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Mitigating Risk in Today's Commercial Construction Climate: Best Practices for Claims Avoidance and Handling

I. Mitigating Risk in Today's Commercial Construction Climate

Key Contract Provisions That Mitigate and Impact Risk

Risk mitigation does not start when a claim arises. In contrast, risk management begins prior to commencement of the construction project and is embodied in the contract documents. Contract terms and conditions can mitigate and impact risk, in addition to shifting risk to those parties that can best control it. Discussed below are key contract provisions that must be evaluated, negotiated, and discussed as part of best practices for risk management.

Indemnity

Rarely, if ever, is an indemnity provision placed before a party that is not reviewed, edited, marked up or revised. And for good reason. Indemnity provisions are the hallmark contract provision that allow one party to shift risk downstream to another party. Typically, there is an indemnity provision in the prime contract between the owner and general contractor, followed by an indemnity provision in the subcontract agreement between the general contractor and the subcontractor. There is also typically an indemnity provision between the owner and the design professional.

The types of indemnity provisions vary, depending on the bargaining position of each party and the level of risk each party agrees to accept. Some indemnity provisions require one party (the indemnitor) to indemnify the other party (the indemnitee) for not only the indemnitor's negligence, but also the indemnitee's own negligence. For example, the subcontractor agrees to indemnify the general contractor for the subcontractor's negligence AND the general contractor's own negligence (both active and passive negligence). That type of provision is typically referred to as a Type I indemnity provision or a "specific" indemnity provision.

There are other indemnity provisions that require the subcontractor to indemnify and hold harmless the general contractor for the subcontractor's negligence AND the general contractor's passive negligence, but not active negligence. That type of provision is typically referred to as a Type II or a "general" indemnity provision. Lastly, there are provisions that

require the subcontractor to only indemnify the general contractor for the subcontractor's negligence. That type of provision is typically referred to as a Type III indemnity provision and carries the least risk transfer.

Clearly, the level of risk borne by the indemnitor is dependent on the precise language of the indemnity provision, which is generally strictly construed by courts against the drafter. That is, if you want a Type I provision/specific indemnity provision to be upheld, the provision must very clearly indicate that the indemnitor is covering not only its negligence, but also the active and passive negligence of the indemnitee. Having counsel with experience litigating these provisions draft your indemnity clauses is a best practice in mitigating and shifting risk.

Parties must also understand the impact of OCIP and CCIP programs on indemnity obligations. While the intent of these programs is to cover the enrolled parties (e.g., the owner, general contractor, and subcontractors) and avoid finger pointing amongst this group, when the claims also involve contractual issues and non-covered claims, the waters get muddy. For example, when an OCIP only covers defects that have caused resultant damage and the claim includes significant defects that have not resulted in any damage, the general contractor will rely on the indemnity clause to transfer risk to the enrolled subcontractor for claims that are not covered by the OCIP. This scenario can create conflicts when one law firm is representing all enrolled parties. Also, when the claims exceed the policy limits of the OCIP or CCIP, the contractual indemnity will also be triggered and creates potential conflicts with counsel representing all enrolled parties. Thus, while OCIP and CCIP programs seek to mitigate the finger pointing amongst enrolled parties, the contractual indemnity provision still significantly impacts the case.

Lastly, while virtually all construction contracts contain one form or another of an indemnity provision, many states have enacted anti-indemnity statutes seeking to limit the ability to transfer risk to another party for one's own conduct. An anti-indemnity statute is a statute that prohibits one party (e.g., a general contractor) from seeking indemnity for that party's own negligence from another party (e.g., a subcontractor). In response to case law that required one party to defend another and pay attorney's fees and costs even where there was no finding of liability, such as the case of *Crawford v. Weather Shield Mfg. Co.* (2008) 44 Cal.4th 541, states have begun to pass these anti-indemnity statutes. An example of an anti-indemnity statute is California *Civil Code* § 2782.05(a), which states as follows:

