



## **Construction Contract Language; a Growing Impediment to Trust and Co-operation**

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### Abstract

Written documents that now serve as standard agreements in the construction industry have become unnecessarily complicated. As such, they very often fail to represent the actual intentions of the contracting parties. As these writings have evolved, they have become dominated by exculpatory and risk shifting clauses that not only fail to reflect the intent of the parties but often place one party at a greater risk than they had anticipated. These writings often reflect a set of conditions that the offeree will accept as a matter of business expediency. This acceptance of unfamiliar provisions creates an agreement that represents a disconnect in expectations between the two parties. This is in contrast with the meeting of the minds that was once required for actual contract formation. As these provisions have become more common they have been legitimized by what is referred to as custom and usage: the conduct has been done repeatedly in the course of business and so it becomes acceptable business practice. Consequently, aggressive contract language has become accepted as common practice placing one party in a position of legal disadvantage. This practice engenders an atmosphere of suspicion and distrust between the contracting parties and has been the source of disputes and litigation.

This paper will examine the industrial context where these writings are deployed and the individuals who enter into and are bound by the provisions of these agreements. We will then define what a contract is and then look to the contract language as it has evolved to establish the actual effect of that language. Finally, it will suggest how education in contract analysis and negotiated contract modification can cause contracting parties to have greater awareness of written provisions and in the process restore contractual balance to the contracting process.

*Keywords: construction, contracts, language*

### The Problem

The nature of the construction industry is practical, technical and relational with practitioners that are generally very good at their core expertise; putting a project together. Knowledge of the business process is learned along the way and often at great expense. Knowledge of the contract law that controls the process is however a foreign language to all but a very few. This is particularly true of small contractors. While small contractors have no difficulty entering into legally binding agreements, they may experience greater difficulty entering into an agreement that will effectuate the intended purpose. Many small contractors cannot afford to hire an attorney and consequently must rely on business experience to protect their interest believing that a contract will perform that function. Unfortunately, business experience alone is often insufficient to protect the contractor's interests (Steverson, 2003). Further, the need to bring work in to the company can cause a contractor to hope for the best before reading the fine print.

Even if your company is desperate for more work, though, it is vitally important to understand fully, before the work begins, the meaning and potential consequences of the contractual terms you are about to enter into. Regardless of whether or not your company is in a bargaining position to meaningfully negotiate those terms before signing on the dotted line, failing to appreciate what it is you are agreeing to can mean the difference between a lucrative project and a messy dispute with damaging financial and reputational fallout. (Tymann and Gearan, 2013)

The relational nature of the industry has created an environment where practitioners are likely to trust first and consider the ramifications later. It is indicative of these relationships of trust that contracting parties, general and subcontractor, often agree to what is to be done, what is to be paid, shake hands and perform the work set forth in their agreement. A significant volume of business is still conducted in this fashion. Construction contracts are entered into and performed without any written documentation every day.

As early as 1636, whether a contract had been formed or not was a question of whether there had been a "meeting of the minds" between the contracting parties which reflected the "will theory" of offer and acceptance (Farnsworth, 1967). The "handshake paradigm of contract formation" set forth above assumed that both parties knew of and were in agreement regarding the terms of the contract. This theory looked to whether there was a true meeting of the minds between offeror and offeree; in this case the general contractor and subcontractor. In the early part of the twentieth century this subjective theory gave way to the objective theory of contract formation.

As the meeting of the minds theory of assent lost influence to the objective theory of contract formation the law became less concerned with what the contracting parties believed to be within the agreement and more concerned with what the *plain language* of the writing stated.

Farnsworth (1982) illustrates the dichotomy between the subjective and objective theories of contract formation.

