CONSTRUCTION RISK MANAGEMENT REPORTER

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ContrACT

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Managing the Risk of Project Funding

Construction in New York is feeling the impact of the current financial crisis. On November 3, 2008, New York Governor David Patterson issued a directive aimed at implementing agency spending controls in the face of the State's deteriorating fiscal condition. The Governor's measures focus on spending that does not involve federal reimbursement of at least 75%. Among the measures implemented, all new contracts, contract extensions and contract modifications must receive the joint *prior approval* of the Division of the Budget and the Office of State Operations. Contractors faced with change order work on public capital projects must recognize that two additional layers of review and prior approval are required before changed work can go forward, each layer a new opportunity for change orders to be rejected. This may also lead to delays in the progress of the work and pressure to proceed without the requisite approvals in place. Do not succumb to that temptation. Proceeding with changed work without the required approvals leaves a contractor at risk for ultimately funding the change itself.

Overall, the financial crisis underscores the need of contractors to obtain complete and updated owner financial information. As discussed in the adjacent article,

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When Less is More: The Importance of Limited Indemnification

BY KEVIN F. PEARTREE

General contractors often try to exact as much as they can from their subcontractors, contractually-speaking. Contractual indemnification is but one area where many contractors demand the broadest protection. Better to overreach on the chance you may actually get what you ask for, the thinking may go. A typical broad-form indemnification provision requires a subcontractor to indemnify a contractor even for losses that are the result of the contractor's sole negligence, gross negligence or intentional acts. More commonly, contractors include in their subcontracts intermediate form indemnification provisions that require a subcontractor to indemnify a contractor regardless of whether a loss was caused "in whole or in part" by the negligence of the contractor. Despite statutes and case law rejecting these types of indemnification provisions, many contractors continue to include them in their subcontracts, relying on the qualifying language "to the fullest extent permitted by law" to salvage what is otherwise an unenforceable provision.

But a recent decision of the New York Court of Appeals demonstrates the risk in overreaching. In *Brooks v. Judlau Contracting, Inc.*, II N.Y.3d 204 (2008), the Court took up the question of whether New York General Obligations Law §5-322.1 precluded a general contractor from enforcing a contractual indemnification provision against its subcontractor when the general contractor was found to be partially at fault in causing injuries to an employee of the subcontractor. Section 5-322.1 of the New York General Obligations Law renders void and unenforceable agreements exempting contractors from liability for their own negligence. In an earlier decision, *Itri Brick & Concrete Corp. v. Aetna Casualty & Surety Company*, 89 N.Y.2d 786, 658 N.Y.S.2d 903 (1997), the Court of Appeals struck down as violating General Obligations Law §5-322.1 contractual indemnification provisions that contemplated a complete rather than partial shifting of liability from the general contractor to the subcontractor; that is, indemnification provisions that imposed liability on a subcontractor even for the general contractor's share of liability. The question left unanswered by *Itri Brick* was whether a negligent contractor could enforce a partial indemnification provision so long as the agreement did not purport to indemnify the contractor for its own negligence.

In *Judlau*, the Court of Appeals answered that question, concluding that a partially negligent contractor could "seek contractual indemnification from its subcontractor so long as the indemnification provision does not purport to indemnify the general contractor for its own negligence." Key to the Court's decision was the fact that the contractual indemnification provision at issue was neither broad nor intermediate form indemnification, seeking to indemnify the contractor for its own negligence. Had it been, the Court in *Judlau* would likely not have upheld the contractual indemnification. By pursuing indemnification that was limited to the extent losses were caused by the negligence of the subcontractor, or the negligence of those for whom the subcontractor is liable, the general contractor was able to secure partial indemnification from the subcontractor. The lesson for contractors in New York is -- do not overreach. In addition to being a fair allocation of risk, limited form indemnification provisions will pass the scrutiny of the courts. E&D

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ConsensusDOCS

A NEW CHOICE

When it comes to standard form contract documents, the industry has a new choice—ConsensusDOCS. Released in the fall of 2007, the ConsensusDOCS standard form contract documents are the product of a new association of industry groups that came together in a collaborative effort to create standard form agreements that, through consensus, balance interests and promote best practices among all parties to the construction project. In all, twenty-one different industry groups representing owners, contractors, subcontractors, sureties, and other construction industry groups, currently make up the ConsensusDOCS effort. *(See listing of participating industry groups to the right).* The very name seeks to promote consensus among Designers, Owners, Contractors and Subcontractors/Sureties. These industry consensus documents signal what could be a transformational moment for the industry.

The ConsensusDOCS drafting process was guided by certain core principles. Instead of simply fighting for what might be in the best interest of each group's own constituency, the drafters' efforts were guided by the question—what is in the best interest of the project as a whole. The answer to this question is not only a fair balancing of all parties' interests, but a continual attempt to define what are or should be industry best practices.

