

# Bids, Warranties and Killer Contract Clauses



By: Lawrence B. Linville

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# **I. BIDDING MISTAKES AND BID WITHDRAWAL**

## **A. INTRODUCTION**

On public works projects, the construction bidding process can be chaotic, and full of pressure and drama. Many subcontractor and supplier bids arrive at the general contractor's office moments before the general contractor must submit its own bid to the owner. There is less drama and trauma in the bidding process on private works projects.

Whether a project is public (e.g., schools, fire stations, etc.) or private (e.g., commercial buildings, residences, etc.) in nature, a subcontractor (more often) and/or supplier (less often) submits a bid or quote to the general contractor that the general contractor reviews and may rely upon in assembling and submitting its own bid to the owner. The subcontractor's bid may be the winning bid by mistake. An error may have been made in reading the drawings or specifications. You may have overlooked your upcoming schedule of work or underestimated escalating prices or availability of materials or labor. You may have made an error in your assumptions or calculations. You may have guessed on an important component of your bid. Under what circumstances is a subcontractor or supplier held to its bid? When is a subcontractor or supplier let off the hook?

## **B. OVERVIEW OF THE LAW**

Submission of the bid constitutes an offer to enter into a contract. However, submitting a bid does not, in itself, form a contract. That is because the general contractor is not offering any promise in return. The absence of this "promise in return" is legally known as the absence of consideration. It bars the formation of a binding contract between the bidder and the general contractor when there is nothing more than the subcontractor's submission of a bid. Something in return, some "consideration" for the bid by the general contractor is required. That is why bids may always be withdrawn before the person who received the bid has taken any action in reliance upon the bid or has otherwise "accepted" the bid (offer).

Courts have developed the doctrine of promissory estoppel to protect general contractors. Section 90 of the Restatement (2<sup>nd</sup>) of Contracts defines promissory estoppel as follows:

**A promise which the promisor would reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise. A remedy granted for breach may be limited as justice requires.**

Promissory estoppel is an equitable claim that arises under circumstances where it would be unfair to let the subcontractor walk away from its bid. In the construction bidding context, promissory estoppel fills the gap between the time when a general contractor has used the subcontractor's or supplier's bid in calculating and submitting its own bid to an owner and the time when the general contractor signs a subcontract with one of the bidders. The general contractor's reasonable reliance upon the subcontractor's or

supplier's bid legally justifies binding the subcontractor or supplier to its bid throughout this period.

The effect of the doctrine of promissory estoppel is to make the subcontractor's or supplier's bid firm and incapable of being withdrawn once the general contractor has used that bid in putting together its own bid to the owner. If the subcontractor or supplier refuses to perform the work it bid, the general contractor is entitled to damages equal to the amount paid to the replacement subcontractor or supplier less the amount bid by the withdrawing subcontractor or supplier. As a whole, the doctrine has the practical effect of encouraging subcontractors and suppliers to be accurate when formulating and submitting their bids.

### C. APPLICATION OF LAW

In *Arango Construction Co. v. Success Roofing, Inc.*, 46 Wash.App. 314 (1986), Success Roofing, Inc. ("Success") submitted a telephone bid to Arango Construction Co. ("Arango") to install a built-up roof on several additions to the tactical equipment shops at Fort Lewis, Washington. The bid included work in only two sections of the project (7A and 7B) and amounted to \$34,659.00. Arango included the Success bid in its prime bid to the United States Army Corps of Engineers for the Fort Lewis project. Arango asked Success to confirm their bid as accurate and current. Success confirmed the bid made for sections 7A and 7B at \$34,659.00.

Arango had received another bid for sections 7A and 7B of \$38,500.00 from Tin Benders, but that bid was expressly contingent on the award to that subcontractor of sections 7C, 7E, and 7F as well. Arango chose to use the Success bid for 7A and 7B with a bid for work on 7C, 7E, and 7F from Cleo Roofing because these combined subcontracting bids made Arango's bid the lowest price for the roofing work.

On January 12, 1984, the Corps of Engineers awarded the Fort Lewis contract to Arango. Arango notified Success by sending its standard subcontract form for signature. Upon receipt of Arango's proposed subcontract, Success requested and received a set of prints and specifications for the project. In reviewing the plans and the bid, Success discovered an error in its bid. The bid for Success was 50 percent less than it should have been because Success had failed to note the drawings and specifications they used to compute the bid were reduced 50 percent. Success telephoned Arango and informed Arango of the error, and stated that they would not perform at the original bid price. Success also wrote Arango, withdrawing its original bid and explaining its error. Because Success refused to perform, Arango awarded the contract for sections 7A and 7B to Cleo Roofing (the contractor that was already committed to do the work on sections 7C, 7E, and 7F). The price at which Cleo agreed to perform the work on the two sections was \$54,733.00. Arango filed a lawsuit for breach of contract against Success based on the doctrine of promissory estoppel.

Success argued that there was no meeting of the minds on the terms of the contract, so there was no contract. Success also argued that the terms of the standard form contract it

received from Arango had not been discussed and were not agreed upon. Success' examples of terms in dispute were of sections that required submission of disputes to arbitration, included an attorney's fees clause, and waived contractor responsibility for the conduct of its officers or agents prior to execution of the contract. The Washington court found that the evidence indicated that the oral bid was given; Success and Arango believed it to be correct; Arango used that bid in its prime bid; Arango then accepted Success' bid when Arango was granted the contract, and Arango promptly sent Success a standard form contract that included Success' bid amount. Upon receipt of the contract form, Success determined that the bid amount was 50 percent less than it should have been. Success then withdrew its original bid and did not make an offer or contest the contract terms at the time. Success' argument that contract terms were in dispute was found by the court to be without merit.

The Washington State Court of Appeals held in favor of the general contractor (Arango) and against the subcontractor (Success) as follows:

**Arangos' motion for summary judgment is based on the *Ferrer/Drennan* rationale that once a general contractor has incorporated a subcontractor's bid, he has justifiably relied and changed position. Thus, if the subcontractor refuses to perform following the award of the contract, the general contractor may recover damages under the doctrine of promissory estoppel. *Ferrer*, at 835, 587 P.2d 177.**

The *Ferrer* court listed the five elements of promissory estoppel:

The prerequisites for an action based on promissory estoppel, a doctrine well recognized in this jurisdiction, have been stated as follows:

**(1) A promise which (2) the promisor should reasonably expect to cause the promisee to change his position and (3) which does cause the promisee to change his position (4) justifiably relying upon the promise, in such a manner that (5) injustice can be avoided only by enforcement of the promise. *Corbit v. J.I. Case Co.*, 70 Wash.2d 522, 539-540, 424 P.2d 290 (1967).**

Elements (1) through (3) were met in this case. Success's bid was a promise. Success could reasonably expect to cause that promise to cause Arango to change the position by including the Success bid in Arango's prime bid. Success confirmed its bid 2 days after it was given, and Arango informed Success that it would be including that bid in its prime bid to be submitted 13 days later. Arango did include Success' bid in its prime bid, thereby changing its position.

The only element of promissory estoppel in dispute was whether Arango justifiably relied on Success' bid. Success contended that as a prudent and experienced general contractor, Arango should have known that Success' bid was too low for the job involved. To avoid Arango's summary judgment, Success had to present evidence supporting this assertion. Success, however, submitted no evidence that Arango should have known. The only other bid found in the record was from Tin Benders. Its bid was for \$38,500.00 for sections 7A and 7B as compared to the \$34,659.00 bid by Success.

There was nothing in the record to support an inference that Arango knew or should have known that Success had made a mistake.

#### **D. SUBCONTRACTOR IS UNPROTECTED**

Since the subcontractor is legally bound to its bid submitted to the general contractor, you might expect that it would also work the other way. You might expect that if the general contractor uses the subcontractor's bid in putting together its own bid to the owner and then is awarded the contract by the owner, the general contractor would be legally bound to subcontract with the subcontractor whose bid was used. But that is not always the case.

The law in Washington, for example, follows a case called *McCandlish Electric, Inc. v. Will Construction Company, Inc.* 107 Wash.App.85 (2001). Here, McCandlish Electric, Inc. submitted a bid to Will Construction, Inc. which was used by Will Construction, Inc. in submitting its own bid to the City of Leavenworth on a public works project. Will Construction, Inc. was the low competitive bidder and was awarded the contract. Will Construction, Inc. listed McCandlish Electric, Inc. as its designated electrical subcontractor on its public works bid, as it was required to do by RCW 39.30.060 which states in pertinent part as follows:

**Every invitation...shall require each bidder to submit as part of the bid, or within one hour after the published bid submittal time, the names of the subcontractors...with whom the bidder, if awarded the contract, will subcontract for performance of the work designated on the list...**

After the award, Will used another electrical subcontractor who undercut McCandlish's bid. McCandlish sued and lost. The Court said:

Reviewing the legislative history, it is clear that RCW 39.30.060 was not enacted for the financial benefit of potential subcontractors on a public works project, but rather to standardize and regulate the competitive bidding process in public works contracts. Moreover, nothing in the wording of the statute supports the creation of a remedy for disappointed subcontractors, nor would doing so be consistent with the purpose of the statute. Weighing the Bennett factors, there is but one conclusion – the statutory scheme does not support implying a private cause of action under this statute.

#### **E. YOUR GOLDEN PARACHUTE**

When you submit a bid, think about adding the following terms to your bid:

1. State that your bid is for informational purposes only, and is not to be relied upon by the general contractor until receipt of your subsequent and written confirmation.

2. State that your bid is an estimate only, and is subject to revision. If the general contractor would like to further consider your bid, the general contractor should contact you for further discussion.
3. State that your bid is only good for a certain period of time (state the time period) and may be unilaterally withdrawn thereafter.
4. State that your bid is subject to you and the general contractor's subsequent agreement upon the terms of a written subcontract.
5. State that your subcontract is subject to certain assumptions and then identify those assumptions.
6. State that your subcontract is subject to certain exclusions and inclusions and then identify those exclusions and inclusions.
7. State that your bid is subject to your availability to schedule the work within the constraints of your company's overall production schedule.

## **F. IT'S ALL ABOUT THE MONEY**

The general contractor is only concerned with its margin. The more a general contractor can shop or chop away at the subcontractor's or supplier's bids, the greater will be the opportunity afforded to the general contractor to submit a more competitive bid, or increase its margin of profit on the job. So, do not be worried that your caveats and reservations in your bid will discourage a general contractor from contacting you in its ongoing practice to shop and chop bids submitted by subcontractors and suppliers. You will no doubt receive a call from the general contractor, who now has your bid (although tentative) on its desk, and will have plenty of time to "do the dance." The general contractor may use another subcontractor or supplier bid in calculating its own bid to the owner, but you will be later contacted in the chop and shop dance. In *Field of Dreams*, it was "If you build it, they will come." The same applies in the building game, "If you bid it, they will call."

Make your bid the first round, the general contractor's inquiring call the second round, and negotiation the third and final round.

## **II. REVIEWING A GENERAL CONTRACTOR'S SUBCONTRACT**

### **A. INTRODUCTION**

It is not the industry practice for a subcontractor to hand its own subcontract to the commercial general contractor and tell the general contractor to sign it or else you won't do the work. However, you do have certain leverage on large commercial and public works projects. On these projects, the general contractor has used your number in bidding the job to the owner, and he needs to keep you in his stable. So, you have some leverage and, while the practice may be that general contractors shop your bid and may secure another subcontractor to perform the work, they may end up doing it at more expense. Plus, the general contractor obviously likes you, the subcontractor, otherwise he

would not have used your bid or indicated that he was going to use you as the subcontractor unless he felt that you could do the right work. The general contractor thought you could do the work, and even perhaps checked out your references. So now, the general contractor would have to revise his plans, find another subcontractor, and possibly pay more money.

Accordingly, every subcontractor should be prepared to sign the general contractor's subcontract "as is", send it back to the general contractor with a letter explaining which terms of the general contractor's subcontract you are not accepting and, instead, what terms you are adding to the subcontract as per the terms of your letter.

## **B. SIGNING THE GENERAL CONTRACTOR'S SUBCONTRACT WITH YOUR MODIFICATIONS**

You really have to make a business decision. It is not so much a legal matter.

- You know you are the low bidder
- Can you afford not to do this job?
- How has this general contractor treated you and others in the past?
- How big is the job? What are the dollars involved?
- Are you going to be in and out of this job in short order?
- What could go wrong on this job?
- How much fluff is there in your bid?
- Do you have other work in the pipeline?

You should take the subcontract which has been proposed by the general contractor, sign it "as is", and return it to the general contractor together with your cover letter explaining and delineating what provisions of the general contractor's subcontract you are modifying by the terms of your letter. You need to carefully read the general contractor's subcontract, and determine those clauses to which you have an objection, and then state in your letter that you are not agreeing to those clauses and/or you are modifying them as you state in the letter. A sample letter is Appendix 10.

Pay particular attention to the notice requirements stated in the general contractor's proposed subcontract. If there are no such notice provisions stated, then check to see whether or not the proposed subcontract binds you, the subcontractor, to the terms of the main contract between the general contractor and the owner. These notice provisions can oftentimes be strict or arbitrary, and have recently been affirmed and enforced by the Washington courts. In *Mike M. Johnson, Inc. v. Spokane County*, 150 Wn.2d 375 (2003), a divided Washington State Supreme Court addressed the consequence of failing to comply with the highly technical notice and claim requirements of the Washington Department of Transportation's Standard Specifications. In a 5-4 decision, the majority determined that the contractor failed to comply with the detailed notice and claim requirements in Section 1-04.5 of the WDOT Standard Specifications, and as a result, the contractor forfeited its claim for additional compensation.

The claims arose from a change order issued by Spokane County at the beginning of two successive road and sewer construction projects in the Spokane Valley. The change order involved widening one of the streets on the first project and adding curbs and gutters. The utility and grading work for the affected street had already been performed, so the change order required the contractor to go back to the street and perform the additional work. The changed work required deeper cuts at the edges of the roadway. As soon as the contract began performing the extra work, it encountered buried telephone lines. The projects were essentially shut down for a month and a half while the County determined how to resolve the utility conflicts.

During the delay period, the contractor sent a dozen written notices to the County that its work was being delayed and that the contractor expected additional compensation for the disruption. As the disrupting events were ongoing, these written notices did not include specific time or cost estimates.

The five-member majority of the Supreme Court held that an owner's actual notice of a claim is not an exception to enforcement of the contractual notice and claim requirements. The majority acknowledged that an owner can waive such provisions through words or conduct but held that there was insufficient evidence of the County's waiver to overcome summary judgment.

### **C. PREPARATION OF SUBCONTRACTOR'S LETTER OF MODIFICATION**

Generally speaking, contracts are made on the basis of an offer and acceptance. In order for there to be an effective acceptance, the acceptance must not substantially vary the terms of the offer.

When the general contractor gives you a proposed subcontract, that is an "offer." That is the general contractor's "offer" to you to perform certain work for a payment of money according to certain terms and conditions in the subcontract that control the subcontractor's performance and the general contractor's duty to make payments. As a subcontractor, you can "accept" the general contractor's "offer" by signing and returning the subcontract, you can "reject" the offer by saying, "No thanks", or you can make a counteroffer.