When a court determines whether a party has assented to an agreement, is it the party's actual or is apparent intention that matters? This question provoked one of the most significant doctrinal struggles in the development of contract law, that between the subjective and objective theories. The subjectivists looked to the actual or subjective intentions of the parties. Actual assent to the agreement on the part of both parties was necessary; without it there could be no contract. As it was often expressed, there had to be a 'meeting of the minds'. The objectivists, on the other hand, looked to the external or objective appearance of the parties' intentions as manifested by their actions. (p.113)

The proponents of the Objective Theory of Assent will posit that we must look to the plain language of the agreement to ascertain the intent of the contracting parties (Perillo, 2000)

Their stated goal for this preference for plain language is that this plain language will assure certainty and clarity of terms. It is then this *written language* that is at issue. The question that must be asked and answered is: *To whom is the language plain?* In too many instances the answer is that it is plain only to the attorney that drafted the writing. The other party frequently enters into the agreement unaware of the terms and conditions of the "agreement". As mentioned, this causes a disconnect; a disparity of expectations between contracting parties regarding allocation of rights and responsibilities under the agreement. It is this disparity of expectations that serves as the genesis of many construction disputes. As long as the project runs smoothly, as is often the case, all is well (some grouching over waiting for payment notwithstanding). However, when a serious dispute arises, the subcontractor awakes to discover that they have accepted terms that place them in a position of legal disadvantage.

Understanding what a contract is, is important to this discussion. A contract, whether oral or written, is private law that is created between parties for the purpose of administering a project undertaken by those contracting parties (Riordan, 2004). We can agree to almost anything as long as it is not illegal or in violation of public policy. This forms a very wide area of commercially legitimate business activity; not all of it good (or should one say not good for one party). If our being bound to the dictates of a contract is no longer gauged by our subjective intent, then we must examine the writing very carefully to ascertain whether the law of the contract is in line with what we bargained for. Case law is replete with examples of people who were taken in by sales talk and vague language only to find themselves in a legal straightjacket that they are compelled to pay for. *See Vokes v. Arthur Murray, Inc.*, 212 So.2d 906, 28 A.L.R.3d 1405 (Fla. Dist. Ct. App. 1968).

### **The contract as opposed to the writing**

What construction practitioners understand as a contract is not the same as a writing that is tendered to memorialize the understanding between the parties (Chenug, 1970). A contract is the enforceable promises made between contracting parties; as mentioned, it is a private law that governs the agreement. The writing is the document that provides evidence of the agreement. Since construction contracts are service agreements they usually do not require a writing (an exception being that the Statute of Frauds requires a writing if the contract *by its terms* would require more than a year to perform) (Lorenzen, 1923). Consequently, a verbal agreement is binding if the basic conditions for contract formation have been fulfilled. The problem that arises is that what the subcontractor believes she has agreed to is often a good deal different from what the writing imposes on her company. It is possible, and is in fact frequently the case, that the writing bears little resemblance to the contract. Once the document has been executed however (signed by both parties), the contract, under the objective theory, and the writing become one. Attorneys in the employ of the general contractor, the party that drafts the writing and tenders these agreements, over time have sought greater advantage for their clients by drafting specialized or custom written agreements. These writings typically include provisions that shift risk to the subcontractor or otherwise place the subcontractor in a position of legal disadvantage.

Amidst the rush to win the work and secure the contract, prudent companies of any size will first have an attorney look over the contract's terms and attempt to negotiate away language that is the most potentially damaging to them. Some of the terms most unfavorable to contractors and suppliers crop up time and again in construction contracts. They are "standard" terms usually drafted by the owner, owner's representative, or project designer and are written to provide the maximum benefit and protection to those parties (Tyman, 2013).

It is the written contract language found in these "custom contract agreements" that are at issue here.

### **Discussion**

AIA 401; a standard subcontract agreement published by the American Institute of Architects will form a basis of comparison; a benchmark of contract neutrality if you will. These agreements while being generally evenhanded and fair to both contracting parties, are lengthy and difficult for the non-attorney to read and understand. They are, and have been, the gold standard for construction agreements for over a century. In an ideal world general contractor/subcontractor agreements would begin with this document as a starting point with ancillary items to be points of negotiation. However, in over thirty years of reviewing construction contract documents the author has seen little use of this AIA 401. Rather, the

reality of the industry is that many general contractors prefer to use “custom contract forms” created by their own counsel or design professional.

