenses	3.7.1		1
Warranty regarding Work	3.8		
Correction of Work within 1 year	3.9		
Safety precautions and programs	3.11		

Risk	**AGC 200 Provision**	**Party Assuming Risk**	
		Owner	**Contractor**

Hazardous materials discovered at site	3.13	1 1	1 1
Hazardous materials brought to the site	3.13.7	1	1 1
Accuracy & conformity of submittals & shop drawings	3.14	1 1 1	1 1 1
Review & approval of submittals & shop drawings	3.14	1 1	
Maintenance of record copies of shop drawings, drawings, change orders incorporating field changes	3.14.4	1 1 1	
Provision of professional design services for project	3.15	1	1 1
Concealed/unknown site conditions	3.16.2		1 1
Permits, licenses, taxes pertaining to Work	3.17		
Cutting, fitting & patching of the Work	3.18		
Clean-up	3.19v		
Confidentiality of information	3.21		
Evidence of project financing	4.2		
Furnishing accurate and timely worksite information such as surveys, legal description, environmental reports, etc.	4.1, 4.3		
Easements, approvals, building permit	4.4		
Damage/loss from separate contractors	4.10		
Time of performance	6.1		
Schedule of the Work: creating, updating	6.2.1		
Schedule of the Work: approval	6.2.1		
Delays: caused by Owner	6.3		
Delays: caused by Contractorv	6.4v		
Delays: beyond control of the parties–e.g., adverse weather, acts of God, government acts	6.3		

Risk	**AGC 200 Provision**	**Party Assuming Risk**	
		Owner	**Contractor**

Changes in the Work	8	1 1	1 1
Payment/payment delay	9, 9.5		1
Removal of liens	9.2.3.2	1 1	1
Indemnity: personal injury & property damage	10.1	1	1
Consequential damages	10.2	1 1	1
Procure insurance: workers compensation, commercial general liability	10.3	1 1	
Procure insurance: property, business income	10.4, 10.5		
Patent & copyright infringement	10.6		
Suspension of the Work: Owner's convenience	11.1.1		
Termination: Owner's convenience	11.4		
Termination: Contractor default	11.3.1		
Termination: Owner default	11.5		
Cost of dispute resolution	12.6		

Beyond the Contract: Strategies to Minimize or Manage Construction Risks

There are various processes that can help minimize and/or manage construction risks and promote successful projects. They include processes to facilitate communication among project participants and to establish a particular party's ability to conduct its business affairs and to perform contemplated contractual obligations.

- *Partnering*. The objective of partnering is to improve project civility and communications through a team-building process. It can be characterized in the following words: "While the contract establishes the legal relationship, the Partnering process attempts to establish working relationships among the parties (stakeholders) through a mutually-developed, formal strategy of commitment and communication. It attempts to create an environment where trust and teamwork prevent disputes, foster a cooperative bond to everyone's benefit, and facilitate the completion of a successful project."

- *Prequalification*. Prequalifying design professionals and contractors allows companies/corporate owners to reduce the chance of contracting with unqualified individuals or firms by assessing their capabilities and "track records" before contract award. AIA and AGC publish forms to assist owners in obtaining qualification statements from design professional and contractors.

- *Bonds*. Bonds are risk transfer instruments in which a third party, the surety, assumes the risk of the contractor's performance and the risk of the contractor's payment obligations to certain subcontractors and suppliers for a particular project in return for a premium payment. Owners (or their lenders) may require the transfer of these risks, which is accomplished by stipulating in the construction contract that the contractor furnish the owner with performance and payment bonds. The contractor then obtains bonds from a surety, who has assessed the contractor's capacity to perform and financial strength. The surety's issuance of the bonds serves as further assurance to the owner that the contractor is qualified for the project.

Conclusion

Taking an enlightened, proactive approach to construction risk allocation and contracting practices will produce short-term and long-term benefits for all construction project participants. Contracting parties should strive to align their respective interests closely by sharing construction risks when appropriate and by properly allocating and compensating for those risks that cannot be shared. Those who choose another path, however, may discover the truth of the following modern construction maxim:

> If you wish to transfer a construction risk, be prepared to compensate for that risk. If you are not willing to compensate for the transfer of that risk, be prepared to compensate a lawyer for that risk.

Now which is the better practice?

Appendix

A LOOK AT AGC DOCUMENT NO. 200

Background

In the early 1990s, the Associated General Contractors of America ("AGC") created the Private Industry Advisory Council ("PIAC") to act as a forum for the exchange of ideas, issues and concerns among contractors and owners. The PIAC membership was to be limited to no more than 50 of the larger private construction users throughout the country to meet for two days every six months with the Building Division of AGC.

The PIAC has turned out to be a very energetic and productive group. The owner members of the group are drawn from diverse economic sectors, such as banking, pharmaceuticals, power generation and distribution, automobile and aircraft manufacturing, retailing, computer chip manufacturing and entertainment. The diverse experiences of these owners have added a depth and breadth to the meetings that is unparalleled in the construction industry.

One paramount concern of the PIAC was to identify the events and/or industry practices that negatively impacted costs on a construction project and hindered cost effective and efficient buy out, production and close out of projects. During the course of that discussion the PIAC decided to develop a set of contract documents. To do that we decided to first create a set of fundamental principles that would govern the preparation of these documents. These principles guided the multi-year collaboration between owners and contractors to craft comprehensive, balanced standard form contract documents.