A counteroffer always constitutes a legal rejection of the offeror's (general contractor's) offer and the making of a new offer, this time by the subcontractor, who now becomes the new "offeror." A counteroffer takes the general contractor's offer "off the table" and places the subcontractor's counteroffer on the table. Then, it is the general contractor's turn to either accept, reject, or make a new counteroffer of its own to the subcontractor.

You should rarely accept the general contractor's proposed subcontract because more often than not, it is one-sided and legally prejudicial to you. You should make a counteroffer. Dare to say, "No" to the general contractor's first offer (or the subcontract as it is originally drafted). You should read the subcontract and make a written counteroffer to the general contractor that rejects certain terms or limitations in the

subcontract. You should identify and modify those terms which are overly burdensome or restrictive and then modify those terms to reduce or eliminate their prejudicial effects. The method by which you should make your counteroffer is a letter to the general contractor, which you should attach to your signed subcontract. The letter should describe what terms of the subcontract you are modifying and should include an explanation why. Together with the signed subcontract (without markings or edits on its face), the letter will have the effect of a counteroffer. The ball will then be in the general contractor's court to either accept or reject your counteroffer.

Your letter should begin with language that expresses your unwillingness to proceed based upon the terms of the general contractor's proposed subcontract, but that you will proceed based upon certain modifications to that subcontract as contained in your letter. This is your counteroffer. The language you would typically begin your letter with (to make this counteroffer) would read something like this:

**We have received and reviewed your proposed subcontract. Subject to the following subcontract modifications, we will proceed with the work according to the terms of our earlier bid and the terms of your subcontract as modified below. While we agree with most of the terms of the proposed subcontract, there are some terms that are inconsistent with our operations and method of business, and we have set those out below. Please review the following modifications and provide us with either your oral or written notice to proceed if you are in agreement with these modifications. We look forward to performing all of our work in an efficient, quality and timely manner.**

You may (and should) also specify the mode of acceptance. An offeror may make the mode of acceptance part of the offer. You should specify the mode of the general contractor's acceptance in your modification letter by stating that the general contractor may accept your modifications (i.e., your counteroffer) by giving you either a written or oral notice to proceed after having received and presumably read your letter. See, e.g., the last two sentences of the proposed language, above.

Your counteroffer is on the table and you have specified the mode of acceptance for the general contractor. If you receive a notice to proceed (either oral or written), you and the general contractor are bound by the terms of the subcontract as modified by your letter. Congratulations!

The following subcontract terms described below are typical one-sided terms that general contractors routinely attempt to incorporate into their subcontracts (and will incorporate absent your modification to the contrary). There are many ways in which you can modify these terms. You may want to consider the suggested methods below.

### **1. Scope of Work**

For obvious reasons, it is important to verify that the scope of work that you intend to perform for the contract price mirrors the scope of work expected by the general

contractor. Disputes about what was or wasn't included in the contract price, *even if you are right*, are costly to resolve. Eliminate the possibility of confusion or miscommunication. If a subcontract references a plan, specification, or drawing that was not included with the contract documents, insist on reviewing these documents before committing to the contract price and/or schedule. Do not agree to terms that leave the scope open-ended or subjective such as a term that might state, "Performance by Subcontractor shall be required to the extent consistent with the Contract Documents and reasonably inferable from them as being necessary to produce the intended results." Don't let yourself get into a situation after the fact where you have to argue over what was "reasonably inferable" by the Contract Documents. It is good practice to nail down the scope of the entire contract by including a confirmation letter with your signed contract reiterating the scope of work that you expect to perform.

## **2. Accepting Prior Work**

It is always a good idea to investigate the project site before you commit to the terms of your subcontract. The plans and drawings that you bid off of do not always reflect the actual conditions on site. Your later request for a change order may be rejected if you accepted the prior work as is, and you may be forced to complete your scope despite the extra difficulties. A typical subcontract clause might read as follows:

**Subcontractor has satisfied itself as to the nature and location of the work, the character, kind and quality of material to be encountered, the character, kind and quantity of equipment needed, the location, conditions and other matters which can in any manner affect the work under this Subcontract agreement, and acknowledges that Subcontractor has had a reasonable opportunity to examine the site. Prior to commencing work, Subcontractor shall examine the site and any surfaces upon which work is to be performed, and shall notify Contractor in writing of any conditions which might adversely affect its work; failure to do so will constitute a waiver of entitlement to any additional compensation or contract time arising out of such conditions.**

You should consider using the following language to modify a subcontract provision like the one above:

**We have visually inspected the work site and do not believe that any conditions exist that would change the terms of our original bid. We accept prior work only so far as we are able to visually ascertain its suitability.**

If you are not in a position to investigate the site prior to signing the subcontract, you should clearly say so in your modification letter. State that you haven't inspected or accepted prior work, and that if it does not conform to industry standards, you reserve the right to be compensated for additional amounts and/or time for your additional work.

### 3. Flow Down Clauses

General contractors do not want to assume any more liability to the owner than they can pass on to their subcontractors. General contractors will try to delegate their liabilities and responsibilities to their subcontractors. The easiest way for general contractors to do this is to have their subcontractors agree to all the provisions in the “main” contract (also known as the “prime” contract). By doing so, the subcontractor legally steps into the shoes of the general contractor and becomes liable for the general contractor’s obligations to the owner. A typical provision might look like this:

**Subcontractor shall assume toward Contractor all obligations and responsibilities which Contractor has assumed toward Owner under the Main Contract to the extent of the work herein subcontracted including, with limitation, provisions of the Main Contract. In case of conflict between the terms of this Subcontract and the Main Contract, this Subcontractor shall control. The Main Contract has been and remains available to Subcontractor for review.**

The classic use of incorporation by reference is to impose technical specifications or other definitions of the work. For instance, reference to a national plumbing code imposed those standards on the contractor even if the standards were more stringent than industry custom. *Appeal of D.E.W., Inc.*, ASBCA No. 35759 (October 24, 1991).

Broad or imprecise references can produce unexpected consequences. A broad incorporation by reference clause in a subcontract imposed not only the technical requirements of the prime contract, but also legal provisions pertaining to risk of loss of the work prior to final acceptance of the project. *Lincoln Welding Works v. Ramirez*, 647 P.2d 385 (Nev. 1982).

In one case, a contract referenced the AIA General Conditions, Document A201, which was attached to the contract itself. The contractor’s representative glanced at the cover of the referenced document, assumed he knew what he was getting, and signed the contract. When disputes subsequently developed, the contractor discovered that the project owner had made extensive revisions to the “standard” form. Those revisions were binding on the contractor even though they had not been noted in the contract itself. *L.R. Roy Construction Co., Inc., v. Dean L. Dauley and Waldorf Associates*, 547 F.Supp. 166 (D.Kan. 1982).

As stated earlier, the device of incorporation by reference is widely used in subcontracts where broad “flow-down” clauses purport to impose terms from the prime contract on the subcontractor. The general nature of these references raises questions of whether they incorporate only the technical requirements of the prime contract or also impose the legal terms and conditions from the prime contract. This is a particularly difficult issue with regard to contractual disclaimers of liability or responsibility.

One subcontract incorporated the general conditions of the prime contract by reference. The general conditions contained a no-damage-for-delay clause which was mandated by a state public works statute. It was held that the incorporation by reference imposed the

disclaimer on the subcontractor. *B.J. Harland Electrical Co., Inc. v. Granger Brothers, Inc.*, 510 N.E.2d 765 (Mass.App.1987).

It should be noted that with federal contracting, the rule is different. When a subcontract contains a general incorporation by reference of the federal contract terms, it is interpreted to apply to the technical work requirements, but not the legal terms and conditions of the prime contract. The rationale is that a general reference is not sufficiently clear to impose disclaimers or limitations of liability on a subcontractor. For instance, a no-damage-for-delay clause in a prime contract was not enforceable against a subcontract. *Wolff & Munier, Inc., v. Whiting-Turner Contracting Co.*, 946 F.2d 1003 (2d. Cir. 1991).

Another issue which arises when prime contract terms are incorporated by reference into subcontracts is the imposition of dispute resolution provisions. The issue is the same as with disclaimers. Should a general reference to an external document alter the fundamental legal rights of the subcontractor?

A provision calling for binding arbitration of disputes effectively eliminates a party's right to litigate a claim. This is a significant alteration of a subcontractor's legal position. Yet a general incorporation by reference was held to impose an arbitration clause in a prime contract on a subcontractor. The sub was obliged to participate in arbitration proceedings between the project owner and the prime contractor when the matter in dispute involved the subcontractor's work. "When the terms of the construction contract were incorporated by reference, the arbitration terms of the construction contract were likewise incorporated." *Slaughter v. Bencomo Roofing Co.*, 30 Cal.Rptr.2d 618 (Cal.App. 1994).

One way to modify a term like the one above so that you do not assume responsibilities to the owner that you neither were aware of nor bargained for is to clearly state in your response to the general contractor that you have not reviewed the main contract and do not agree to be bound by the main contract. To cushion the blow that those words might have on the general, you might want to add that you have no problem with reviewing *particular portions* (e.g., Division 1) of the main contract that the general contractor insists that you agree to. You might also want to add that any new information learned from reviewing those portions of the main contract could result in you having to adjust the amount of your bid or the project schedule.

#### **4. Pay-if-Paid & Pay-When-Paid**

"Pay-if-paid" means that the general contractor will not pay the subcontractor *unless* the general contractor is paid by the owner. General contractors, however, might not get paid by the owner for any number of reasons having nothing to do with the subcontractor's work. In such a situation, the general contract does *not* have a contractual or legal obligation to pay the subcontractor. Washington case law has established that a subcontractor is legally bound by a pay-if-paid clause. You should never, never enter into a subcontract with a pay-if-paid clause. You are obligated to pay *your* vendors, subcontractors, employees, etc. whether you are paid or not. A "pay-when-paid" clause

is similar to a pay-if-paid clause in that the general contractor intends to condition payment to the subcontractor upon payment by the owner to the general contractor. A subcontract with a pay-when-paid clause will allow the general contractor to pay its subcontractor only *after* the general contractor is paid by the owner. The growing weight of legal authority is that pay-when-paid clauses only go to the matter of *timing*, not entitlement. Generally, courts now require the general contractor to pay the subcontractor within a reasonable amount of time after receipt of the subcontractor's invoice, assuming that the subcontractor's work is acceptable and the terms of invoice are not disputed.

A Maryland court has ruled that a "pay-if-paid" clause in a subcontract did not shift the risk of owner nonpayment from the prime contractor to the subcontractor.

The city of Frederick awarded a contract to Richard F. Kline, Inc. for construction of a flood control project. The contract included a contingent item for the removal of any contaminated soil that was encountered at the site.

Kline subcontracted the excavation work to Shook Excavation & Hauling, Inc. The scope of work did not include the handling or removal of contaminated soil. The subcontract incorporated the terms of the prime contract by reference. The subcontract also contained Article XIX which said that with regard to any claim for additional compensation, "the Subcontractor hereby waives any right it otherwise might have against the Contractor and agrees never to look to the Contractor for payment on account of any such claim except to such extent, if any, as the Contractor shall be paid by the owner on account of any such claim of the Subcontractor."

Shook encountered contaminated soil during the excavation. At Kline's direction, Shook removed that soil. The City refused to pay Kline for removal of the contaminated soil because the prime contractor had not obtained permission from the project engineer and state authorities. Kline refused to pay Shook, so the subcontractor filed suit.

Kline defended the claim on the grounds that Article XIX was an enforceable pay-if-paid clause.

The Court of Special Appeals of Maryland said that under Maryland law, the courts are reluctant to interpret a contract in a manner that causes a party to forfeit its right to payment. In order for a subcontract to shift the risk of owner nonpayment from the prime contractor to the subcontractor, the subcontractor must expressly state that owner payment is a "condition precedent" to the prime contractor's payment obligation to the sub. This subcontract did not contain such language.

"Upon examination of the language in Article XIX, we are persuaded that it does not clearly and unambiguously create a condition precedent...Therefore, Article XIX is not [an enforceable] pay-when-paid provision."

The real question is why did Shook sign the subcontract in the first place – a subcontract that said that Shook would “never look to the contractor for payment”.

Obviously, Shook should have read the subcontract before he signed it, and then modified out the pay-if-paid clause. Do *you* read the subcontracts offered to you by prime contractors? Do *you* blindly sign and seal with a prayer? Be careful, or next time may be your time to get “all shook up”. (Horrible pun, I know).

Bonding companies may not automatically take advantage of pay-when-paid and/or pay-if-paid clauses in their principal’s subcontract. It may be possible to assert a claim against the general contractor’s payment bond or registration bond, despite a subcontract provision restricting the subcontractor’s entitlement to payment from the general contractor if the general contractor receives payment from the owner for the subcontractor’s work. In *U.S. for the Use and Benefit of Walton Technology v. Westar Engineering*, 290 F.3<sup>rd</sup> 1199 (9<sup>th</sup> Cir. 2002), the Ninth Circuit invalidated the use or enforceability of pay-when-and-if-paid subcontract language with respect to claims asserted against the general contractor’s surety under the Miller Act (federal projects). The court held that such a clause was basically tantamount to a waiver of Miller Act rights, which would only be enforced with clear and explicit language. (Implicitly the court ruled that “pay when and if paid” language was not an express waiver of the Miller Act.)

In practice, a pay-when-paid clause allows general contractors to drag their heels on payment by blaming nonpayment on the owner. However, even if the general is telling the truth and there really is a genuine nonpayment issue with the owner, it could be for a number of reasons having no relation to the subcontractor’s work. A typical subcontract provision attempting to condition payment to the subcontractor upon receipt of payment by the owner might look like this:

**No payment, including payment of retention or other compensation to Subcontractor for work hereunder, shall be due Subcontractor from Contractor unless and until Contractor has received such payment from Owner. Receipt by Contractor of such payment from Owner shall constitute, and is acknowledged by Subcontractor to be, expressly a condition precedent to Contractor’s obligation to pay Subcontractor.**

The way to modify a pay-if-paid or a pay-when-paid provision is to state that you do not agree that payment of the contract price be conditioned in any way upon payments by the owner, but rather insist on getting paid 40 days after your invoice, etc. You can say this by stating:

**We do not agree to your conditioning payment to us upon your receipt of payment from the owner. There are several reasons. You could possibly become involved in some dispute with the owner which results in the owner withholding payment from you for reasons**

**having nothing to do with work performed by us. Also, we are not in a position to review your applications for payment or receipt of payments from the owner. In addition, none of our suppliers or employees are operating on a pay-if-paid basis with us, nor are the applicable taxing authorities. We will submit timely applications for payment to you and will make every attempt to do so within the period of time that will allow you to make timely applications for payment to the owner.**

## **5. Final Payment**

Similar to a pay-if-paid or a pay-when-paid clause, sometimes, general contractors add a provision in their subcontracts that will state that “Final payment for work under this Subcontract shall be made *after* Contractor receives final payment from the Owner.” Again, since the owner might not want to pay the general contractor for a plethora of reasons, you should insist that final payment shall not be conditioned on payment by the owner to the general, but rather shall be due 40 days after the general’s receipt of your last invoice.