Frequently, the parties do not consult with a construction attorney when drafting contracts. This might be acceptable when the parties use standard forms, such as the American Institute of Architects documents, but the situation can rapidly disintegrate when the parties use home-brewed documents or heavily edit the standard documents. Architects are among the worst offenders, often choosing to use “letter agreements” that they have cobbled together from various sources. They don’t like the length and legalese of the AIA documents and fear that an owner will not take kindly to the use of such documents. They prefer a more “friendly” document. Architects believe that they can use plain English in a simple agreement to form a bond with an owner. Unfortunately, this is usually a flawed view. In the event of a problem, such a document is often used against the architect and the result is exactly the opposite of what the architect intended. The “plain and simple” document drafted by the architect is not clear. Clarity is required and is often not present because the architect is not trained to draft contracts”. (Sabo, 2014)

What follows is a brief, and by no means exhaustive, catalog of some of the more common legal devices at issue here. This list was taken from a contract for a tenant improvement at a shopping center in St. Charles, IL in 1992. The identities of the parties to this dispute must remain confidential in part because of the attorney/client relationship and in part because the law requires confidentiality when a settlement has been reached (which it was here subsequent to a lien filing).

The first and most innocuous of the contract provisions under review here is the “Time is of the essence” clause.

“The Subcontractor understands that the materials described herein are for the structure mentioned as about to be erected, or in the process of construction or reconstruction, *and that the time is of the essence of this contract in respect to delivery, installation, erection and otherwise.*” (italic authors)

Time is of the essence is a concept borrowed from and largely applicable to the sale of goods that has been transferred to other areas of contract law. The corollary of a time is of the essence clause is the imposition of liquidated damages which is a sum of money, generally agreed to at the outset, designed to make the aggrieved party whole for the alleged harm caused by a delay. There needs to be a showing of economic loss that the plaintiff has suffered as a consequence for the defendant having failed to deliver by a specified date.

From Farnsworth (1982):

Courts also base their determination of the required length of time on the nature of the contract. In doing so, they have distinguished contracts for the sale of goods from

contracts for the sale of land or for services. Time will be important to the seller of goods if he has contracted to obtain the good from a third person or must make arrangements with forwarding agents or carriers to help ship them; time will be important to the buyer of goods if he must make arrangements through banking channels to pay for the goods or has contracted to resell them to a third person... Therefore, courts have often held that “time is of the essence” under a contract for the sale of goods, while they have not routinely required prompt performance of other types of contracts. (p. 617)

The imposition of time is of the essence in a construction agreement is particularly onerous in light of the reality that construction, unlike the sale of goods, is dependent upon variables that are often beyond the control of the subcontractor and can in fact be caused the general contractor himself.

It is important to mention here that the time is of the essence clause is not without legitimate precedent with respect to construction contracts. Whenever there is a clear, legitimate need that a project be performed by a certain date this type of clause is appropriate; public school projects are a good example. When these projects are entered into however, all parties are aware of, and funds have been allocated for, the accelerated schedule. A careful reading of AIA 401 Sec. 9.3 and 9.4 demonstrate this point. While AIA 401 contains time is of the essence language, that language is mitigated by text that qualifies its application:

#### § 9.3

The Work of this Subcontract shall be substantially completed not later than (Insert the calendar date or number of calendar days after the Subcontractor’s date of commencement. Also insert any requirements for earlier substantial completion of certain portions of the Subcontractor’s Work, if not stated elsewhere in the Subcontract Documents.), subject to adjustments of this Subcontract Time as provided in the Subcontract Documents. (Insert provisions, if any, for liquidated damages relating to failure to complete on time.)

#### § 9.4

With respect to the obligations of both the Contractor and the Subcontractor, time is of the essence of this subcontractor.

The AIA document is unambiguous: it calls for specific dates of commencement and completion. It also allows for adjustments to the time to complete as may be required by the exigencies inherent in the construction process. Finally, it establishes a place to set forth the provision for liquidated damages; if none are set forth, none are to be considered in the agreement.



The “custom agreement” conversely, contains the provision to be enforced against the subcontractor without specific dates to be complied with and without the mention of liquidated damages. This omission leaves the door open to action against the subcontractor not envisioned by the AIA.

Another example of misuse of an AIA provision is the Indemnification/Subrogation clause. The following clause is from the aforementioned custom agreement.

“...and at all times to fully indemnify the Owner, Contractor, and Architect, against any liability, claims, suits, or actions arising out of his work, including any costs, attorney’s fees and incidental damages resulting there from.”