The ConsensusDOCS catalogue includes more than 70 contracts and standard forms. The contract forms include both long and short-form documents for a variety of project delivery methods (design-bid-build, design-build, construction management) and compensation approaches (lump sum, cost plus, guaranteed maximum price). The administrative forms include pay applications, change orders, submittal form and bond forms, for example.

The ConsensusDOCS are available for purchase at ConsensusDOCS.org. As the ConsensusDOCS grow in use and acceptance, the ranks of those endorsing the documents may swell to include more industry groups, particularly designer associations that were invited but declined to participate in the ConsensusDOCS process. Moving forward, ConsensusDOCS will continue to pursue a more proactive and collaborative path toward improving the industry as a whole through the expression of best practices and balanced contract documents. E&D

By Kevin F. Peartree, who has been a long-time participant in the AGC's contract documents programs and was involved in the ConsensusDOCS drafting process.

PARTICIPATING ORGANIZATIONS

National Association of State Facilities Administrators (NASFA)

The Construction Users Roundtable (CURT)

Construction Owners Association of America (COAA)

Associated General Contractors of America (AGC)

Associated Specialty Contractors, Inc. (ASC)

Construction Industry Round Table (CIRT)

American Subcontractors Association, Inc. (ASA)

Associated Builders and Contractors, Inc. (ABC)

Lean Construction Institute (LCI)

Finishing Contractors Association (FSA)

Mechanical Contractors Association of America (MCAA)

National Electrical Contractors Association (NECA)

National Insulation Association (NIA)

National Roofing Contractors Association (NRCA)

Painting and Decorating Contractors of America (PDCA)

Plumbing Heating Cooling Contractors Association (PHCC)

National Subcontractors Alliance (NSA)

Sheet Metal and Air Conditioning Contractors' National Association (SMACNA)

National Association of Surety Bond Producers (NASBP)

The Surety & Fidelity Association of America (SFAA)

Association of the Wall and Ceiling Industry (AWCI)

A Bridge to Nowhere

BY THEODORE M. BAUM

Relying only on the contract documents for job site conditions can prove costly. Compounding the error by failing to conduct a simple pre-bid visual inspection of readily-apparent conditions is even more costly. In a recent decision, a New York court decided that a contractor's failure to conduct an investigation of the thickness of the concrete deck of a bridge in connection with a demolition project erased a claim worth three-quarters of a million dollars.

In a September 2008 decision, the Appellate Division, Second Department, reversed a decision in favor of Rapid Demolition Company, Inc. the contractor on a New York State project to demolish an existing bridge. During the work, Rapid Demolition found that the concrete deck was substantially thicker than what was shown in the project plans and specifications, and asserted a claim for extra costs. The case went to trial before the New York Court of Claims, where the trial judge determined that the State must pay $772,000 in extra costs to Rapid Demolition.

The State appealed. The appellate court determined that the contract required the contractor to conduct its own investigation. According to the appellate court, Rapid Demolition admitted that it did not do such an investigation. As a result, the Appellate Division reversed the trial court's award of $772,000 and dismissed Rapid Demolition's entire claim.

> The appellate court said that for business dealings between the State of New York and private parties, the contract is the "ultimate guide" when a claim for extra work is presented. In this case, the contract contained "numerous clauses" which said that the State would not be responsible for extra work costs if the contractor did not perform a personal inspection of the site.

Rapid Demolition Company, Inc. v. State, 54 A.D.3d 921 (2nd Dep't 2008). In addition to Rapid Demolition's admitted failure to investigate, the appellate court observed that there was "testimony at the trial that even a visual inspection of the concrete overlay would have revealed its true thickness."

This sort of result is not limited to contracts with the State, nor is it at all surprising. Many if not most contracts contain language requiring contractors to independently verify job conditions or characteristics. What is surprising is the contractor's failure to do what should be standard operating procedure—inspect the site. Unless a contractor is denied a reasonable opportunity to investigate and verify project conditions, or the nature of such conditions is that they are not easily determined, a contractor bears the risk of the cost to perform work. If the contractor fails to see what there is to be seen, the risk may be his even if that work is dramatically different from what is described in the documents. There is no excuse for not looking before you leap. E&D

ConsensusDOCS vs. AIA A201

Just as the ConsensusDOCS were arriving on the scene, the American Institute of Architects (AIA) published the 16th edition of its A201 General Conditions of the Contract for Construction. For the first time in 50 years the Associated General Contractors of America (AGC) declined to endorse the document citing concerns with various changes made to the document that increased risk for contractors. What are some of these changes in the A201, how should they be addressed and how do the ConsensusDOCS address the same issue?