"Except as provided in subdivision (b), provisions, clauses, covenants, and agreements contained in, collateral to, or affecting any construction contract and amendments thereto entered into on or after January 1, 2013, that purport to insure or indemnify, including the cost to defend, a general contractor, construction manager, or other subcontractor, by a subcontractor against liability for claims of death or bodily injury to persons, injury to property, or any other loss, damage, or expense are void and unenforceable to the extent the claims arise out of, pertain to, or relate to the active negligence or willful misconduct of that general contractor, construction manager, or other subcontractor, or their other agents, other servants, or other independent contractors who are responsible to the general contractor, construction manager, or other subcontractor, or for defects in design furnished by those

persons, or to the extent the claims do not arise out of the scope of work of the subcontractor pursuant to the construction contract. This section shall not be waived or modified by contractual agreement, act, or omission of the parties."

Similarly, Texas passed an anti-indemnity statute in 2012, which voids any indemnity provision that requires the indemnitor to indemnify the indemnitee for the indemnitee's negligence or fault. See, Texas *Insurance Code* § 151.102. Florida has also passed an anti-indemnity statute, which voids any indemnity provision that requires the indemnitor to indemnify the indemnitee for the indemnitee's acts, omissions or default. See, Florida Statutes § 725.06. Therefore, any indemnification provision in a construction contract must comport with the applicable statute.

Additional Insured Requirements

Part and parcel of risk transfer is the requirement for the indemnitor to name the indemnitee as an "additional insured" under the indemnitor's insurance policy. For example, the general contractor will require the subcontractor to name the general contractor (and a series of other entities) as additional insureds. The additional insured status means that the general contractor will be defended and indemnified by the subcontractor's liability insurance policy. The benefit to the general contractor is that its liability policy limits are not eroded and it does not have to satisfy a deductible or self-insured retention.

A key issue that frequently arises pertaining to the additional insured status, is the selection of defense counsel. Typical contract language regarding the duty to defend gives the general contractor the right to approve of defense counsel assigned to defend the additional insured. Often times, the insurance carrier affording additional insured coverage will select counsel of their choosing (e.g., panel counsel or in-house counsel) and the general contractor will seek to appoint counsel they are familiar with and who are experienced and capable handling the claim, creating a dispute between the carrier and the additional insured.

In addition, while the contract may require that one party name the other as an additional insured, this contractual requirement is not always followed in the field. For example, the subcontractor forgets or intentionally does not obtain the additional insured endorsement. This exposes the subcontractor to a breach of contract claim, where the damages for the breach constitute significant attorney's fees and costs incurred by the general contractor defending the claim/settling the claim that would have been covered by the additional insured endorsement had the subcontractor complied and obtained the form.

The party receiving the additional insured endorsement must also perform due diligence in securing the proper endorsement. Is there an exclusion for residential construction? Is there an exclusion for a project covered by an OCIP? Is the endorsement only for ongoing operations of the subcontractor? What are the policy limits? There are also instances where the underlying policy period expires during the life of the construction project. As part of basic risk management, there should be a dedicated person(s) tasked with obtaining and reviewing the additional insured endorsements and ensuring that all contract insurance requirements are met.

Scope/Price

Two basic and "must have" provisions of any construction contract are scope and price. The scope of work to be performed by the contractor must be clearly delineated within the terms of the contract. Best practice for identifying the scope of work is to identify each sheet of the plans and identify all sections of the specifications. Ambiguities in the description of the scope of work invariably leads to change orders, delays, and claims. As a result, a clear and unambiguous description of the scope of work must be included in the contract and will result in reduced risk on the project.