Once again, the attorney who drafted the agreement utilizes a contract provision from the AIA thereby cloaking it in the garments of known authority and omitted text that limits its application.

#### § 4.6 INDEMNIFICATION

##### § 4.6.1

To the fullest extent permitted by law, the Subcontractor shall indemnify and hold harmless the Owner, Contractor, Architect, Architect’s consultants, and agents and employees of any of them from and against claims, damages, losses and expenses, including but not limited to attorney’s fees, arising out of or resulting from performance of the Subcontractor’s Work under this Subcontract, provided that any such claim, damage, loss or expense is attributable to bodily injury, sickness, disease or death, or to injury to or destruction of tangible property (other than the Work itself), but only to the extent caused by the negligent acts or omissions of the Subcontractor, the Subcontractor’s Sub-subcontractors, anyone directly or indirectly employed by them or anyone for whose acts they may be liable, regardless of whether or not such claim, damage, loss or expense is caused in part by a party indemnified hereunder. Such obligation shall not be construed to negate, abridge, or otherwise reduce other rights or obligations of indemnity which would otherwise exist as to a party or person described in this Section

##### 4.6.

##### § 4.6.2

In claims against any person or entity indemnified under this Section 4.6 by an employee of the Subcontractor, the Subcontractor’s Sub-subcontractors, anyone directly or indirectly employed by them or anyone for whose acts they may be liable, the indemnification obligation under Section 4.6.1 shall not be limited by a limitation on the amount or type of damages, compensation or benefits payable by or for the Subcontractor

or the Subcontractor's Sub-subcontractors under workers' compensation acts, disability benefit acts or other employee benefit acts.

A careful reading of the AIA text limits the application of the Indemnification/Subrogation language to specific, commercially reasonable circumstances. The language found in the "custom agreement" conversely leaves the door open to wider application. Specifically, a prominent construction law firm recently sought to compel an electrical contractor to drop her demand for wages due and owing under a Davis-Bacon prevailing wage dispute on the basis that the subrogation/indemnification language in the agreement implied that she will not only be compelled to pay for her opponent's attorney but will also be bound to pay the judgment that the court may impose on the defendant.

The final contract provision under examination is the pay-when-paid/pay-if- paid language now finding its way into construction agreements. In this contractual stipulation the subcontractor agrees that she will wait to be paid until the contractor is paid. It is perhaps the most egregious of the risk shifting language and subjects the subcontractor to levels of uncertainty wholly inconsistent with the role they play in the construction process. Through its application, the subcontractor becomes a guarantor of the credit of someone she has never dealt with before and has no actual knowledge of. These provisions are becoming increasingly common and their legitimacy has been challenged in litigated disputes. Courts are divided on whether these provisions can be enforced.

A typical example is as follows:

"All payments to Subcontractor (progress, final and retention) shall be paid only after receipt of said payment by Contractor."

This clause represents the pay- if- paid clause and is the more predatory of the two. These clauses are onerous enough that they are considered a violation of public policy in a number of jurisdictions. Specifically, both of these clauses have been found to be a violation of public policy in New York. The vague verbiage causes the difference between this and a pay-when-paid clause to be difficult to distinguish. The differences however are critical. Case law on point has ruled that pay when paid anticipates that there will eventually be payment; it merely creates a longer time frame for the general contractor to pay. Pay-if-paid conversely, bars recovery on the part of the subcontractor if the general contractor can demonstrate that he has not been paid. Some courts in New Jersey have held that pay if paid creates a condition precedent that conditions the subcontractor be paid: The subcontractor has no legal claim for payment unless the general contractor has been paid. Pay-when-paid however has been found to create a period of time wherein the general contractor has more time to be paid.

Fiorita (2012) provides a snapshot of how these clauses are viewed by the courts:

Generally, New York courts rule that pay-as-paid or pay-if-paid clauses are unenforceable as a violation of state public policy (i.e., waivers of mechanics' lien rights), *see West-Fair Elec. Contractors v. Aetna Cas. & Sur. Co.*, 87 N.Y.2d 148, 638 N.Y.S.2d 394 (1995); whereas New Jersey courts are split as to whether such clauses are valid relying on freedom of contract principles without state intervention. *See Fixture Specialist, Inc.*, 2009 WL 904031.