Review of Contract Documents and Field Conditions

Under paragraphs 3.2.2 – 3.2.4 of the 1997 edition of A201, a Contractor was only liable for damages resulting from errors, inconsistencies, omissions or differences in the Contract Documents and field conditions if the Contractor recognized such and "knowingly" failed to report them to the Architect. Under the 2007 edition, a Contractor assumes more liability for discovering errors, inconsistencies and omissions in the Contract Documents prepared by the Architect. The obligation to carefully study and compare the Contract Documents is unchanged. However, the prior version imposed upon the Contractor the obligation to report only those discrepancies it "discovered"—a very objective standard. The new documents require the Contractor to report those errors, inconsistencies or omissions not merely discovered, but also "made known" to it. At first blush, this may seem entirely appropriate. If an error, etc. is objectively made known to the Contractor, it should report such error to the Architect. But the words "made known" inject an element of subjectivity into the analysis that subtly shifts risk to the Contractor. Will an Owner or Architect argue that certain circumstances "made known" to the Contractor errors, inconsistencies or omissions in the Contract Documents?

In contrast, the ConsensusDOCS employ an objective standard, holding the Contractor liable only for damages resulting from defects, errors, etc. the Contractor actually discovered and knowingly failed to report to the Owner. (ConsensusDOCS 200, ¶ 3.3.2-3.3.3). This is essentially the same approach found in AIA A201 1997. A Contractor negotiating the terms of a contract using A201 General Conditions should argue for either the ConsensusDOCS or A201 1997 language.

Inspecting Work Performed by Others

A Contractor's Work frequently depends upon construction performed by separate contractors. Paragraph 6.2.2 now requires a Contractor to inspect such work and report "reasonably discoverable defects..." The 1997 edition of A201 used the more objective standard of "apparent discrepancies". This change places a higher standard on the Contractor when it comes to inspecting work performed by other contractors retained by the Owner. While it may be hard to argue against a standard based on reasonableness, it is important to recognize that the AIA does not subject the Architect to the same subjective standard. When it comes to evaluating work in progress, the Architect's obligation to the Owner is to "report *known* deviations..." and "defects...*observed*". (AIA B101 2007, ¶3.6.2.1).

ConsensusDOCS employs an objective standard, making a Contractor liable when it fails to report patent defects in the work of others. (ConsensusDOCS 200, ¶3.2.4). If a Contractor cannot negotiate a purely objective standard, then it must be extra vigilant in inspecting the work of other contractors.

Project Financing Information

The golden rule in construction is "He who has the gold, rules." This is what makes the issue of the Owner's project financing information so critical. Does the Owner have the financial means to pay the Contractor for its work? The 2007 A201 waters down the Contractor's right to obtain proof of adequate financing from the Owner once the work has commenced that it enjoyed under the 1997 A201. Now, under ¶2.2, a Contractor can only request Owner financial information after the work has started if: 1) the Owner "fails to make payments to Contractor" as required; 2) when there is a change in the Work which "materially changes the Contract Sum; or 3) when "the Contractor identifies in writing a reasonable concern regarding the Owner's ability to make payment when due." These limitations may seem entirely reasonable on the face of it, but the effect is to give an Owner an argument to oppose providing information when it may be most critical for a Contractor to obtain it. Has there been a "material" change? Has the Contractor identified a "reasonable concern"? The ConsensusDOCS do not impose such limitations but instead strike the balance in favor of full accountability and transparency. This is especially true in this period of turbulent credit markets.

There were a number of other changes made to the A201 that raised concerns for the AGC, some of which will be discussed in later editions of this newsletter. More fundamentally, the AGC was concerned about philosophical disagreements with the AIA over the architect's authoritative role on a project and linear processes mandated in the AIA documents. With the industry more and more pursuing collaborative technologies such as BIM and collaborative contract approaches, the AGC viewed the philosophical approach of the AIA, both in its documents and their drafting process, as contrary to the direction of the industry. Contractors should be especially cautious when presented with the new AIA documents as the basis for contract. E&D

CONTINUED "MANAGING THE RISK"

changes to the AIA A201 have watered down the right of a contractor to obtain owner financial information once the work has commenced. Requests for project financing information before work has commenced become all the more critical. But the impact of market turmoil on funding for public and private construction projects underscores the need for contractors to secure project financing information whenever a concern presents itself. E&D

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ERNSTROM & DRESTE NEWS

John Dreste, Kevin Peartree and Douglas Bass presented a seminar on January 9, 2009 on the topic of AIA Contracts for Lorman Education Services.

Ernstrom & Dreste, LLP, along with Leo & Weber, PC and Shields Mott Lund, LLP, will be hosting its annual cocktail reception at the ABA Midwinter meeting in New York City on January 22, 2009.

Kevin Peartree's article on ConsensusDOCS 300, the Standard Form of Agreement for Collaborative Project Delivery will appear in the Winter 2009 edition of The Construction Lawyer, published by the American Bar Association's Forum on the Construction Industry.