It goes without saying that the price must be clearly set forth in the contract. While it would seem on its face that there should not be any dispute arising from the description of the price in a contract, but that is not always the case. There are multiple ways in which the contract price can be defined: (1) lump sum fixed price, (2) unit price, (3) cost plus and (4) cost plus with a guaranteed maximum price. In contracts where the price is not a lump sum fixed price, the end price may not be known at the outset. In cost plus contracts, ambiguities and disputes arise pertaining to which costs are actually covered as reimbursable and non-reimbursable "costs" in the contract. As a result, identifying the contract price and the means in which that figure is derived must be clearly set forth in the contract.

Limitation of Liability

Limitation of liability clauses seek to limit a party's liability to a sum certain. For example, many design professional contracts include a limitation of liability clause which limit the design professional's liability to the contract value, a percentage of the contract value, or insurance policy limits. Less frequently, prime contracts will include a limitation of liability clause. The limitation of liability clause seeks to shift the risk of loss to another party for any amount beyond the stated sum. An example of such a provision is as follows:

"In recognition of the relative risks and benefits of the Project to both Owner and the Architect, the risks have been allocated such that Owner agrees, to the fullest extent permitted by law, to limit the liability of the Architect to Owner for any and all claims, losses, costs, damages of any nature whatsoever or claims expenses from any cause or causes, including attorney's fees, costs, and expert witness fees and costs, so that the total aggregate liability of the Architect to the Owner shall not exceed the Architect's fee under the Agreement."

The limitation of liability clause results in a substantial shift of risk from the architect to the owner. Given the increased use of the design-build project delivery method (see below), limitation of liability clauses is becoming more prevalent in contracts between design professionals and contractors. Caution must be used when negotiating a limitation of liability clause and a reasonable prediction of the risks associated with the design professional's work must be taken into consideration.

Contract Duration

The contract duration or contract time must be identified in the contract. Typically, the contract duration is set forth in terms of days from commencement in which the work must be substantially completed. Calendar days are generally used in order to eliminate disagreement over counting of holidays and weekends. For example, the contract duration may be 365 days from issuance of a Notice to Proceed.

Most construction contracts will set forth two completion dates: (1) substantial completion and (2) final completion. In most circumstances (e.g., the AIA A 101), the contract states that the contract must achieve substantial completion by a certain number of days. Final completion is then achieved when all punch list items are completed. Most contracts will also indicate that "time is of the essence" to ensure that the contract duration and other important timing requirements are strictly construed.

Disputes over contract duration regularly give rise to high dollar claims, especially when liquidated damages are involved. For example, a contract may state that for every day the contractor fails to achieve substantial completion by the date set forth in the contract, the owner is entitled to recovery of liquidated damages at a certain per diem rate (e.g., \$1,000 per day). Disputes revolve around whether the contractor was entitled to an extension of the contract time for changed conditions and whether the contractor is entitled to compensation or just a time extension. To the extent the contractor is entitled to an extension of the contract duration, liquidated damages will not be assessed. However, where the contractor is not entitled to an extension, liquidated damages will be imposed.

Therefore, as part of risk management and review of the construction contract, close attention must be paid to the contract duration and an evaluation made as to whether the duration is realistic and achievable. Having a project schedule that is neither realistic nor achievable by the contractor creates tension amongst the project participants and is a recipe for a project riddled with claims.

Alternative Project Delivery Methods and Their Advantages and Disadvantages

There has been a growing trend in the construction industry for parties to move away from the traditional project delivery method of design-bid-build and utilize alternative project delivery methods, such as design-build and integrated project delivery. Each of these methodologies is discussed below.

Design-Bid-Build

Design-bid-build is the traditional project delivery method whereby an owner contracts with separate entities to design and build the project. There are advantages and disadvantages to this delivery method. The advantages to this delivery method are: (1) the architect is impartial and looks out for the interests of the owner, (2) the owner obtains the lowest bid with maximum competition, (3) design is complete before construction commences, and (4) owner controls design/construction quality. The disadvantages to this delivery method are: (1) owner at risk to contractor for design errors, (2) requires significant owner expertise and resources, (3)

no contractor input into design, (4) longer schedule, and (5) potential for higher overall project cost. The trend in the construction industry is to go away from this traditional project delivery method in favor of more flexible delivery methods.

