

Solid contracts

Negotiating construction contracts to limit or avoid financial loss or liability **Interviewed by Leslie Stevens-Huffman**

Executives are frequently diligent and detailed negotiators when consummating a real estate purchase contract or long-term lease. But even the most thorough owners and tenants do not pay enough attention during the next phase, when construction or tenant improvement contracts need review and approval. Many of these contracts begin as boilerplate documents created by construction-related associations and, unless they are meticulously reviewed and modified, owners may forfeit savings opportunities, sustain cost overruns and assume financial liability for the contractor's debts.

"Almost invariably, the contract presented to the owner by the contractor is missing fundamental provisions required by law or good construction practices to protect the owner against preventable risks," says Katherine M. Knudsen, a construction litigation attorney with Procopio, Cory, Hargreaves & Savitch LLP. "If the contract does not provide adequate protection, the owner's financial liability can quickly grow to hundreds of thousands of dollars due to delays, the contractor's failure to pay its subcontractors or other situations. To avoid or limit financial loss or liability, owners should address and allocate these risks in the contract."

Smart Business spoke with Knudsen about how to avoid the hidden pitfalls in construction agreements.

What is the first step in negotiating a construction agreement?

Before contract negotiations begin, owners should check with the California Contractors State License Board to verify the contractor's history and to make certain the contractor has an active license. Also, an owner should verify that the contractor has adequate insurance coverage, including comprehensive general liability and workers' compensation, preferably from an A-rated carrier, and verify the contractor's ability to obtain payment and performance bonds. Further, the owner should check references and investigate the contractor's qualifications and experience. Next, have a construction attorney review the contract to protect the owner's interests and to make certain the scope of work, the compensation and the schedule for performance are all spelled out in detail. It is impera-



Katherine M. Knudsen
Construction litigation attorney
Procopio, Cory, Hargreaves & Savitch LLP

torative that the contract include a construction schedule identifying completion dates for each phase of the project so the contractor is held to a timeline.

What else should be included in a contract?

Contractors should be required to provide a schedule of values or a budget for the project to help ensure that the contractor stays within the contract price and to guard against overpayment. Further, the contract should provide that the owner may withhold 5 to 10 percent from each progress payment until the work is fully completed and inspected and the time for subcontractors and suppliers to record mechanics' liens has expired. The contract should also have a clause providing the owner the right to receive timely audits, a full accounting for the project and documentation of expenses if the contractor is being paid based on the cost of the work.

Are indemnification clauses and lien waivers important?

Owners should make certain the contract contains an indemnification clause stating that if the contractor fails to pay its subcon-

tractors or suppliers, fails to keep the property free from liens, or causes injury or damage to persons or property, then the contractor shall indemnify the owner for all claims, lawsuits, losses, attorneys' fees and costs. In addition, the contract should also contain language requiring the contractor and its subcontractors and suppliers to execute conditional and unconditional lien waivers and releases before receiving progress payments and final payment, making it less likely that any mechanic's liens or stop notices will be filed against the property.

How can construction delays be prevented?

The owner may consider including a 'no damages for delay' clause to help safeguard against a delay claim the contractor may assert if the project is not completed within the agreed-upon completion time. On the flip side, the owner may want to consider the inclusion of a liquidated damages clause entitling the recovery or withholding of a set amount for each day the project completion is delayed beyond the date set forth in the contract due to the contractor's fault.

What bonds should be required?

The general contractor should be required to carry payment and/or performance bonds on the project, although the premium for such bonding is customarily borne by the owner. Even with a competent, adequately capitalized contractor and a well-drafted contract, unforeseeable difficulties may arise on a project. Payment and performance bonds offer additional protection to the owner. Generally, a performance bond ensures that the construction of the project will be completed if the contractor is unable to do so and a payment bond ensures that the subcontractors and suppliers will be paid if the contractor fails to pay them.

These recommendations are just a fraction of what owners should include in construction contracts. The main thing to remember is that 'contract due diligence' should not end when the lease or purchase agreement is signed. <<

KATHERINE M. KNUDSEN is a construction litigation attorney with Procopio, Cory, Hargreaves & Savitch LLP. Reach her at (619) 515-3206 or kmk@procopio.com.

Insights Legal Affairs is brought to you by Procopio, Cory, Hargreaves & Savitch LLP