## **6. Insurance Requirements**

All general contractors require their subcontractors to provide insurance for each project they work on. You should not agree to perform a subcontract if your insurance policy does not fully cover the general contractor’s insurance requirements set forth in the subcontract. Never hesitate to call your insurance agent with questions or fax them the general contractor’s insurance requirements for a particular job. Your agent is the expert. Let them do their job. Make it your practice to send the particular insurance requirements for each job you work on to your agent for review, comment, and approval. Does your own insurance satisfy the general contractor’s requirements per the subcontract? That will also allow your agent the information s/he needs to provide you with the certificate of insurance required by the general contractor. You don’t want to end up with gaps and exposures in your coverage.

Be careful about waiving your subrogation rights, making your insurance primary (and the general contractor’s insurance secondary), or making the general contractor an additional insured under the terms of your own insurance policy. These three matters (subrogation, primary coverage, and additional insured status) should be fully reviewed by your insurance agent and your agent should confirm in writing to you that agreeing to these terms will not void your insurance. These three matters all affect underwriting considerations and requirements of your own insurance coverage. It’s not your prerogative or call to waive subrogation rights, determine whose coverage is primary or secondary, or stretch an insurance policy to include additional insureds. Your insurance agent needs to give you the green light on these issues before you agree to the general contractor’s insurance requirements.

## **7. Indemnification**

Indemnification is a term that describes one party’s obligation to reimburse a second party for costs incurred by the second party as a result of having to defend against certain

claims brought by a third party. In the context of construction contracts, general contractors' subcontracts commonly provide that the subcontractor shall indemnify the general contractor for all claims brought by anybody (who isn't the general contractor) which implicates the subcontractors' work of the performance thereof. A typical way that a general contractor might do this is with the following clause:

**The subcontractor agrees to indemnify and hold harmless the Owner and the Contractor and their respective agents for loss, damage, and/or injury from a negligent act or omission of the Subcontractor, its employees or agents, to the person or property of the parties hereto and their employees and to the person or property of any other person or company, while engaged in the performance of these duties. All work covered by this Agreement done at the site of construction or in preparing or delivering materials or equipment, or any or all of them, to the site shall be at the risk of Subcontractor exclusively. Subcontractor shall, with respect to all work which is covered by or incidental to this subcontract, indemnify and hold Contractor harmless from and against all of the following: Any claim, liability, loss, damage, cost expenses, including reasonable attorney's fees or judgments arising by reason of bodily injury to persons, injury to property, or other loss, damage or expense, including any of the same resulting from Contractor's alleged or actual negligent act or omission, regardless of whether such act or omission is active or passive.**

Normally, it is acceptable for the subcontractor to agree to indemnify the general contractor against third party claims to the extent that these third party claims arise out of the subcontractor's own errors or omissions. That's because the subcontract would normally otherwise be liable to these third parties. If you cause a loss to somebody, you should pay for it. The problem occurs where the general contractor requests indemnification for liabilities over which the subcontractor has no control of or which are beyond the scope of the subcontractor's work.

For example, a drywall subcontractor who is bound by an indemnification clause like the one above could potentially be held liable to the general contractor for any number of claims asserted by, say, the owner against the general which implicate the subcontractor's work. The owner may have a problem with an item of the drywaller's work that it performed at the direction of the general contractor. Unless, the drywaller limits its duty to indemnify the general contractor for defects or problems for which the drywaller could be said to be responsible, the general contractor may assert its right to be *fully* indemnified notwithstanding the role it may have played in causing the defect or problem.

You should not agree to indemnify a general contractor for liabilities outside of your control (e.g., for work performed by other subcontractors or by the general contract). Further, you should limit your obligation to indemnify the general contractor to the extent that *your* negligence or breach causes the damage. More often than not, fault can be

attributable to more than one party. Don't get stuck shouldering all the blame and all the liability in a situation where you are only *partly* to blame. One way to limit your duty to indemnify per the terms of a provision like the one, above, is to include the following provision in your modification letter:

**Our duty to indemnify you shall not apply to liability for damages arising out of the bodily injury to persons or damage to property caused by or resulting from the sole negligence of you or your agents or employees. Our duty to indemnify you for damages arising out of bodily injury to persons or damage to property caused by or resulting from the concurrent negligence of you our your agents or employees and us or our agents or employees, shall apply only to the extent of the negligence of us or our agents or employees.**

The State of Washington, as a matter of public policy, enacted RCW 4.24.115 in 1986 to protect subcontractors from overreaching indemnification clauses. It explicitly prevents parties from attempting to contract around the statute.

RCW 4.24.115

**Validity of agreement to indemnify against liability for negligence relative to construction, alteration, improvement, etc., of structure or improvement attached to real estate. A covenant, promise, agreement or understanding in, or in connection with or collateral to, a contract or agreement relative to the construction, alteration, repair, addition to, subtraction from, improvement to, or maintenance of, any building, highway, road, railroad, excavation, or other structure, project, development, or improvement attached to real estate, including moving and demolition in connection therewith, purporting to indemnify against liability for damages arising out of bodily injury to persons or damage to property:**

**(1) Caused by or resulting from the sole negligence of the indemnitee, his agents or employees *is against public policy and is void and unenforceable;***

**(2) Caused by our resulting from the concurrent negligence of (a) the indemnitee or the indemnitee's agents or employees, and (b) the indemnitor or the indemnitor's agents or employees, *is valid and enforceable only to the extent of the indemnitor's negligence and only if the agreement specifically and expressly provides therefore, and may waive the indemnitor's immunity under industrial insurance, Title 51 RCW, only if the agreement specifically and expressly provides therefore and the waiver was mutually negotiated by***

**the parties. This subsection applies to agreements entered into after June 11, 1986.**

In *Truck Ins. Exchange v. BRE Properties, Inc.* 119 Wash.App. 582 (2003), the Court of Appeals stated the indemnification law as follows:

RCW 4.24.115 prohibits an indemnitor in a construction contract from contracting away its liability. But indemnitors may enter into such agreements for the purpose of making subcontractor liable for their own fault. And although these agreements do not serve to make the subcontractor liable for the general contractor's negligence, they do remove the subcontractor's immunity, making the subcontractor liable to the general contractor the subcontractor's own share of any judgment obtained by the subcontractor's employee. In Washington, courts enforce third party indemnification agreements despite the exclusivity of the Industrial Insurance Act because the liability is not imposed by the law. Rather, the employer voluntarily assumes liability in a contract. Enforcing such indemnification provisions allows contractors to allocate "responsibility to purchase insurance" according to their negotiated allocation of risk and potential liabilities.

#### **8. Pass-through Claims**

Situations may arise during the course of a job that put the subcontractor or some aspect of its work into an adverse position with the owner. An example might be where the owner is not happy with a particular item of work attributable to the subcontractor and does not want to pay the general contractor for the work. Another example is when the owner interferes or prevents the subcontractor from performing its work as planned. The general contractor may be affected by an owner's claim of improper work by the subcontractor or the subcontractor's claim of improper act or failure to act by the owner.

One way for general contractors to assume essentially no liability in such circumstances is to insist that the general contractor bind itself to the subcontractor only to the extent that the owner is bound to the general contractor and further only to the extent that the general contractor is able to recover the subcontractor's claim from the owner. Further, the general contractor may require the subcontractor to allow the general contractor to prosecute and/or defend the subcontractor's claims directly with the owner. However, in the case of prosecuting the subcontractor's claims (e.g., for a change order), the general contractor has little incentive to *zealously* do so because the general contractor, in most circumstances, has usually not yet had to pay the subcontractor for the disputed item. Moreover, the general contractor likely has headaches and claims of its own with the owner, so your claims are likely to be the first to be pushed to the side. In sum, the general contractor may only half-heartedly defend their subcontractors' work and prosecute their subcontractors' claims. Therefore, subcontractors should not agree to rely on their general contractor to stick up for them. An example of a pass-through claims provision in a contract is as follows:

**In the event of any dispute or claim between Contractor and Owner which directly or indirectly involves the work performed or to be performed by Subcontractor, or in the event of any dispute or claim**

**between Contractor and Subcontractor caused by or arising out of conduct for which Owner may be responsible, Subcontractor agrees to be bound to Contractor and Contractor agrees to be bound to Subcontractor to the same extent that Contractor is bound to Owner by the Terms of the Main Contract, and by any and all procedures and resulting decisions, findings, determinations, or awards made thereunder by the person so authorized in the Main Contract. Contractor's determination as to whether any Subcontractor claim arises out of the Main Contract, or is one for which the Owner may be responsible, shall be final and conclusive. If any dispute or claim of Subcontractor is prosecuted or defended by Contractor together with disputes or claims of Contractor's own, and Subcontractor is not directly a party, Subcontractor agrees to cooperate fully with Contractor, and to furnish all documents, statements, and other information required by Contractor for such purpose, and shall pay or reimburse Contractor for all expenses, costs, and attorneys fees incurred in connection therewith.**

Consider the possible harm to your company before agreeing to a general contractor's pass-through claims procedure. This clause is as dangerous as a pay-if-paid clause because it amounts to exactly the same thing. Allowing the general contractor to be your "ambassador" on all claims involving the owner can be fatal to your position considering that your interest as a subcontractor does not always align with that of the general contractor. One way to modify a pass-through clause is with the following language:

**We do not agree to any pass-through procedure or anything like that. We don't have any relationship with the owner. Furthermore, we don't have any control or interest as to what claims you may submit to the owner, or what the owner's reaction may be to those claims. If we have a claim, we will take that matter up directly, one on one, with you and vice versa, regardless of what happens between you and the owner. Any claim or dispute that you may have against us will be similarly resolved on a one-on-one basis without any involvement of the owner.**

## **9. Liquidated Damages**

Some subcontracts include provisions that call for "liquidated damages." Liquidated damages are specific prescribed penalties that may be assessed against the subcontractor in the event that the subcontractor fails to perform a specified part of the contract. You will usually see liquidated damage provisions in the context of delays to the project schedule. If a delay occurs and a provision in the subcontract calls for liquidated damages, the subcontractor is liable in the amount described in the subcontract *regardless* of the *actual* amount of damages cause by the delay/breach. A typical liquidated damages clause looks like this:

**Time is of the essence of this Agreement, and if the Work is not completed by the Scheduled Completion Date, General Contractor shall have the right to offset and retain from sums otherwise earned by Subcontractor under this Agreement in the sum of \$500.00 for each calendar day that the Work remains uncompleted following the Scheduled Completion Date. If liquidated damages are assessed against Contractor by Owner under the Main Contract, Subcontractor shall pay such damages to the extent of any delay caused by Subcontractor.**

Although it may be difficult to insist on performing your work on your own time frame, you may want to limit your exposure to harsh and excessive penalties in the event that a general contractor seeks to backcharge you an arbitrary amount of money for delays. Suggested language for this might be to simply say that you do not agree to a liquidated damages clause. You might want to add that if you delay the work in any way or cause damage to the project, you will be responsible for the extent of those damages for which you are responsible. That way, you are not exposing yourself to the risk of being assessed an arbitrary backcharge, but rather a fair dollar amount in direct proportion to the damage or delay you cause. The following language may work:

**We do not agree to a liquidated damages clause. If we delay the work in any way or cause damage to the project, we will be responsible for the extent of those damages for which we are responsible.**

#### **10. Notices**

Subcontracts are filled with notice requirements that obligate the subcontractor to follow specified claims and notification procedures, which, if disregarded, may result in the subcontractor's waiver of the claim. The laws in your area may require you to follow the exacting requirements contained in contractual notice procedures unless those procedures are waived by unequivocal acts evidencing an intent to waive them. See, e.g., a Washington case titled, *Absher Const. Co. v. Kent School Dist. No. 415*, 77 Wn.App. 137 (1995).

Notice requirements abound in subcontracts when it comes to delay claims, unforeseen site conditions, compressed schedules, site access, and change orders. Subcontracts often contain specific notice requirements that must be followed *before* the general contractor is obligated to pay for the work. Usually, notice requirements require the subcontractor to notify the general contractor within a certain time of discovery of the event giving rise to the claim, require that the claim be submitted in a certain format (e.g., in writing with supporting time and cost data), and also require the claim to be submitted through certain channels (e.g. directly to home office, to project manager, etc.). In the event that a site condition or circumstance during performance of the work necessitates additional work beyond the scope of the original contract, it is important that the subcontractor comply with all of the subcontract terms regarding proper notice to the general contractor.

Unfortunately, general contractors are not always as anxious as you are to approve additional payment and/or extensions of time for extra, necessary work. Sometimes, the notice requirements in subcontracts are somewhat unrealistic. The following is such example:

**Subcontractor shall provide written notice to Contractor within 48 hours, or if the Main Contract provides for a shorter period, within sufficient time to allow Contractor to give timely notice to Owner, after the occurrence of any instance of interruption, extra work, additional work, delay, hindrance and/or efficiency loss of any nature whatsoever in Subcontractor's work that is believed by Subcontractor to be caused, in whole or in part, by acts or omissions of Contractor, other Subcontractors, the Owner, or other third parties. Failure by Subcontractor to provide timely written notice as provided in the paragraph is agreed by the parties to constitute a waiver of Subcontractor's claim.**

In order to prevent the general contractor from claiming that you waived your right to assert a claim for additional time or money because you failed to strictly comply with the specified notice requirements, you need to modify the notice requirements of your subcontract so that they make more practical sense. One way to do so is as follows:

**We are not in the business of litigation or submitting claims. However, if we are adversely impacted in the process of our work, and we believe the impact is due to the fault of others, we will submit the appropriate claim within a reasonable time. We do not agree to any set or arbitrary time limitation for submitting a claim. We will certainly try to resolve the claim prior to submitting any paperwork, but if we are unable to resolve the matter satisfactorily with the personnel or parties involved then, if appropriate, we will submit the appropriate claim in a timely manner. We do not limit our claims to time extensions only. If we incur additional costs for which we are not responsible, we expect to be reimbursed for such costs. We do not waive damages for disruption, impact, loss of efficiency, loss of productivity or any similar form of damages or compensation as a result of delay."**

Some subcontracts contain terms that insist on formal notice procedures that must be *strictly* complied with in order for the notice to be deemed effective. If not followed to a "t", the subject of your notification may be waived. Recent legal cases have enforced these rigid notice procedures even in cases where the subcontractor provided *some* form of notice that more than likely communicated the relevant information to the relevant recipient. Never rely on having *substantially* complied with a specific notice procedure. Notice procedures must be *exactly* followed unless your counteroffer states otherwise. An example of a subcontract term setting forth notice procedures reads like this:

**Any written notice required to be given to a party shall be hand-delivered or delivered to the address of that party indicated above via certified mail only. Oral, faxed, and/or electronic communications shall be deemed insufficient for purposes of providing proper notice under this paragraph.**

You can modify any harsh or overly burdensome notice requirements in your modification letter to the general contractor by stating how you intend to give the relevant notices. Granted that it is generally good practice to put all important notifications in writing, you might want to relax unreasonable notice provisions in subcontracts by stating in your response letter that *any* form of notice that has the effect of adequately notifying the proper recipient shall constitute good notice. You might want to include a few examples of acceptable methods of providing notice, e.g., faxes, emails, telegraphs, etc. One way to do this is as follows:

**Any notices required by the subcontract shall be permitted to be made via successful fax, US mail, email, or in any written form that indicates receipt by the proper recipient. All notice periods in the subcontract shall be prolonged to account for any intervening weekends or holidays.**

## **11. Delays**

In the event that your work is delayed, it is important that you comply with the protocol regarding proper notification to the general contractor. Your work could be delayed by change orders, other subcontractors, by acts (or non-acts) of the general contractor or owner, by acts of God, or by any number of unforeseeable circumstances and events. It is important that you *strictly* comply with the general contractor's notice requirements pertaining to any claims that you intend to make for additional time or money. If you don't, you may inadvertently waive your right to recover additional payment or an extension of time. Even if you are at a stage where you are not entirely sure whether the delay will cause you to incur additional costs or require an extension of the project schedule, it is good practice to inform the general of your position and that you are not sure what the consequences or impact a particular delay will have on your work, but that you reserve the right to make a claim for extra payment or extra time in the event that these extras are incurred or are necessitated.