The PIAC has created a number of contract documents with more in the works. The first such document, published in 1997, was AGC Document No. 200 (AGC 200), an integrated lump sum agreement with related general conditions document. The next set of documents was the AGC 400 series, composed of 16 different design-build contract documents and published in 1999. One of the series, AGC Document No. 410, an owner-design-builder cost plus with optional guaranteed maximum price agreement, recently was praised by a national owners' group.

> "This document represents, at least to the owner, the best standard form design-build document in current use." *Associated Owners and Developers Design-Build Subcommittee* commenting on AGC Document No. 410.

The PIAC also has worked on an owner-architect/engineer agreement (AGC Document No. 240), an owner-contractor guaranteed maximum price contract (AGC Document No. 250) and an owner-contractor cost of the work plus a fee contract (AGC Document No. 230). All of these documents were published by AGC in July 2000.

The Underlying Premises of the AGC/PIAC Documents

The primary lynchpin for these unique documents is project cost. At every discussion of the terms and conditions to be incorporated into the documents the question that was always asked was: "What effect will this have on the cost of the Project?" If the consensus of the group was that the concept would drive up the price of the project, the concept was rejected.

In addition to the cost issue, other fundamental premises that formed the basis of these documents included:

- *Equitable risk allocation*. The test put to each part of the contract documents is whether the document is allocating risk to the party who should have that risk— that is, the party who can best control, manage and insure against the risk. As a result there are many provisions that give heart-burn to contractors and just as many that have that same result on owners. However, all-in-all, the risks these documents address are allocated in a way that is fair and reasonable and will yield the best price.

- *Moving the "rock."* Another of the primary principles is to focus on how our documents can improve the industry (move the "rock") to establish "best practices" to reduce project costs.

- *Clear communications pathways*. AGC 200 makes the owner "primary" in terms of project decision-making and communication. Whereas in the AIA documents the architect is the switchboard for all project communications, in AGC 200 that is not the case. There was considerable discussion on this and related points in terms of project "success." The consensus of the group was to focus on and to forge a more direct link between the owner and the contractor in an effort to minimize misunderstandings that may arise from filtering relations through others, such as the architect/engineer. The PIAC espoused the belief that the more the owner was involved in the project, or at least in the decision-making process, the more likely the probability of success was for that project. The consequence of that conclusion is that the architect/engineer becomes an important consultant to the owner during the construction administration portion of the project, but the architect/engineer does not stand in the place of the owner for project decisions.

To understand the project role of the architect/engineer in the new AGC 200 series documents, one needs to look at the three different aspects of the project for the architect/engineer: the design phase, the construction phase and the quasi-arbitrator role.

1. In the design phase, (addressed in AGC 240) the architect/engineer acts as an independent contractor to the owner. In the owner-architect/engineer agreement, the architect/engineer's responsibilities in the design phase are expanded in areas such as design coordination and pre-design evaluation to meet the owner's expectations for professional design services.

2. In construction administration, the architect/engineer acts as the owner's consultant, assisting and advising the owner in project decision-making, communication, and evaluation. However, as between the owner and the contractor, emphasis is placed on the owner, not the architect/engineer, as the party who must make the legally binding decisions for the direction of the project.

3. With respect to the third area/role of the architect/engineer— acting as an initial adjudicator of disputes— AGC 200 recognizes industry reality and best practices by removing this responsibility from the architect/engineer. Architect/engineers, who are not formally trained as facilitators and/or adjudicators, often represent another procedural layer that may slow down an expedient resolution to a dispute.

The Core Issues

Having established the cornerstones of AGC 200, we then looked at the core issues that adversely impacted buy-out, production and close-out of projects. These included:

1. **Indemnification**–including casualty provisions.

2. **Insurance**–including waiver of subrogation, casualty provisions and insurance certificate issues.

3. **Hazardous Material**–including hazardous material found at the site and brought to the site.

4. **Changes in the Work**–including equipment rental, claims process, "reasonably inferable"/precedence clauses.

5. **Site Conditions**–including existing and unforeseen conditions and site inspection.

6. **Safety**–including code compliance.

7. **Delay/Acceleration**–including project coordination/third parties.

8. **Final Acceptance/Final Payment**–including payment process, especially with regard to retainage and substantial completion, impact of pay-when-paid developments.

9. **Defective Work**–including: punch lists, latent defects, warranty provisions and process.

1. **Limits of Liability**–including contractor requirements to provide professional services.

Each issue is addressed thoroughly in AGC 200 and is reflective of many hours of discussion among owners, contractors and other industry professionals.

The core issues are overlaid by a "positive" and "communicative" owner-contractor relationship.

- At the outset of AGC 200 is a statement that the owner and contractor will proceed with the project on the basis of good faith and fair dealing.
- The contractor promises to use its "best efforts" to perform its work.
- Certain negotiation points, such as the amount of retainage, if any, and the increase in fee for change order work, are left blank so that the parties can specifically determine appropriate amounts in relation to the type and complexity of the project.
- The contractor promises to maintain the owner's confidential information.
- Resolution of a dispute is first attempted through direct discussions between the owner and the contractor, in an effort to preserve the parties' autonomy to find a common-sense solution, before resort to mediation and binding dispute resolution methods.
- AGC 200 also addresses many of the contractor's responsibilities, such as for safety, clean-up, delay, and damage to owner's existing adjacent property, more thoroughly than other existing standard forms.

By emphasizing the primacy of the owner-contractor relationship and by establishing a positive tone, AGC 200 seeks to improve the industry by moving the "rock," lowering the cost of projects and reducing the potential for claims and disputes.