A pay-if-paid provision typically seeks to make payment to a lower tier subcontractor or supplier conditioned on the general contractor receiving payment from a higher tier party, namely the project owner. The variations of such phraseology are numerous, i.e., "conditioned upon," "only if," and "to the extent" paid by another. In reality, a pay-if-paid provision limits the general contractor's liability and shifts the risk of the project owner's non-payment to the subcontractor. Any way you phrase it, the outcome is the same – a condition precedent to receiving payment.

On the other hand, a pay-when-paid clause requires payment to the subcontractor when the general contractor gets paid. A contractor's obligation to pay under the pay-when-paid provision is triggered upon receipt of payment from the project owner. Courts have interpreted pay-when-paid clauses to mean that the contractor's obligation to make payment is suspended for a reasonable amount of time for the contractor to receive payment from the project owner. This type of provision essentially creates a timing mechanism, not a condition precedent, to the obligation to make payment, and does not expressly shift the risk of the project owner's non-payment to the subcontractor. *See Fixture Specialist, Inc. v. Global Construction, LLC*, 2009 WL 904031 (D.N.J. 2009).

Courts in the state of Indiana have upheld both of these provisions as a matter of freedom of contract. The Seventh Circuit Court of Appeals however went a step farther and ruled that if both clauses are present, the more draconian controls; the subcontractor has no claim for payment if the general has not been paid.

A recent decision from the Seventh Circuit Court of Appeals has recognized and upheld a pay-if-paid clause under Indiana law. The court held that, pursuant to the clause, a subcontractor was not entitled to payment when the upstream contractor had not been paid. The court also held that even if language construed as a pay-when-paid clause also exists in the contract, the condition precedent identified by the pay-if-paid clause controls. The actual language considered by the court was: "It is expressly agreed that Owner's acceptance of Subcontractor's Work and payment to the Contractor for the Subcontractor's work are conditions precedent to the Subcontractor's right to payments by the Contractor."

The grandeur of this risk mitigation tactic is breathtaking when considered: as a contracting entity, I am responsible for knowing who I am dealing with. In practical terms I have no way of

knowing the credit worthiness or the good faith of the owner with whom the general contractor is dealing. Further, the risk of fraud and collusion should this clause be enforced is immense. How am I to know whether the payment has not been made later, surreptitiously or in some other manner?

It is worth mentioning at this juncture that the author, when handed a writing that contained the offensive language outlined above, took the time to interline (redact) the predatory language and return the amended writing to the general contractor; this we consider a necessary first step in the negotiation process. The contractor's response was to complain, "Everybody signs our agreement." But he allowed the project to move forward. This is significant in that it is commercially understood that the last boilerplate prior to commencement of the project controls. The amended writing that was returned to the general contractor constituted a counter offer in that it was not a "mirror image" of the offer. That offer was accepted by him (whether he knew it or not) through his silent acquiescence when the contractor began performance. This is a concept borrowed from the Uniform Commercial Code known as the battle of the forms.

Farnsworth (1982) states:

"In disputes over some aspect of performance, traditional contract doctrine favors the party who fires the "last shot" in the battle of the forms. Performance by both parties makes it clear that there is a contract, and since each subsequent form is a counteroffer, rejecting any prior offer of the other party, the resulting contract must be on the terms of the party who sends the last counteroffer, which is then accepted by the other party's performance." (p. 159)

Consequently, the agreement was ratified by him on our client's terms when he accepted by silence the amended writing. It is possible that he was not aware that he had been given what was in effect a counter offer but his silence nonetheless constituted acceptance on the author's terms.