## **12. Payment Conditioned On "Satisfaction"**

Sometimes, generals put provisions in their contract that attempt to condition payment to the subcontractor upon the general's or the owner's "personal satisfaction" of the work. Don't agree to be subject to this arrangement. Your work might be rejected for a number of reasons that have no relation to the actual quality of your work. A typical provision may look as follows:

**Payment for Subcontractor's work shall be paid for its work upon the full satisfaction of the Contractor, Owner, Architect, and/or Engineer.**

You should think about modifying a provision like the one above by stating:

**We cannot agree to perform the subcontract ‘to the full and complete satisfaction’ of you, the owner, the architect, or the engineer. That standard is too subjective and indefinable. Instead, we will commit to performing our work according to the applicable building codes, current industry standards, and recommendations issued by the Northwest Wall & Ceiling Bureau.**

It is important that you tie the quality of your work to some *objective* standard. You never know what the general contractor’s or owner’s expectations might be regarding your work. Do not bind yourself to somebody’s *personal* expectations or *subjective* standards. If an issue about the quality of your work comes up later on, you want to be able to cite industry standards, building codes, etc., for direction in resolving any dispute, and not have to contend with the owner or general contractor’s opinions or feelings.

### **13. Lien Waivers**

A lien is a recorded claim of interest in real property. Washington law permits contractors who improve real property to lien property on which they furnish materials or perform services. Property owners are wary of liens because liens cloud title to their property and have the potential of resulting in a public auction and sale of property (with some or all of the proceeds going to the lien claimant). Therefore, (smart) owners will insist that their general contractor provide them with signed “lien waivers” from *every* subcontractor performing work and supplying materials on the project. A lien waiver prohibits the subcontractor from recording a lien on the property for the dollar amount of the labor or materials acknowledged as “paid for” by the general contractor as stated in the lien waiver. Lien waivers are requested by the general contractor for (and to the extent of) each progress payment issued to the subcontractor. Especially on commercial projects.

A typical lien waiver will contain language that will state something along the lines of, “...Upon receipt of payment in the amount of \$XX.00 from the general contractor, subcontractor agrees to waive its right to record a lien upon the subject property.”

There is no problem with signing lien waivers throughout the course of a job so long as you are being fully paid by your general contractor. But, you will not be able to wait until the end of the job to submit your change orders or claims for additional compensation. You will start each month with a “clean slate.”

### **14. Scheduling**

Maintaining the project schedule should always be a high priority considering that most subcontracts provide for serious consequences in the event that the subcontract causes delays to the project.

After limiting your exposure to the general contractor’s unnecessarily harsh penalties caused by your delay, you may want to affirmatively insist upon being compensated for project caused by others that result in delays to *your* work and productivity. One way to

do so is with the following language:

**We agree that we shall be responsible for any delays and/or resulting costs and damages incurred by us as a result of our failure to timely commence, perform, and complete the work. In the same fashion, we shall be reasonably compensated and receive an extension of time to complete the work if you or the owner impose significant scheduling changes (accelerations or delays) pertaining to our work. In the event that we make a claim on account of your acceleration or delay, we shall submit the claim in writing within a reasonable period of time. We do not agree to a 3-day deadline for submitting such a claim.**

#### **15. Risk of Loss & Protection of Work**

Materials that you store on site are always subject to the risk of damage, destruction, or theft. It is more often than not the case that the materials you store on site have yet to be paid for. It is important that you do not waive your right to be reimbursed if others damage your materials. The general contractor and the owner are usually in the best position to protect against the risk of destruction and theft because they have the most control over site access and site organization and they are the one who designated your staging / storage area(s). Many subcontracts however provide for the subcontractor to bear the risk of loss during storage. So reads the provision below:

**It shall be Subcontractor's responsibility to unload, store, and protect its materials; to bear the risk of loss thereof; and to protect such materials against loss until it has been actually incorporated into the work. This responsibility shall continue until the work is accepted, even though title thereto may previously have passed to the Owner.**

You should only modify a provision like the one above, by stating the following:

**Materials that we need to store on site will be stored in areas that you direct us to store them. Without specific direction otherwise, we will store our materials where we believe they will be safe and out of the way. If our materials are damaged or stolen by others, we shall not bear the risk of loss and shall be compensated for the costs of replacing the materials.**

After your materials are installed, but before you have completed your work, there is always the risk that your work may be damaged by others. It is good to clarify that you do not accept responsibility if this happens. One way to do so is to include the following language in your modification letter:

**We will protect our work until such time as our work has been completed and we have removed our materials and equipment from the area. After we have left the area, damage caused by other trades**

**is the responsibility of the general contractor. We do not agree that you or other workers may occupy or use any portion of our work which is in progress. Interference by other trades affects our labor efficiency and poses great safety risks upon our crews.**

## **16. Termination & Take-Over**

Most subcontracts contain a provision describing the grounds upon which the general contractor may rightfully terminate your subcontract . You should know that the general rule is that a party to a contract can only terminate its contractual obligations if the other side “materially breaches” the contract. “Materially breaches” is a legal term of art. It applies in situations where one party so fails to perform its own contractual obligations that the other party cannot or will not substantially receive its benefit of the bargain.

Be on the lookout for provisions in subcontracts that attempt to give the general contractor excessive termination powers which allow for termination for rather minor events which fall short of being accurately characterized as “material breaches.” Also, be wary of termination clauses, such as the one below, that require the general contractor to give you only short advance notice of their intent to terminate (for whatever reason they may cite). An example of a termination clause is as follows:

**If Subcontractor (i) refuses or fails to supply enough properly skilled workers or materials to maintain the schedule of work; (ii) refuses or fails to make prompt payment to sub-subcontractors or suppliers of labor, materials or services; (iii) fails to correct, replace or re-execute faulty or defective work done or materials furnished; (iv) disregards the law, ordinances, rules, regulations or orders of any public authority having jurisdiction; or (v) is guilty of a material breach of this Subcontract, then Contractor, without prejudice to any rights or remedies otherwise available to it, shall have the right to any or all of the following remedies:**

- 1) Supply labor or materials or equipment as deemed necessary by the Contractor and charge the cost thereof to Subcontractor;**
- 2) Contract with one or more additional subcontractors to perform such part of Subcontractor’s work as determined by Contractor is needed to provide timely completion and charge the cost thereof to Subcontractor;**
- 3) Withhold payment of monies otherwise due or to become due to Subcontractor;**
- 4) Terminate this Subcontract.**

The sample clause, above, is not completely one-sided. It provides certain grounds upon which the general contractor will be justified to terminate the subcontract agreement. However, the above clause does not specifically state that the general contractor is obligated to warn you of its intent to terminate based upon an alleged breach of one of those conditions. You would want to clarify in your modification letter the need for the general contractor to give you five days notice (or however much notice you feel is

necessary) before it may terminate based upon one of those conditions. Within that five day (or other) period, you should explain that you reserve the right to correct the deficiency, and if you do, then the general may not terminate you. An example might be as follows:

**Prior to the event of any termination of this subcontract by you, we must be given at least 5 (five) days advance notice of your intent to do so. After receipt of said notice, and before 5 (five) days have lapsed, we reserve the right to correct the deficiency and continue our work. Similarly, if we feel that you are in breach of the subcontract, we will give you 5 (five) days notice of our intent to terminate the subcontract. Within said time, you will be afforded the opportunity to correct the problem, and if you do, we will proceed with our obligations under the subcontract.**

Some subcontracts permit the general contractor the right to terminate the subcontract without *any* cause or for the general contractor's "convenience", and without the need to cite any reason. Such a term may look like this:

**At its sole option, and at any time and for any reason, Contractor may terminate this Subcontract as to all or any portion of the uncompleted Work. Subcontractor hereby waives any claim for (damages on account of such termination, including, without limitation) consequential damages and loss of anticipated profits. Upon receipt of notice of termination, Subcontractor immediately shall, and as instructed by Contractor, proceed with performance of the following duties, regardless of delay in determining or adjusting amounts due under this article...**

Do not agree to be bound by a clause that allows the general contractor to terminate you without having to give a reason, or without cause. No doubt, you incur considerable expenses in preparing for and organizing each job. You may even pass up other work. You expect to make all this back via your profit on the *entire* job, not just on the first part of the job. One way to modify a termination clause is as follows:

**We do not agree that you may terminate the subcontract without cause or at your own convenience. Similarly, we agree not to terminate our performance under the subcontract without cause or at our own convenience. Premature termination by either party without cause will constitute a breach of contract, the remedy for which will depend on the circumstances and the nature of the breach, but in any event, may include a claim for anticipated profit.**

## **17. Correction of Work**

Construction is an art, and there are usually tolerances within which any work is properly considered acceptable. In the event that you make a mistake and you agree that the work

needs to be repaired or replaced, it is important that you have already established your right to do the corrective work.

Otherwise, you might get stuck paying what could easily amount to an expensive repair bill. The subcontract provision that allows for corrective work is usually found in the subcontract's Termination Clause (see Paragraph 16, above). You should always reiterate your right to perform any necessary repairs in your modification letter. In your letter, tell the general contractor that he must provide you with a sufficient notice of his dissatisfaction with your work. That way, if the general contractor fails to give you notice, you will not be responsible for the cost of the repair work. An example of how to accomplish this is with the following language:

**We will, of course, correct any of our work that is incomplete or defective, but we need reasonable notice. Reasonable notice may be more or less than forty-eight (48) hours, depending on the circumstances. In the event that the Contractor directs another party to perform correction work regarding work within the scope of our contract, the Contractor must first give us forty-eight (48) hours notice, and an opportunity within that time period to perform the corrective work.**

## **18. Venue**

"Venue" refers to the location where a dispute will be resolved. Subcontracts oftentimes contain venue clauses that set forth the geographic location where any lawsuit, commenced as a result of a dispute arising out of the subcontract, will be adjudicated. Venue clauses are usually embedded in the "Disputes" section of the subcontract.

You should not agree to a venue clause that requires you to travel unnecessarily far (i.e., out of state) to resolve a potential dispute between you and your general contractor. The process of resolving legal disputes is always burdensome. Do not make it more burdensome by agreeing to travel long and far to meet with lawyers, attend court proceedings, etc. When dealing with an out-of-state general contractor, pay extra special attention to the "Disputes" section of the subcontract and make sure that you do not agree to resolve a potential dispute in the general contractor's "back yard."

## **19. Dispute Resolution**

You do not want to get bound up in proceedings with the American Arbitration Association or the Construction Industry Arbitration Rules of the American Arbitration Association. Those proceedings are very expensive and very time consuming. Rather, you want any dispute (especially if you are a subcontractor) to be resolved expeditiously according to the Mandatory Arbitration Rules (MAR) which are covered earlier in the course book, starting at page 11. The Mandatory Arbitration Rules (MAR) are attached as an appendix to the course book, Appendix 11.

A typical subcontract between general contractor and a subcontractor is Appendix 9, published by the Associated General Contractors. PARAGRAPH U. DISPUTES provides in pertinent part as follows:

A. Arbitration: All other claims, disputes, and other matters in question between Contractor and Subcontractor arising out of, or relating to, the Main Contract of this Subcontract, the breach thereof, or work thereunder (for which a dispute resolution procedure is not otherwise provided in the Main Contract), shall be decided by arbitration in accordance with the Construction Industry Arbitration Rules of the American Arbitration Association then obtaining, unless the parties mutually agree otherwise. Contractor and Subcontractor agree to be bound by the findings and award of such arbitration finally and without recourse of any court of law other than for the enforcement of the arbitrator's decision.

B. Mediation: As a condition precedent to the hearing of any trial or arbitration, the parties to this Subcontract shall submit any and all disputes between them to non-binding mediation with the assistance of an experienced mediator. The parties shall each designate a representative with full settlement authority who will participate for at least four hours in the mediation. The parties shall bear equally all expenses, exclusive of attorneys' fees, associated with the mediation.

If the main contract requires arbitration and mediation (i.e. mandatory) but your subcontract provides for an alternative dispute resolution procedure, the alternative dispute resolution procedure (i.e. Mandatory Arbitration Rules) will be enforced, notwithstanding the terms of the general contract. In *F.L. Crane & Sons v. Malouf Construction*, 2006 WL 2522795 (Ala), the court concluded that the dispute resolution terms of the subcontract prevailed. The terms of the subcontract provided for *permissive* arbitration, whereas the terms of the main contract provided for mandatory arbitration before the American Arbitration Association. In *Crane v. Malouf*, the subcontractor sought to enforce the terms of the main contract. But, the court ruled that the terms of the subcontract prevailed, and arbitration was only permissive, and that the general contractor was not required to arbitrate with the subcontractor. The court stated as followed:

**Crane (subcontractor) argues that the prime contract (the contract between Malouf Construction and Palm Beach Condominiums, LLC, the owner) governs this dispute because the subcontract incorporates the terms of the prime contract. That incorporation results in the adoption of the terms of the prime contract into the subcontract. (Citation omitted). However, it does not abolish the dispute-resolution scheme in place in the subcontract between Malouf and Crane. (Citation omitted). While the reference in the subcontract to the provisions, plans and specifications of a general contract imports them into the subcontract were not inconsistent with its terms, it is quite well settled that such a reference is not effective beyond this, and**

**that if the subcontract contains words of definite limitation, they will be given effect and the reference limited accordingly.**

#### **D. CONCLUSION**

In summary, before entering into any subcontract, you should first read all of the terms of the subcontract to see if you agree with them. While you do so, make notes of the terms you do not agree with. Most likely, you will find terms in the subcontract with which you do not agree. Some of those terms should include ones to which these materials have drawn your attention to. You should reject those terms that you do not agree with, or modify them, as the case may be, so that they become acceptable. The way to reject and/or modify those terms with which you take issue should be via a letter containing and explaining all of your rejections and/or modifications. Attach your letter to your signed subcontract, and together, that will constitute your counteroffer to the general contractor. If the general contractor directs you to proceed, you will do so based upon the terms of the original contract *as modified by your attached letter*. If the general contractor takes issue with the fact that you reject or modify a particular term, you should either try to find a way to modify the term so that it is mutually acceptable, or simply not take the job. Modifying subcontracts is not brain surgery. You do not need to go to school for ten years to learn how to do it. All you need is a good understanding of the many potential things that can go wrong on a job. Experience is key. You may want to ask your lawyer to help you review and modify your subcontract. A lawyer, especially a lawyer whose practice focuses on construction law, can help you better understand your rights and obligations under both signed and unsigned subcontracts.

### **III. CONTRACTING WITH AN OWNER**

#### **A. INTRODUCTION: IT'S WHAT'S UP FRONT THAT COUNTS**

Whether you are a subcontractor or a general contractor, the sole importance of a contract is to plan for contingencies, to make provisions for all those things that could go wrong or sour on the job, and to put down in writing what you expect you and the other party's performance and remedies to be under those adverse circumstances. The purpose of a written contract is to force you to plan ahead for everything that could go wrong on the job in order to make provisions to deal with and help you avoid expensive and time-consuming lawsuits.

That is why there is no one standard contract. There are so many different types of jobs, different owners, different working conditions, different financing arrangements, different architects, different general contractors, different usages and trade customs, different patterns of dealing between contractors and subcontractors, etc.

Contracts are **so** important. What you sign is what you live (or die) with.

#### **B. TERMS OF THE CONSTRUCTION CONTRACT**

You need a contract that is specially drafted for your business. Don't try to skimp. Avoid forms. You didn't marry your spouse through a mail order catalog, and you sure shouldn't base your business dealing on some form contract that was not prepared with **you** specifically in mind.

Drafting a contract is an art. Every lawyer has his or her own style, plus you do too. So, there is no standard form of contract for general contractors or specialty contractors. Recognize that. Don't try to save a nickel by forcing a square plug into a round hole. The following clauses are clauses which are essential for you to consider. They are listed in descending order of importance. For example, the singularly most important clause that you will ever have in your contract is a Disputes and Remedies clause, which is the number one clause which immediately follows.

There are several reasons to make your contract more readable (and grammar/spelling error free for that matter) and more user friendly. Contracts should be broken into paragraphs in a logical manner – not random sentences. Insert titles for each paragraph. Titles should be in bold face and capitalized. For contracts over four pages, consider using a table of contents. Use a page-numbering system that shows the total number of pages on each page, e.g. 1 of 5, 2 of 5, 3 of 5 etc.

### **1. Disputes and Remedies Problem**

Disputes invariably happen in construction work. The combination of there never being sufficient funding on projects, unavoidable changes and delays in the work, low or mistaken bids, and unrealistic expectations of owners/developers set the stage for constant litigation. No matter how good a craftsman you are, no matter how subservient you are to the owner's demand and whim, you are going to run into customers who cannot or will not pay for your work. Kick the dog, curse the fates, but it is not going to help. Somebody else has your money and it is up to you to get it. You are going to have to spend new money to get old money that is owed to you. You run the big risk of throwing good money after bad. And the key here is that the other side knows it. The other side knows that they have your money and that you're going to have to spend new money to get paid your old money. A lot of creditors give up at this stage. They feel that the prize is not worth the fight. In a lot of cases, they are right.

Courtroom litigation is a last resort. Can anybody really afford to pay a lawyer \$250.00 an hour? Even if your lawyer wins the case, it could be years before the litigation and appeal are over and by then you will have a judgment that is maybe not worth the paper it is written on because the debtor has fled or filed bankruptcy. Plus, you'll still have the legal bills. This is the dread of all creditor litigants.

The American rule is that in the absence of a contract or statute, each party is responsible for his or her own attorney fees. So, you can easily spend \$5,000 on a trial with or without appeal that gets you a \$6,000 or \$7,000 judgment which will net you \$1,000 or \$2,000, which doesn't begin to fairly compensate you (assuming the judgment is collectable) for your cost of the labor and materials, let alone begin to compensate you for the time that you spent with your lawyer and away from your business.

## **Solution**

Think ADR. Everybody else does. ADR stands for Alternative Dispute Resolution (ADR). You and your customer need to agree on a method of resolving disputes which is fair, fast and final. Above all, you and your customer need to stay out of court. **FAIR** – the dispute resolution procedure has to be fair – otherwise you will never get a customer to voluntarily agree to it. Plus, courts are reluctant to enforce contractual provisions which are obviously penalties to one party. So, the procedure has to work fairly for both parties. **FAST** – quick resolution prevents debtors from sticking their heads in the sand and avoiding the reality of the debt and their accountability for payment. When they know that the trial date is light years away—somewhere out the in la-la land, they know that they’re not going to have to face the proverbial music very soon. On the other hand, you will be amazed how serious people can get about paying bills that are truly due if their feet are to the fire and they know that they can only stall you for just so long. For bills that are in genuine dispute, the faster the dispute resolution procedure, the less opportunity or invitation there is for the debtor to conjure up phony back charges, offsets, counterclaims, etc. **FINAL** – you only want to go through it once. You don’t want to face endless appeals. One hearing—everybody says their piece. Then it’s over. Whatever the decision is, we all live with it. You also want to have a decision which can be immediately and inexpensively registered as a judgment which will have the full effect of law. You want an arbitration award which can be immediately converted into a judgment so that you can proceed against the debtor’s property through attachment or garnishment proceedings. Immediately, unless the bill is paid. **FEES** – you want the other party to pay your reasonable attorneys’ fees and court costs if you win. And, most important, you want that person or company to know he is going to have to pay those costs, in addition to the debt. Just a little something for that debtor to think twice about before he begins to feel too smug about hanging onto your money

## **Contract Clause**

You need a clause entitled “Disputes and Remedies.” You need a contract clause that accomplishes all of the above concerns. You do it by writing a clause that clearly spells out the rights and responsibilities of the parties regarding exactly what happens if a dispute arises, and how that dispute is going to be resolved. Under the law in many states, any standard agreement which provides for the recovery of attorney’s fees to one party, automatically affords the opportunity to the other party for similar recovery of attorney’s fees.

Therefore, if a contractor states in the construction agreement that the contractor will be entitled to attorneys’ fees in the event that the contractor prevails at arbitration, without saying anything more, Washington law presently concludes that the owner automatically has a similar right, regardless of the absence of such contractual language. That is why any contract clause dealing with disputes and remedies might as well go ahead and expressly state that it is for the benefit of both parties to the contract.

The contract clause dealing with disputes and remedies should have the heading "***Disputes and Remedies***," and should proceed along the following lines:

**1. *Dispute Resolution.*** Any dispute that cannot be resolved between the parties themselves, should be resolved in a forum that is the most efficient and economical. So, your dispute resolution clause should state that if any dispute arises between the parties, the parties will make a good faith effort to first resolve the dispute without resort to litigation. Your contract should state that as a condition precedent to any lawsuit, the customer must first present any claim in writing to the contractor and provide the contractor a reasonable opportunity to correct or complete any work which the customer claims to be defective and require correction or completion. If a dispute cannot be resolved between the parties, then your clause should state that either party may file suit in an appropriate court of jurisdiction.

**2. *Lien Enforcement.*** The arbitrator should have authority to determine the amount, validity and enforceability of a lien and your contract should expressly state this. Ordinarily, arbitrators may only award money judgments, so you will need a contract clause that goes the extra distance of authorizing the arbitrator to also determine the basis for equitable relief such as determining the validity and enforceability of a labor and materialman's lien. In that way, the arbitrator can handle a money claim as well as a lien claim, all in a single hearing and all with one decision. The court may then forthwith enter a decree of foreclosure based upon the arbitrator's award.

**3. *No Appeal.*** The parties should each waive their right to file any appeal for trial de novo in court and should agree to accept the arbitrator's award as final and binding, thus assuring cost-effective finality of any decision tendered.

**4. *Attorneys' Fees.*** Your Disputes and Remedies clause should state that in the event a dispute arises and either party seeks and receives legal counsel for which a fee is charged, the prevailing party should in all cases be awarded his or her reasonable attorneys' fees regardless of whether the dispute is resolved through settlement or arbitration. Your Disputes and Remedies clause may define prevailing party as the one party in whose favor a net monetary judgment is entered, after all offsets, counterclaims and backcharges have been considered and arbitrated. This may or may not be binding in a court. In the end, the court is vested with the absolute discretion as to the amount of attorneys' fees to be awarded. The court is bound by an attorneys' fees clause that mandatorily awards attorneys' fees to the prevailing party. But to the extent that a party prevails, and to the extent that the prevailing party's attorneys' fees are reasonable, the amount of the fee award is always within the discretion of the court.

Whether or not you recover your attorneys' fees should not depend upon whether a lawsuit is filed. If you incur attorneys' fees in resolving the case either through settlement or arbitration, you should be reimbursed for those attorneys' fees. Equally important, the debtor should know that if you have to go to a lawyer for legal assistance, the debtor is not only going to end up paying whatever was ultimately due on the bill, but also going to have to pay your attorneys' fees as

well.

How much of your attorneys' fees is the court going to make the other side pay? Do you get all of your attorneys' fees just because you ended up with the net monetary judgment in your favor? The answer is more than likely no. In Washington, the courts are increasingly drawn to the proportionality approach adopted in *Marassi v. Lau*, 71 Wash.App. 912 (1993).

**5. *Tenders of Payment and Offers of Settlement.*** In determining the party in whose favor a net monetary judgment is awarded, the arbitrator should not consider tenders or payment or offers of settlement made *after* suit has been filed. The situation you want to avoid is having the debtor come to his senses the day before the arbitration and try to make a payment to you in order to make it less likely that a net monetary judgment will be entered in your favor. Well, it's too little and too late. The debtor should have been making that payment long ago, so don't let him come in at the eleventh hour, make a payment and then make it less likely or harder for you to become the prevailing party, i.e. the party in whose favor a net monetary judgment is awarded after all backcharges, offsets and counterclaims have been arbitrated.

**6. *Precedence Over Other Laws and Rules.*** The Disputes and Remedies clause should expressly supersede all statutes and court rules dealing with the determination of prevailing party, offers of settlement, or offers of judgment and the award of attorneys' fees as expressed in your state.

**7. *Limitations on the Hearing.*** You might consider limiting the arbitration hearing to certain claims and to a certain amount of time to be allotted to each party. For example, you might consider a contractual clause that limits the arbitration to only eight (8) hours. The arbitrator would allocate time appropriately to each party. At least thirty (30) days before any scheduled mandatory arbitration hearing, each party would be required to prepare a complete description of its claim(s), attach a dollar amount of each claim, and forward these written claims to the other party. Within seven (7) days thereafter, each party could be required to prepare a complete response to the other party's claim(s), and forward that written response to the other party. Those claims and responses would then exclusively form the basis upon which the arbitrator would proceed at the time of any mandatory arbitration hearing. That would preclude and surprises. It would also set the stage for an award of attorney's fees. No other claims could be asserted, as they would be waived.

So, this is it. This Disputes and Remedies clause is the sole and exclusive procedure for resolving disputes. Isn't this great? Fair, fast and final fees. The debtor will and cannot string you out any more.

Remember, this clause works both ways. If you have been overpaid, or if you face legitimate backcharges, you are going to be facing a binding arbitration decision in short order, and you may not be the net prevailing party.

**8. Small Claims Court.** An optional clause is to provide that any claim under \$4,000 must be decided in Small Claims Court. This completely avoids the need for legal representation at a hearing because the parties cannot be represented by legal counsel in Small Claims Court. Judgments obtained in Small Claims Court can be readily transcribed into Superior Court where, once entered, they may be recorded with the county<sup>7</sup> auditor's office where, once recorded, these Small claims Court judgments have the effect of any other civil judgment in the state of Washington and becomes liens not only on all the real property owned by the debtor inside the county in which the judgment is registered, but also the personal property of the debtor as well. Once you get a Small claims Court judgment transcribed into Superior Court, you can typically garnish, attach, go after bank accounts, and do a lot of damage. Judgments often remain uncollected because they aren't pursued. If you pursue a judgment and get it transcribed into Superior Court, you have tools available to you to collect the money. Often you're entitled to recover your attorneys' fees for collection of a small claims court judgment.

**9. Time Limitation on Suit.** You can and should contractually limit the time within which your customer may file a lawsuit against you. The limitation should be conspicuously stated in the contract (italics, bold, colored ink, 10 point print etc.). The clause should state that any claim based on contract, tort, warranty or indemnification must be filed in a court of competent jurisdiction within four (4) months following expiration of the warranty (see section 4: Warranty).

**10. Venue.** In Washington law, if the parties to a contract agree to a certain county within which suit must be filed (i.e. venue), a court cannot permit the suit to be brought in any county other than the one agreed upon by the parties. Public policy strongly favors enforcement of forum selection clauses.

### **Summary**

In summary, a Disputes and Remedies clause will put energy and vitality into your accounts receivable. Your lender and your bookkeeper will have renewed interest in your business because they know (as you know) that if you have an account receivable problem with a debtor, the problem will be resolved fairly, fast, and finally within a very short period of time, and if you do prevail in the dispute, you will recover your attorney's fees. Equally important, the debtor will know this.

## **2. CORRECTION OF WORK**

### **Problem**

The problem here is that you are trying to finally get paid on the job, and the customer is holding back a final payment of \$8,500, when you really only have about \$300 worth of pickup work to do. But, the customer has leverage over you because the customer can beat you up with that \$8,500 retainage in order to get about \$4,000 worth of discounts and free work from you. You can find yourself in a no-win situation. The more pressure

you put on your customer, the longer the punch lists become and the more complaints are fabricated by the customer. On the other hand, if you just go back and silently acquiesce in all of this free work and discounts, you are giving up a big portion (if not all) of your profit on the job.

This is exactly what happens. If this has not happened to you, then you have led one charmed life. At the end of the project, the customer panics. The customer realizes that the party is soon coming to an end, and the customer believes that this is the customer's last chance to "get his money's worth" out of the contractor. In a worst-case scenario, the customer tells the contractor that the customer is going to get a second contractor to come out and look over the job and either price out what work remains to be done or finish up the remaining work and, of course, back charge you accordingly. So, this second contractor is going to come out and give a Cadillac bid for your Chevrolet job. Plus, once on the job, Mr. Cadillac will, you can be most sure, find about 35 zillion things wrong with your work that need to be corrected—at your expense. It is definitely certain time if there is going to be a second contractor coming out on your customer's job in order to look over your work for purposes of figuring out back charges. The second contractor is looking for work, he has a willing customer who is more than willing to spend whatever was left on your contract with the new contractor, and you will not be around to defend yourself.

Customers, just like anybody else, want to surround themselves with people who tell them what they want to hear. Wasn't that Nixon's problem? Your customer is going to find a sympathetic second contractor and then after about a four or five months of stall, the customer will hand you a pickup list that will simply blow your doors in. Plus, you will have wasted four or five months of being stalled and you're never likely to see your final payment.

A further problem is with multiple punch lists. You send your crew out to correct one punch list, and then after two or three weeks of delay and stalling, the customer then gives you another punch list, and then another, and then another. Not only is it uneconomical for your crews to keep coming back and doing punch list work on a piecemeal basis, but what is really happening is that the customer will keep having you come back and do free work until the customer feels good and satisfied that he or she "got his or her money's worth."

### **Solution**

You never want to be forced off the job. You will lose total control of the job and your customer if you leave, and you will totally lose your pocketbook. Don't leave! Don't let anybody finish up your work for a back-charge. That's the solution. If you made a mistake, you go back and correct it.

Let's write a contract clause that makes sure that if our customer is unhappy with our work, the customer's sole remedy is to have us fix it—not hire somebody else to either price out the corrections or fix it at our back-charged expense. Is there anything unfair about such a clause? Hardly. If we have not fully performed according to our contract, we

want the opportunity to correct or complete our work in order to fully comply with the terms of our contract. How could anybody object to that? If we made a mistake out on the job, we'll fix it. But we don't want to have somebody else fix it and then get back-charged.