Terms and conditions that remove rights and impose novel responsibilities on the subcontractor should cause the subcontractor to redact the onerous language or reconsider the deal altogether; this will at least form the basis of a negotiation. As a rule however they do not. Contractors wade into these legally difficult waters because of ignorance, need or blind trust. All of which are the antithesis of a healthy bargained for exchange. Since most construction operations would rather take an agreement and stay busy than decline the agreement and wait for a better deal, they look past the onerous verbiage and hope for the best. Consequently, because there are contractors who are willing to enter into agreements on terms that place them in a position of vulnerability, these writings have become accepted in common practice and become legitimized by the legal understanding of "custom and usage"; that is, contracting parties have been operating under this form agreement and so it gains legal acceptance. It is this continuation of a bad practice that perpetuates the problem; we have been doing business in this manner and so it

becomes accepted behavior. Custom and Usage is a contract theory borrowed from the Uniform Commercial Code.

Again from Farnsworth (1982), here quoting from UCC 1-205(2):

The Code describes a usage of trade as a “practice or method of dealing having such regularity of observance in a place, vocation or trade as to justify an expectation that it will be observed with respect to the transaction in question.” ....The term *usage of trade* (italics by others), is relatively new and favored by the Code over the more traditional and narrower term *custom*. However, the underlying principle, which is that the agreement is read in the light of a common practice or method of dealing is an old one. Consequently, what has arisen is the legitimization of a system wherein adverse (potentially ruinous) conditions are visited upon the less legally sophisticated party by the one more able to pay an attorney. It is important to note however, that these more blatant examples of problematic contract language are not to be found in either the standard AIA General Contract agreement or the emerging Consensus Document format: they are to be found in “custom contract” form agreements. That is, for projects where both parties are evenly matched in terms of sophistication, the general contractor will use an AIA form agreement that is less likely to cause question by the other party. (p. 508)

### **Education**

The law of contract will allow us to enter into any agreement, commercial practicality notwithstanding, no matter how slanted it may be. This has had the effect of placing those without legal education or the funds/inclination to hire an attorney, at a disadvantage. The threshold answer therefore in addressing the subject of risk shifting and exculpatory clauses in construction writings is education. The evolving practice of injecting predatory contract language into construction writings has occurred largely because a lack of legal knowledge among trade businessmen. This in turn has caused an unwillingness to take the bargaining process beyond the realm of what price for what project. Most non-lawyers cannot fathom negotiating things legal. For most, it is a frightening prospect; the realm of the attorney. Whether it is a good or bad thing, we all must be lawyers to a certain extent in order to protect our interests. This extends well beyond the industrial environment under discussion here. As we train our students in the basic understandings of commercial law, we ask them if they have ever parked their automobile in a lot which had the following disclaimer: “Not responsible for goods lost or stolen from your car while it is in this lot”. Most of course have. Almost all are surprised that it is a lie; the owner of the parking lot is in fact liable (“a bailment for the benefit of the business owner has been created and liability for the bailed item is the consequence”, National Paralegal College/National Juris University)

The owner of the parking facility is merely propagating a lie that insulates the knowledgeable from legal liability to the detriment of the uninformed. With a simple sign bearing an untruth, the lot owner saves thousands of dollars. As a Contracts professor quipped: “There is no law against lying”. Similarly, when we redact onerous provisions from writings that we have received, most contractors are willing to discuss the provisions in question. As we tell our students; whether the contractor is willing to negotiate on the harsh provisions will tell us much about their intentions. At bottom we will now have the opportunity to put it all on the table and negotiate each point.

Consequently, it is our belief that the study of Construction/Engineering Law is a necessary component of the education process. Students in our Project Management class are, over a semester period of time, trained on contract analysis, redaction of onerous provisions and the negotiations that will follow. What is often the case is that good faith and fair dealing cannot be instituted by edict; only by conscientious contract analysis and a willingness to challenge questionable contract provisions will the industry develop in an egalitarian direction.

### **Conclusion**

The law of contracts as applied to the commercial transactions of commerce in a free market system exists to protect the legitimate expectations of the contracting parties. Protecting these expectations is the cornerstone of commercial vitality; we understand what we are paying for and what we are receiving. Consequently, we deal freely, confident in the parameters of the agreement we are entering into. Traditional contract law theory defines a contract as a “meeting of the minds” regarding the thing being agreed upon; this theory depends upon the intention of each party to be bound by the terms of the contract. The issue arises that in many instances, the written instrument contains language that was not a part of the mutual expectation of both parties. The litigious world in which we live requires that we have a working knowledge of the law so that we can avail ourselves of the benefits of that system.

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