Secondly, there should only be one punch list. You and the customer should carefully go through the work together. You and the customer should be given full opportunity to determine if there is anything incomplete or incorrect about the work. And then a single comprehensive list should be prepared and signed by the customer.

How can a property owner hire the services of a second contractor to complete your work without breaching to contract where the contract states that the homeowner cannot do this until and unless he has provided you a punch list and a reasonable opportunity to perform the work on the punch list? The answer is, the owner can't back charge you the costs incurred by the second contractor, unless (of course) the owner gave you the punch list and a reasonable opportunity to correct the work on the punch list and you refused to do so (which you would not likely refuse to do).

A good correction of work clause will place the owner in breach of contract unless the owner provides a punch list to the builder together with a reasonable opportunity to the builder to correct or complete the work identified on the punch list. The owner's failure will likely constitute a material breach, and then the cost to correct or complete the work is the cost to the initial or original builder to correct or complete the work, rather than a second or alternative builder (who is always more expensive). This correction of work clause will likely restrain a thoughtful owner from terminating your contract and hiring an expensive alternative contractor to complete the work because the difference between your cost and the second builder's cost is going to come right out of the owner's pocket.

### **Contract Clause**

You need a clause entitled "Correction of Work." You need a clause that accomplishes all of the above concerns about multiple pickup lists and back charges. You do it by writing a clause that clearly spells out the customer's responsibility to identify defective or incomplete work on a single punch list and then provide you, the contractor, a reasonable opportunity to correct or complete the work identified on the customer's list. The contract clause dealing with correction of work should proceed along the following lines:

- 1. Punch List.** Prior to making a final payment to the contractor, the customer may inspect the work to determine that the work has been completed according to the contract. The customer may prepare a written list of work that the customer believes should be completed or corrected according to the contract. This written list is called a punch list and it usually is prepared at the time that final payment is applied for by the contractor. The reasonableness of a contractor asking for a punch list can hardly be disputed. In some states, contractors are entitled to a punch list as a matter of law. For example, in *Tentinger v. McPheters*, 977 P.2d 234 (1999) the Idaho Court of Appeals ruled that a project owner's intentional

failure to provide a contractor with a punch list of defective or incomplete work waived the owner's right to hold the contractor responsible for deficiencies. In the *Tenting* case, Steven McPheters, a real estate developer and home builder, awarded a painting contract to Terry Tentinger, doing business as New Horizon Construction. The contractor was priced on a time-and-materials basis.

McPheters was apparently dissatisfied with the quality of the painting work, but never expressed these concerns to Tentinger. When the contractor submitted a final invoice, the owner questioned the number of hours that had been billed and refused to make payment. Tentinger filed a mechanic's lien on the property. McPheters counterclaimed for the cost of correcting the allegedly defective work.

Tentinger said that neither McPheters nor any of his employees ever expressed any dissatisfaction with the painting work. Tentinger contended that if McPheters had provided a punch list of work items that required attention, Tentinger would have gladly addressed those items. But the first time Tentinger learned of the alleged problems was in response to the mechanic's lien.

McPheters responded that "it's not common for us to give painters punch lists". McPheters argued that there is no industry or trade custom requiring a punch list. And McPheters did not raise the topic of defective workmanship because he did not think Tentinger would be responsive.

The Court of Appeals of Idaho ruled that it is customary for project owners to provide contractors with a list of incomplete or defective work items. A project owner cannot choose to remain silent and then use dissatisfaction with the workmanship as a defense to a payment claim or mechanic's lien. McPheters had waived that right.

**2. *Single Punch List.*** There should be only one punch list of work, identifying work to be completed or corrected, and the list should be signed by the customer. This clause emphasizes that we are not going to get into a scenario of multiple punch lists or oral punch lists. A punch list has to be in writing and there will be only one punch list which must be given to the contractor. In that way, you will not run the risk of your customer's telling a judge or arbitrator down the line that "I told the contractor this" or "I told the contractor that." Everything has to be in writing, and it all has to be on a single written punch list.

**3. *Completion of Punch List Work by Contractor.*** The contract should state that the contractor shall expeditiously complete all work stated on the punch list for which the contractor is responsible under the terms of the contract. This clause protects the contractor from customers who come up with punch lists that would have the contractor perform all sorts of work not covered under the scope or terms of the contractor's agreement with the customer. This clause does not say that the contractor is obligated to correct everything on the punch list. The clause simply says that the contractor is obligated to correct all work stated on the punch list for

which the contractor is *responsible* under the terms of the contract. The contract should then go on to state that following completion of work on this single punch list, all further work shall be performed as warranty work.

**4. *First Opportunity to Correct Work.*** Your contract should state that the customer cannot contract with any alternative contractor for the performance or completion of work, nor claim a credit or back charge for the cost of completing any item stated on the written punch list, nor occupy or use the contractor's work until and unless the contractor shall have first been given reasonable notice and opportunity to correct the work stated on the punch list. This is the clause that you want. You want a clause that keeps the customer from using your work, keeps the customer from trying to back charge you, and keeps the customer from having someone else come in and finish up your work without your first having been given the opportunity to be presented with a single punch list and be further given the opportunity to correct the work on the punch list which is your responsibility. This is exactly what you need. Also, it is exactly what the customer needs. What could possibly be said to be unfair about a clause that requires the customer to first give you the opportunity to correct your own work? If you do not come back to correct the customer's work and make things right, the customer is free as the wind to contract with some other person to finish your work and back charge you to death. But *first* you have to be given the opportunity to correct your own work.

**5. *Customer's Penalty for Failure to Provide Opportunity.*** Your contract should go on to state that if the customer does contract with an alternate contractor to perform the pickup work or otherwise complete the project without first affording the opportunity to the contractor to do so, or if the customer commences to use or occupy the space or work in which the contractor performed work, the customer then agrees to accept all work "as is" and thereby waives any claim against the contractor. This clause will make your customer think twice about having another contractor come in to your work and "look things over" and will certainly make your customer think twice about tossing you off the job and having "a real contractor" come in to complete your work, because if he does this he then accepts your work "as is" the moment that he has someone come in and correct or complete work, without having given you the notice and opportunity to correct the defective work yourself.

**6. *Payment of Retainage.*** Your contract should finally state that upon the contractor's completion or correction of the work identified on the single written punch list, any retainage or amount withheld from final payment shall be paid within the next three days to the contractor. All further work shall be performed as warranty work. Once you correct the work on the punch list, you get paid within three days. That's pretty fair. Any further work has to be performed as warranty work, which is defined and covered separately under the terms of your contract with the customer.

**7. Affirmative Defenses.** Some states now provide for certain affirmative defenses to builders. Affirmative defenses are legal responses a defendant makes to a plaintiff's claim, so even if the plaintiff's claim is true (the windows are leaking), the affirmative defense (the homeowner failed to annually caulk the windows) prevents the claim from being successfully asserted. Such law often identifies specific affirmative defenses which may be asserted by a builder., In Washington, the law identifies the following seven affirmative defenses which may be asserted by a builder:

- (1) If it is caused by an unforeseen act of nature that prevented compliance with codes, regulations or ordinances. "Act of nature" includes weather, earthquake, war, terrorism, or vandalism.
- (2) If it is caused by a homeowner's unreasonable failure to minimize damages.
- (3) If it is caused by the homeowner's substantial failure to follow written maintenance recommendations.
- (4) If it is caused by the homeowner's alteration, misuse, abuse, or neglect.
- (5) If the builder obtained a release for the violation.
- (6) If the builder has repaired the violation or defect.
- (7) If the construction defect lawsuit is not brought within six years of substantial completion of the house.

In order to take advantage of affirmative defenses regarding the homeowner's failure to follow a maintenance schedule, the law often requires that you give the buyer a notice of the schedule. You should include reference to the schedule in your signed contract or sale documents. You should also have the buyer or customer acknowledge in writing that he or she has received, reviewed, and accepted the maintenance schedule. Your maintenance schedule must be realistic, reasonable, and based on common sense. Your maintenance manual should reflect commonly accepted maintenance practices which do not unduly burden the homeowner.

**8. Recovery of Attorneys' fees from Contractor's Registration Bond.** The general rule regarding payment of attorney fees, commonly referred to as the "American rule", requires that each party in a civil action remain solely responsible for paying its own attorneys fees and costs, regardless of who wins or loses. This general rule can only be modified by a contract, a statute, or a recognized ground in equity.

Historically, courts deciding cases involving a claim against a contractor's registration bond have allowed the successful claimant to recover its attorney fees against the contractor, without being limited by the (all too) finite dollar amount of the bond. However in 2006, the Supreme Court of Washington ruled that a bond claimant's recovery of attorney fees is limited to the amount of the contractor's bond. The name of this case was *Cosmopolitan Engineering Group v. Ondeo Degremont*, 159 Wash.2d 292 (2006). The holding of *Cosmopolitan* means that now the maximum dollar amount a bond claimant can recover *as far as attorney fees are concerned* in Washington, is whatever is available for collection of the contractor's bond. In the past, courts had allowed the successful claimant to recover its attorney fees from the contractor *in addition to its bond*. Not so anymore. Each state will have common law or statutory rules for recovering attorneys' fees from a contractor's registration bond and its important to know how your state will rule in such situations.

### **Optional Clause**

An optional or alternative clause is to state that the customer may withhold a sum of money from final payment equal to the customer's estimated cost of completing or correcting the work stated on the punch list. This, of course, will make the customer happy because he or she will beef up the estimate to be on the "safe side". But, then they'll have to think twice when they continue to read in the contract that the contract requires them to deposit a dollar amount equal to the withholding in a joint interest-bearing account within seven (7) days of your written demand for the customer to do so; otherwise, the customer waives any right to claim against the contractor to complete or correct the work stated on the punch list and agrees to pay the full balance due on the final invoice without offset or deduction for work stated on the punch list. The language in the contract should be stated in terms of "conditions precedent" and "absolute waiver".

You should also consider a clause that states that the customer grants the contractor the irrevocable right to photograph and/or video the project during and after completion of the project for purposes of amending the work, portfolio presentation, and publication. You might consider a more expanded version of the "right to photograph work" term by inserting the following language:

In the unlikely event that the Customer remains unsatisfied with the Contractor's work after providing the Contractor with access and opportunity to correct and complete the Contractor's work as stated above, and the Customer chooses to hire a third party to correct or complete the Contractor's work, the Customer shall first provide Contractor with a written notice and reasonable opportunity for the Contractor to take pictures of the Contractor's work at the job site prior to a third party correcting or completing the Contractor's work. Otherwise, any disagreement between the Customer and the Contractor as to the state of the Contractor's work when the Contractor's services were terminated shall be resolved in favor of the Contractor and the Customer shall be deemed to have accepted all of the Contractor's work "AS IS" and waives any claim against the contractor for the Customer's cost to correct and complete the work.

Where you are installing goods, but the primary purpose of your work is to install a product such as a hot water heater, a furnace, a hot tub etc., you should consider a clause that states that the customer failure to state in connection with rejection in a particular defect which is ascertainable by reasonable inspection precludes the customer from relying on the unstated defect to justify rejection or to establish breach where you (i.e. the contractor) could have cured the defect had the defect been stated seasonably. This is language found in the Uniform Commercial Code and is likely codified in your state's statutes.

### **Summary**

In summary, a proper *Correction of Work* clause will guard you well against the scenario of a neighbor or "friendly contractor" whispering in your customer's ear and causing a rift between you and your customer that can oftentimes result in your customer's withholding final payment from you based upon multiple punch lists (or is that "wish lists"?) at the end of the job. You need this Correction of Work clause.

As in all contract clauses, the question we should ask ourselves is this: "Is this clause going to protect the contractor, while at the same time being fair to the customer?" A good Correction of Work clause will fill the bill!

## **3. WARRANTY**

### **Problem**

Beyond the common issue of limiting your time exposure to having go to back to the property and correct defective work, you need a clause that defines warranty work. Even if you say there is no warranty given at all, the customer may still sue you up to six years down the road for breach of contract. For example, the bathroom fan malfunctions. The fan was in perfect working order when you left the job, and it was installed correctly. But the fan has simply burned out. The customer claims that this is just not a warranty item. Rather, you breached your contract because you did not install the fan that was specified or instead installed a fan that was inadequate for the purpose intended. The right fan would not have burned out at the end of four years. The useful life of a bathroom fan is 20 years (at least that is what your customer would say). Other examples come to mind such as hardwood floors that begin to cup, lazy susans that disintegrate, siding that starts to come apart, a roof that leaks, decks that sag, concrete that cracks, countertops that bubble, insulated glass that fogs up, etc. Is this warranty work or is this just plain failure to perform the work correctly in the first place? So, you need to be clear about this. You need to specifically identify what is warranty work and what is original scope of work.

A further problem is the scope of your warranty. Are you going to warrant everything? Are you going to warrant windows, appliances, furnaces, service panels and other products that are simply supplied by outside suppliers or manufacturers? You should be willing to warrant your labor to the extent that you install these products correctly, but you need to think twice about whether or not you want to warrant roofing materials, garbage door openers, etc. Another problem with warranties is figuring out the date from which the warranty will run and when it will expire. Exactly when are you "done," "finished," "completed," etc.? What do these words mean? You need a warranty clause that objectively measures the specific date beyond which the warranty will no longer be

in effect. If you simply say the warranty runs from one year beyond the date of completion, then the issue is whether or not the job can really be considered complete when some of the work was installed incorrectly and you were now being called back to correct that work.

You can be drawn into a case, not by your customer, but by your customer's customer. For example, if you're doing the work for a general contractor who gets sued by his customer, the general contractor may (and naturally would) bring you into the case for the purpose of reimbursing the general contractor in the event that the general contractor has to pay any damages to the general contractor's customer (the owner) based upon your defective or uncompleted work. So, you want to address this in your warranty to the general contractor (a customer with whom you do have privity of contract). You want to tell the general contractor that you warrant your work for only a certain period of time, and any claim against you or your company based upon the warranty of the subcontract, including any claim of indemnification, must be filed within a certain period of time or date when the general contractor first paid its own customer for damages based on your work.

### **Solution**

The solution is as obvious as the problem. The solution is to write your own warranty for a defined period of time, and disclaim any further liability or responsibility to the customer. The law in most states clearly permits this. If the law in your state allows you to write your own warranty, you should write a strong and fair warranty in favor of your customer, one that will guarantee that if anything goes wrong with your work within a certain period after you sign the contract with the customer, you will come back to the customer's property and repair or replace the work at no cost to the customer. You need to be careful about whether you are warranting product or labor (or a combination of both), and you need to be careful about excluding all the other available warranties and liabilities available to customers in your state. If you want to make your warranty run for a period of one year or two years or three years or four years or fifty years, you can do it.

In some states, you can even give no warranty at all. You can sell a house or complete and turn over a remodel "as is". In a Washington case, *Warner v. Design and Build Homes*, 128 Wash. App. 34 (2005), the Court of Appeals dismissed the homeowner's lawsuit against the contractor after the Court of Appeals found that the contractor had sold the house "as is".

In March 1999, the Warners entered into a purchase and sale agreement with Design and Build Homes for the sale of a new home. The agreement, drafted by the Warners' real estate agent, included a clause stating that the Warners had inspected the property and agreed to purchase the property "in its present 'as is' condition." An addendum to the agreement also stated that the sale was conditioned on the Warners' approval of a general building inspection report. The addendum provided that the Warners could decline to purchase "on the basis of any condition identified in the inspection report that the inspector recommends be corrected". If the inspector recommended further evaluation of the home by a specialist, then the addendum gave the Warners additional time to

complete this further evaluation. The addendum also gave Design and Build Homes the option to preserve the contract for sale by correcting any condition disapproved by the Warners.

The Warners had the home inspected. The inspection report contained the following findings and recommendations: (1) “exterior wall cracks” and “bulging in the stucco” on the rear wall, which “should be further evaluated to verify that a problem does not exist, and what correction is needed to repair/seal the cracks”; (2) “evidence of past water in the crawl space at the north wall,” which should be monitored; and (3) the “flashing at the front wall... should be checked, due to the potential of water leaking into the stucco.” The inspection report recommended that a certified professional engineer complete a further evaluation “where there are structural concerns about the building” because “[a]ssessing the structural integrity of a building is beyond the scope of a typical home inspection.”

The Warners declined to have a further evaluation completed, but they did request that Design and Build Homes repair certain conditions identified in the inspection report. These conditions included the exterior wall cracks and defects in the flashing and stucco. After these conditions were repaired, the Warners completed a walk-through inspection and closed the sale of the property.

In September 2001, the Warners began noticing leaks and water damage inside the home. They hired a professional stucco consultant who concluded that the water intrusion was due to defective stucco installation. The Warners also hired an industrial hygienist to evaluate mold contamination in the interior of the home. The hygienist concluded that the water intrusion had led to a significant presence of “several potentially toxic species of airborne fungi” throughout the house.

The Warners moved out of the home when it became apparent that Ana Warner and the Warner children were having allergic reactions to the mold. The Warners then hired an engineer and construction company to repair and replace the exterior siding as well as damaged structural components. The engineer eventually concluded that “substantial water intrusion [had]... resulted in substantial rot and fungal growth” which has caused “structural damage to the sheathing and framing components of the Residence.” The engineer opined that if the water intrusion, rot, and fungus had been allowed to continue, the home would have collapsed within a reasonably foreseeable period.

In November 2001, the Warners sued Design and Build Homes and the siding subcontractor. Design and Build Homes had subcontracted for the installation of the stucco siding. The Warners alleged that Design and Build Homes had breached the implied warranty of habitability.

The Court of Appeals concluded that “as is” was plain enough English and the buyers (Warners) were bound. The Court of Appeals held as follows:

An “as is” clause means that the buyer is purchasing property in its present state or condition. **Olmsted v. Mulder**, 72 Wn. App. 169 (1993). “The term [“as is”] implies that the property is taken with whatever faults it may possess and that the seller or lessor is released of any obligation to reimburse the purchaser for losses or damages that result from the condition of the property.” **Olmsted**, 72 Wn. App. At 176. Because a warranty disclaimer is not favored in the law, it must meet two conditions to be effective: (1) it must be explicitly negotiated or bargained for; and (2) it must set forth with particularity what is being disclaimed. **Pugent Sound Fin., L.L.C. v. Unisearch, Inc.**, 146 Wn.2d 428, 47 P.3d 940 (2002). An “as is” clause is generally inserted in a contract by the seller and the negotiation and particularity requirements are designed to protect a buyer who, not being in a position of equal bargaining power, is forced into signing a contract prepared by the seller that may contain fine print and boilerplate language. **Olmsted**, 72 Wn. App. At 176; **Lyll v. DeYoung**, 42 Wn. App. 252, 257, 771 P.2d 356 (1985), **review denied**, 105 Wn.2d 1009 (1986).

Here, the Warners do not assert that they were either unaware of the “as is” clause or in a position of bargaining power which was grossly disproportionate to Design; either contention would be undercut by the fact that the Warners’ real estate agent drafted the purchase and sale agreement. As such, the “negotiation” element is satisfied. **See Olmsted**, 72 Wn. App. At 176-77; **Miller v. Badgley**, 51 Wn. App. 285, 294, 753 P.2d 530, **review denied**, 111 Wn.2d 1007 (1988). But the Warners maintain that the “as is” clause is ambiguous and, therefore, ineffective and unenforceable, because it does not explicitly state the warranties being disclaimed. We disagree.

“[U]nless the circumstances indicate otherwise, all implied warranties are excluded by expressions like ‘as is,’ ‘with all faults’ or other language which in common understanding calls the buyer’s attention to the exclusion of warranties and makes plain that there is no implied warranty.” RCW 62A.2-316(3)(a) (emphasis added); **see also Ltd. Flying Club, Inc. v. Wood**, 632 F.2d 51, 56 (8<sup>th</sup> Cir. 1980) (“It is fairly clear that [“as is”]... operates to disclaim implied warranties.”). As the just quoted language indicates, an “as is” clause is unambiguous: the seller makes no warranties regarding the item sold. It is thus unnecessary to list warranties, none of which are being made.

Inexplicably, the Warners’ agent drafted an agreement containing an “as is” clause which a reasonable person would understand to waive all implied warranties, including the warranty of habitability. Moreover, before the agreement became binding, the Warners were told about existing defects in the stucco and were advised that they should pursue further inspection and evaluation of potential nonvisible stucco and structural deficiencies. The Warners chose not to pursue these further inspections. As our Supreme Court has stated: “They had ample opportunity to inspect. They had their own [real estate agent and inspector]. The extent to which they inspected... was their choice. The contractual language is clear. This court not only should not, but it cannot, rewrite the clear agreement of the parties.” **Frickel v. Sunnyside Enters., Inc.**, 106 Wn.2d 714, 721, 725 P.2d 422 (1986). The trial court did not err in giving effect to the Warners’ “as is” clause by granting Design and Omega summary judgment.

If you are going to use the “as is” language as a means of limiting your liability and risk, make sure you verify such a limitation is allowed in your state. Also be wary of any conditions to using such language, as often the “as is” language will not work with regard to the sale of new condominiums and, in all events, should be accompanied with a conspicuous disclaimer.

### **Contract Clause**

Your warranty clause needs to address the above-stated problems in a comprehensive manner and on a basis which is fair to the customer. The customer needs to be provided with a warranty that is commercially reasonable. On the other hand, you need to limit your liability in the warranty as follows:

**1. *Scope of Warranty.*** The contractor should warrant that all work will be performed in a commercially expeditious manner and all work will be performed to industry standards. If your company uses a private insurance/warranty program, state that in your contract.

**2. *Manufactured Products.*** The contractor should state that products supplied by suppliers, manufacturers and subcontractors to the project are warranted only to the extent that the suppliers or manufacturers of those products provide a warranty. In the event that a defect is discovered in one of these products, the contractor should warrant to the customer that the contractor will assist the customer in securing repair or replacement of these products under the warranty provided by the supplier or manufacturer. So, if the double insulated windows start fogging in between the panes of glass, the contractor is not going to have to come back four years later and replace all of the glass windows in the house at his own expense. Rather, the contractor will come back within the warranty period and assist the customer in contacting the manufacturer or supplier of those windows and getting some replacement windows. As long as the problem with the windows did not have to do with the installation work or labor of a contractor, the contractor's only involvement on this aspect of the warranty would be to assist the customer in getting through to the supplier or manufacturer of the windows so that the supplier or manufacturer could come on out and repair or replace the windows.

**3. *Define "Warranty" Work.*** Your warranty clause should define warranty work to mean work that was initially performed correctly and completely done, but becomes non-operational or dysfunctional within the warranty period.

**4. *Period of Warranty.*** The warranty should be for a period of so many months or years from the date of the contract and thereafter expires. For example, if you are doing remodeling or building a new house, you should say that the warranty is for a period of 18 months from the date of the contract. In that way, you know exactly when the warranty will expire. If you say that the warranty is going to run for a period of one year following the date of “completion,” you will never know when the warranty is done because you will never be able to come to an agreement with the unhappy customer as to the “date of completion”. How can

you say a project is “done” when you have left all sorts of defective work on the project (as the customer would claim)? An alternative is to say 12 months from the date of first occupancy, usage, or the signing off on the building permit, or issuance of a certificate of occupancy.

Consider not tying the warranty expiration date to any event (e.g. sign off on building permit) at all. Just give a date. In the contract, just say the warranty expires on a certain date. Don’t call the warranty a “one year warranty” or similar, period. Just say that you warrant your work against failure until a certain date.

Also, consider an extended warranty period for structural defects or seismic integrity.

**5. *Time for Filing a Warranty Claim.*** The warranty should state that any claim or cause of action arising out of tort or out of the terms of the contract, including the warranty, and any claim for indemnification must be filed in a court of competent jurisdiction within a certain period of time (e.g. 4 months) following expiration of the warranty period. This clause should then go on to state that any cause of action based upon breach of contract, tort, warranty or indemnification which is not filed within this period of time is waived. In this way, you will only have to look over your shoulder for a period of four (4) months following expiration of the warranty. It is not enough to just limit your warranty. Warranty claims are in addition to breach of contract claims. So, even if your customer accepts a tailgate warranty (“as is”), the customer could still sue you for breach of contract or misrepresentation or indemnification. That is why it is so important to limit all claims to four (4) months following expiration of the warranty.

Include a provision in your warranty clause that states that any claim asserted under the warranty or the terms of the Agreement is expressly limited to claim(s) made in writing and sent to the contractor during the warranty period. Go on to say that the choice between repair or replacement is solely that of the contractor, and that the contractor must be provided the first opportunity to perform any warranty work, otherwise the owner’s claim(s) is waived.

**6. *Contractor's Responsibility Under Warranty.*** The contractor should warrant that it will perform all necessary labor to repair or replace all defective work at no cost to the customer, and will expeditiously act in good faith to secure replacement product under warranty of others, as stated above. This is a fair obligation to be imposed on the contractor. If something goes wrong on the house within the warranty period, you need to go back to the house or the commercial building and fix your work at no cost to the customer.

**7. *Warranty Should be Nontransferable.*** The general rule is that contracts are assignable, unless assignment is expressly prohibited by statute, contract, or is in contravention of public policy. To avoid application of this default rule

permitting transfer, your warranty should state that it is nontransferable, thus limiting your exposure to unknown third parties. A word of caution is in order here. Although courts generally will enforce clauses in contracts prohibiting transfer or assignment, they are reluctant to do so. If the contract simply says that it is nontransferable, a court may interpret that as meaning that the right to compel performance is not transferable, but the right to sue for breach is transferable.

**8. *No Extension of Warranty Period.*** The warranty clause should state that any warranty work performed by the contractor does not extend the warranty period any further.

**9. *Voiding Warranty if Others Correct the Work.*** The warranty needs to state that if a person or company other than the contractor performs or re-performs any work within the scope of your contract, then the contractor shall be relieved of its obligations under the warranty and the customer shall be deemed to have waived the benefits of the warranty.

**10. *Some Express Exclusions.*** Sometimes you may want to state in your warranty clause that certain work is *not* warranted. The following are some examples of work which you may want to specifically exclude from your warranty:

- Concrete or mortar cracks caused by normal expansion and contraction that do not substantially impair structural elements.
- Cracking in the brick facing, both inside (if fireplace is bricked) and outside which does not affect the safety or use of the facing or fireplace. Discolorations due to the elements, rain runoff, weathering, leaching or salts, or bleaching.
- Floor squeaks not brought to the Contractor's attention in writing within the warranty period. Misuse or overloading of structure by Customer negates
- Contractor's obligations under this clause. Floors are either nailed, stapled, screwed or glued in a special manner to try to eliminate squeaking. Customer should be aware, however, that it is virtually impossible to "squeak-proof" a wood floored structure.
- Warpage, cupping or shrinking of hardwood floors. Hardwood floors are beautiful but have drawbacks. One drawback of hardwood flooring is the possibility of warpage, cupping, or shrinkage. A moisture variation of as little as 2% may warp or cup hardwood flooring. Contractor will be responsible for hardwood floors until occupancy. Customer will assume responsibility for any warping or cupping not stated on the punch list. Specifically excluded from any warranty coverage is any hardwood flooring in the kitchen or bathroom(s). In using real wood, there will be variations in color, grain and texture.
- Mold is inevitable in the Pacific Northwest. Contractor warrants that all construction shall conform to industry standards and applicable

building codes. We do not warrant against mold.

- Cracks and nail pops in the sheetrock caused by normal shrinkage and settling appearing after one year. Sheetrock or drywall will sometimes develop nail pops or settlement cracks. These nail pops or settlement cracks are a normal part of the settlement process. These items can easily be handled by Customer with spackling during the normal redecorating. However, if the Customer wishes, at twelve (12) months Contractor will send a worker to do the spackling. Contractor repairs will not include repainting.
- Warpage of doors due to temperature differential or temperature changes unless the doors become inoperable or cease to be weather resistant.
- Discoloration and erosion of tile grout.
- Expansion and contraction of the siding. The Customer should be aware that siding does change dimension with changing weather conditions, swelling in wet weather and shrinking in dry. Furthermore, the siding may shrink vertically to expose thin, unpainted siding below the butt of the beveled siding, a condition for which Contractor offers no warranty.
- Cracking of wood. Wood will sometimes crack, check, or “spread apart” because of the drying out process. This condition is most often caused by the heat inside of the house or exposure to the sun on the outside of the house. This may show up, and the Customer is responsible for any resulting maintenance or repairs.
- Cracking or bleeding of caulking. Exterior caulking and interior caulking in bath tubs, shower stalls, ceramic tile surfaces, and countertops will crack or bleed somewhat in the months following installation. These conditions are normal and should not be considered a problem. Maintenance or repairs of them are the Customer’s responsibility.
- Variation in stain. All items that are stained will normally have a variation of colors because of the different texture and species of the woods.
- Because of weather changes, doors that have panels will sometimes dry out and leave a small space of bare wood. These normal conditions are not considered defects.
- Exterior. This warranty does not cover landscaping, grading, bulkheads, earth movement, or instability of soil or earth, or freezing of hose bib outlets, warpage of exterior French doors or store doors.
- Interior. This warranty does not cover adjustments to pocket doors or shower doors.
- Manufactured Products and Appliances. This warranty does not cover appliances, fixtures, or manufactured products. Customer must rely on the manufacturer’s warranty. Most warranties by manufacturers provide that the end-user is a beneficiary of its warranty, then the Contractor shall provide to the Customer any warranty from that manufacturer, if any, of which the Contractor is a beneficiary, but only to that extent.

#### 4. CHANGE ORDERS

##### **Problem**

The problem is that people kid themselves into wanting or designing a project that they can barely, if ever, afford. They have some architect or designer draw plans for something they cannot possibly afford, and then they have to go through a downsizing and redesign phase where they end up reducing the quality and scope of work so that it can meet their budget, but the dream still lingers on. So the contractor comes on the scene and bases his contract on the bare bones drawings. But, because the dream still lingers on, the customer wants all the bells and whistles added back on – those same bells and whistles that the architect or designer took out of the plans so that the customer's budget could be met. People simply want more than they can afford.

Beyond the matter of affordability, people think that if they could just have “this” or “that” then their dream will be fulfilled, their friends will be impressed, their marriage restored, their elder years will be full of bliss, etc. If that is not enough, then there are problems with vague drawings, miscommunications with the customer, the architect, building codes, inspectors, etc. and all of this results in change orders. Change orders should be put in writing, but they are usually not. Then, the customer later remembers something else. You end up in some huge argument about what was said regarding modification of the work, the cost of the modification, etc. It all gets down to who said what to whom. The arbitrator or judge has to believe one side over the other. Too often than not it is just a matter of who is the best witness.

There are always change orders on a job. There are change orders because owners kid themselves into believing that they will be able to afford just a little bit extra, and they get all caught up in the excitement of new construction and they become unsatisfied with the original plans. They simply want more, and kid themselves into thinking that they will somehow find a way to afford it.

Oftentimes, a customer talks to your lead carpenter (or worse yet) your recently hired summer laborer, who then tells your customer that an upgrade from standard interior doors to raised six-panel oak doors should ballpark at, say \$50 per door extra. You don't even find out about this change order until the following month after you are looking over the project's invoices. By then, the doors have already been delivered and installed. Naturally, there was nothing in writing so then there is some big flap over who said what to whom, and whether or not you are stuck with a \$50 upcharge per door, when the actual upcharge cost you \$250 a door.

On another tangent, customers tend to consider the general contractor as their own private gofer, or their own private (i.e. free) interior designer, architect, chief estimator, sounding board, etc. So the owner has the general contractor running all over the place pricing out this or pricing out that, determining the feasibility of this or that, running Mrs. Sawtooth down to Miller's Interiors for the zillionth time for tile selection, etc. You simply can't afford to be running all over town for the owner trying to work up this or that price – especially when the owner tells you in the end that they just can't afford it, but thanks anyhow.

Change orders invariably increase the time that the project is going to take. They increase the time because they throw all the work out of the sequence, long lead times cannot be easily accommodated, and it simply takes a lot of time to work up a change order during the middle of a project, when you have lots of other things to do to keep the basic project moving forward. Then, when the project falls behind the original schedule, the owners start climbing down the general contractor's neck because the owners are paying interest on their construction loan and they want the project finished yesterday. Does all this sound very familiar?

As if this weren't enough, there is the basic problem of just being able to collect payment for a change order. Where the eyes have grown bigger than the budget, the customers just simply run out of money and oftentimes getting paid for a change order is pretty hard. In the end, owners convince themselves that you owed them that darn extra as a freebie because you already made so much money, on your padded original bid.

The pricing of change orders (that have not been put in writing) presents a whole series of problems in itself. Since the change order was not in writing, there was nothing down to show a judge or arbitrator how the price was figured or agreed upon. You will get a contractor who says that he charges "cost plus 25 percent" on a change order, but that begs the whole question of what is "cost." That starts a never ending grand jury investigation into the contractor's costs such as FICA, workmen's compensation, social security, vacation benefits, etc., etc. You may spend more time and money trying to put the paperwork together to defend your "cost claim" than the claim could sometimes be worth. When you start defining your entitlement in terms of "cost plus something," you are opening an awesome Pandora's Box concerning the issue of what is the contractor's "cost."

Then again, you will run into the customer who agrees that a change order was supposed to be paid for on a cost-plus basis or a time and material basis, but the same customer then launches into an argument that he is being charged too much because you had a carpenter doing work that could have been done by a laborer, or you had your project superintendent make a trip to the yard to pick up something and you should have had the laborer do it.

Overall, the moral or theoretical problem with change orders is that the contractor has the last chance, or the best opportunity, to put it down in writing. He is in the contracting business. The owner is not. So, arbitrators and courts mentally or emotionally put the burden on the contractor, because he is in the business of contracting and he "should know better" than to proceed on the basis of an unwritten change order. If there is a misunderstanding over the scope or price of extra work, well that is more contractor's fault than the owner's fault because the contractor had the final and last say or control over whether or not to even begin to lift his little finger to do the change order without it having been reduced to assigned writing. The contractor is just in the best position to say "I don't want to perform a change order unless everyone is agreed to it in writing." The contractor controls the paperwork and he controls the performance of the work so the burden, more often than not, gets placed on the contractor regarding unwritten change

orders.

And, that is the way it *should* be. The contractor should not begin to perform work outside the original scope and price unless the extra price and effect on completion date has been agreed to in writing by the customer. Appendix 1 of the Coursebook is a good change order form. You should use it lavishly for each project change order. On a project-by-project basis, each change order should be serially numbered, commencing with the number one. Every day, as the project progresses, changes should be documented in your notes, your foreman's notes, etc. From there, change orders should be immediately prepared on Appendix No. 1, and presented to the owner for signature. Some change orders may not involve a change in price. Others may. Always be aware of the effect of the change order on the project time. Really, the ball is in your court.

### **Solution**

The solution is to have a concisely drafted change order clause which addresses and resolves each of the above problems in plain English. It does not do any good to print the change order clause on the change order form itself because the problem with change orders, as discussed above, is that change orders are rarely put in writing and signed by the parties. The change order clause is a key component of your contract, whether or not you are a subcontractor, remodeler or builder of custom homes.

Your change order clause needs to be flexible in terms of hourly rates, timing of payment, etc. Each customer and project is a little bit different, and so you need a change order clause which allows you some flexibility on a contract-by-contract basis. This is accomplished by leaving blanks or spaces in your change order clause to fill in on a project-by-project basis.

In the end, you really need an "attitude" regarding change orders. The attitude is one of immediate recognition and presentation to your customer of any change order, using either Appendix No. 1 or Appendix No. 2, depending on the whether your contract is fixed price (Appendix 1) or time and materials (Appendix 2). You have to own up to your responsibility to remove as much uncertainty and gray area from the project as possible. You do this by having written change orders on the project. The contract clause dealing with change orders serves as a good backup for those occasions where you failed to recognize and immediately present the written change order to the customer. It is good backup. Not a *substitute*.

### **Contract Clause**

Your contract clause should set out the rights and responsibilities of you and your customer regarding the handling of change orders. Because change orders are such a *major* source of conflict on construction projects, you need to spend some time and space in the contract devoted to the handling of change orders. You should consider inserting some of the following clauses into your contract.

- 1. *Obligation to Perform Change Order Work.*** You should only allow the customer to request modifications in the work, or extra work, after the

construction has begun. You often see contracts in the commercial (as opposed to residential) context that **require** the contractor to perform change orders at the direction of the general contractor or customer. If there is a dispute or disagreement regarding timeliness or price of the change order, those matters are subject to a later “equitable adjustment” between the parties. You don’t want to sign a contract with a change order clause like that. You don’t want to be “required” to perform a change order. You may have a customer or a project that is already on thin ice, and for you to get involved with a substantial expansion in the scope of work and price of the project will just put you further in red in the project or put you further in jeopardy of not getting paid on the project. So, you simply want a clause that says that the customer “may request” modification in the work. Dare to say “no” to change orders.

**2. Who is Authorized to Accept a Change Order.** Change order requests should be made directly to the contractor, but not to subcontractors or employees of the contractor. This solves the problem of the customer telling your foreman or laborer to change this or change that, and then getting mad at you later on in the project because “this” or “that” wasn’t changed. This also solves the problem of your subcontractor or employee committing you to perform change order work at prices that you would never have agreed to. Also, customers can get pretty excited about change orders, and the contractor is in a good bargaining position to make sure that the customer is current with all progress payments to date **before** the contractor goes ahead and starts processing or performing a change order. The customer has something that the contractor wants (money), and the contractor has something that the customer wants (modification of the work, in the middle of the project). So, change orders can be used as a bargaining chip.

**3. Signed Change Orders in Writing.** All change orders **should** be reduced to a signed writing in order to avoid misunderstandings over cost or scope of work. We should be up front in our contract and tell the customer that we would like change orders to be in writing. There is nothing mandatory about a clause like this. It simply says that change orders **should be** in writing.

**4. Change Order Form.** For change orders that **are** reduced to a writing, the written change order should be prepared on a form furnished by the contractor and should state the effect of the modification upon the contract price and the completion date. You are telling the customer, right in the contract, that the contractor will prepare a written change order using the contractor’s form (Appendix 1). We don’t want the customer to come into court with notes and memoranda that have been fabricated after the fact to “document” discussions with the contractor regarding costs of change orders.

It is always best to have change orders signed and paid for before the change order is processed or performed. But, oftentimes you don’t know the price of a change order because the prices are not available or the customer does not know exactly what specifications to choose for the change order. If that is the case, then

a change order should nonetheless be prepared in writing and signed by the customer giving an *approximate* cost and specification for the change order, subject to later final calculation.

**5. *Timing of Payment.*** Your change order clause should provide options for timing of payment of change orders. The price of all written orders should be paid in full by the customer to the contractor at one of the following times.

At the time the change order is performed

At the time the next progress billing is sent to the customer

Other (please specify) \_\_\_\_\_

You need a contract clause that offers a selection of one of these options on when change orders are going to be paid.

**6. *Customer May Orally Authorize Change Order Work.*** Now we all know that not all change orders get reduced to a signed writing. So, we want to clearly state in our contract that the customer may elect to orally authorize or approve change orders. We want to make it clear in the contract that the customer has the option of orally authorizing or approving a change order. They are going to do it anyhow, so let's just make it perfectly clear that the customer has the right to orally authorize or approve a change order. This sentence opens the door for further contract clauses dealing with just how these orally authorized and approved change orders are going to be computed and paid for.

**7. *Pricing of Oral Change Orders.*** The contract should then state that unless a change order has been prepared in writing and signed by both parties, the cost of processing or completing any change order shall simply be calculated on the basis of:

- (1) A labor rate of \$\_\_\_\_ per hour for all office or administrative time spent on processing a change order request which is processed by the contractor, but which the customer ultimately elects for any reason not to have performed;
- (2) A flat labor rate of \$\_\_\_\_ per hour for all contractor's personnel, including project managers, superintendents, carpenters, laborers, etc., who work on the change order.
- (3) A markup of \_\_\_\_ percent on all actual material, equipment or subcontractor invoice costs to the contractor for change order requests actually performed and completed by the contractor.

What this clause does is handle change orders on an "automatic pilot" basis. If you have a change order in writing, signed by both the customer and the contractor, well that's great. If you don't, then all change orders are going to be paid for on a predetermined basis. You will be paid a fair hourly rate for all change orders that you spent a ton of time running around searching and researching on behalf of the customer who decided not to go ahead with the work. Where the customer elects to proceed with the change order work and actually elects to go ahead and how those change orders performed and paid for, in which

you will charge a certain hourly rate as a flat rate for all of your personnel. You will make some money on change orders where you have laborers working at a flat or single hourly rate. On the other hand, you will lose money for some of your researching time that you won't be able to recover, and some of your higher paid project personnel will cost you more than the flat hourly rate. You need to pick a flat rate which you are going to apply to all of your project personnel. Remember, we don't want the owner to come back and start nickel and diming us about whether we should have had a laborer go to the lumber mill instead of your project superintendent, etc. When you have a flat rate that you are charging for all your personnel, and the customer has agreed to pay that flat rate, then it doesn't matter whether you had your laborer or your lawyer run to the lumber mill to pick up some extra trim. Also, by specifying a specific hourly rate which is not tied to cost, you avoid the horrendous scenario where the customer starts challenging what your "real costs" were. Who cares what your real costs were with a change order clause like this. The customer has agreed to pay a flat hourly rate and a percentage markup on your invoices that you receive from your suppliers or subcontractors. Costs have nothing to do with it.

**8. *Completion Date Extended.*** Change orders slow down the project, so your contract should state that in the absence of a written agreement to the contrary, the effect on the completion date should be twice the proportion by which the contract price is increased. For example, if a requested modification increases the contract price by one percent, then the completion date will be extended by two percent. If you have a \$25,000 job, and you have \$2,500 in change orders, well that is an increase of 10 percent of the contract price. That means that you get 20 percent more time (2 x 10%) to complete the work. So, if you told a customer you were going to complete the work in 10 days, you would have 12 days to actually complete the work. You would have two extra days to perform the 10 percent extra work.

In appeal of Gavosto Associates, Inc. PSBCA No. 4058 (April 25, 2001), the Postal Service Board of Contract Appeals ruled that when a government orders additional work and unilaterally grants an extension of time, the government creates a rebuttable presumption that it is responsible for the extended overhead associated with that continued site presence. The Board ruled that "by directing additional work and granting associated time extensions, the Postal Service recognized that it delayed the overall project to that extent. This circumstance creates a rebuttable presumption that the Postal Service is responsible for those delays and that Gavosto is entitled to compensation." This case is important for supporting the contractor's claim for costs associated with extended general conditions or side conditions such as rental of barricades, sani-cans, extended supervision time, etc., but also forms the basis for the contractor's claim for extended overhead costs such as lights, electricity, insurance, taxes, etc.

## **Time Cards**

Now, this is one awesome change order clause that is totally square with both parties. But, it won't do you one iota of good if you don't segregate change order work on your time cards. Your employees won't do it unless you really stay on their cases. Even then, you've got to personally review your employees' time cards each week and make sure that change order work is listed out separately. This is true on all contracts, even cost-plus contracts. On cost-plus contracts with a guaranteed maximum price, you have to show what work fell within the original scope, and what work was extra. On cost-plus contracts with no guaranteed maximum price, you still have to defend your original estimated cost of work, so you still have to track the change order costs.

## **Multiple Change Orders**

When a project owner issues a directive altering or increasing the scope of work, the change order is typically priced on the basis of the direct cost of the additional work, plus a mark up for overhead and profit. The contractor may also receive an extension of time, if warranted, and the contractor is asked to acknowledge that this compensation is full satisfaction for the changed work. This is generally how change orders work on commercial projects. However, project owners often times continue to issue change order after change order, either as a result of poor planning and design due to factors beyond the owner's control. Each individual change order might be priced fairly, but an ongoing series of changed over the life of a project can have a cumulative impact on the contractor's productivity and cost experience.

Courts and administrative boards have long recognized that cumulative impact costs can exist as a distinct element of recovery. In appeal of Charles G. Williams Construction, Inc., ASBCA #33766 (2/27/89), the project owner issued a series of twenty-six change orders to correct defective drawings and specifications. In addition to direct costs, each change order granted the contractor a 15% overhead mark-up for indirect costs. The Armed Services Board of Contract Appeals ruled, however, that this mark up did not adequately compensate the contractor for the cumulative disruption of the performance and administration of the contract, and the Board went on to award the contractor additional compensation for the cumulative impact costs. Other contracts have been awarded compensation for lost labor efficiency/productivity due to cumulative impact of numerous change orders. Appeal of Atlas Construction Co., Inc. GSBCA No. 8593, (3/1/90).

## **Summary**

You can see that the above clause is much more realistic and comprehensive than the traditional clause that simply says that "all change orders must be in writing." You want a clause that addresses reality. The reality is that change orders should be in writing, but they usually aren't. In those many cases where change orders are not put in writing, you need a clause that serves loyalty as your "sixth man," coming off the beach and keeping the game under control.



#### **ABOUT THE AUTHOR**

Larry Linville is a native Seattleite and member of the Seattle law firm Linville Law Firm PLLC. He received his law degree from the University of Washington School of Law in 1975 and has since specialized in business and construction law. Mr. Linville is admitted to practice in all courts in the State of Washington, the federal courts and the United States Supreme Court. Together with other members of his firm, Mr. Linville presents a number of seminars each year to contractors and trade associations on matters dealing with contracts, collections, liens, incorporations, employment and current legislation. You can learn more about these seminars as well as sign up for these seminars by visiting the Linville Law Firm PLLC website at [www.linvillelawfirm.com](http://www.linvillelawfirm.com).

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