Design-Build

Design-build is a project delivery method whereby the design and construction of a project are performed by a single entity. The are advantages and disadvantages to this delivery method. The advantages to this delivery method are: (1) transfer of design and construction risk from the owner to a single entity, (2) construction starts before design is complete, reducing the project time, (3) construction cost is known and fixed during design, (4) emphasis on cost control, (5) contractor participation in the design, and (6) requires less owner expertise and resources. The disadvantages to this delivery method are: (1) minimal owner control over both design and construction, (2) design changes after construction commences are costly, (3) potentially conflicting interest as both design and construction is performed by a single entity, (4) no party is responsible to represent the owner's interests, and (5) high bid costs, few bidders.

According to a survey by RCD/RS Means Market Intelligence, the market share of non-residential design-build projects in 2013 was 39% and the use of design-bid-build projects was 52%. See, Design Build Project Delivery Market Share and Market Size Report, dated May 2014, found at <https://www.dbia.org/resource-center/Documents/rsmeansreport2014.pdf>. There was a 10% increase in the use of design-build projects from 2005 to 2013 and there was a 15% decrease in the use of design-bid-build projects over the same time period. Thus, there is a definite construction industry trend towards using design-build in non-residential construction projects.

Integrated Project Delivery

Integrated project delivery is defined as follows: "A project delivery method that integrates people, systems, business structures and practices into a process that collaboratively harnesses the talents an insight of all participants to reduce waste and optimize efficiency through all phases of design, fabrication, and construction." See, Integrated Project Delivery: A Guide, American Institute of Architects. In contrast to other delivery methods where there are silos of responsibility amongst the project participants, in the integrated project delivery method, the silos of responsibility are broken down and all participants share in the responsibility and close cooperation among all major participants is required.

The advantages of this project delivery method are: (1) early and open sharing of knowledge among project participants, (2) strengthens the project team's understanding of the owner's desired goals and outcomes, (3) allows the contractor team to contribute their specialized skill and knowledge early in the design process, (4) allows for better pre-construction planning, (5) improves cost control and reduces design changes, and (6) can be used across a variety of contractual arrangements. The disadvantages of this project delivery method are: (1) blurred lines of responsibility and liability, (2) contractual enforceability is unclear, (3) imputed obligations of project participants beyond licensure, (4) no singular decision maker, and (5) shared responsibility among joint venture parties.

The use of the integrated project delivery method is on the rise in the construction industry, especially in highly complex and sophisticated projects, such as hospitals. The use of this delivery method is believed to mitigate risk and avoid claims amongst the project participants. By having the contractor involved very early on in the design and to have input in the design from all parties is believed to reduce claims, mitigate change orders, and avoid finger pointing by the parties, all to the benefit of the project's ultimate cost and schedule. While integrated project delivery has many benefits, the model blurs the lines of responsibility amongst the design team and the construction team, giving rise to potential legal implications that have not previously been addressed by the courts.

II. Mitigating Losses Tied to Subcontractor Defaults

The impact of a subcontractor default on a project can be substantial. This impact can push the project schedule by months and bring the project to a screeching halt. Imagine a first tier structural steel subcontractor filing for bankruptcy and walking off the job while in the middle of construction on a 50 story high rise tower. The cost impacts are significant and can cause a rippling effect on all project participants. Avoiding subcontractor defaults and dealing with them when they arise are a key risk management function of any project. There are two major means by which a general contractor can mitigate losses tied to subcontractor defaults: (1) subcontractor default insurance ("SDI") or (2) bonded subcontractors.

Subcontractor Default Insurance

SDI is a relatively new product in the construction industry and is an alternative to requiring the subcontractor to obtain a performance bond. Subcontractor default insurance is an agreement between a contractor and an insurer that provides the contractor with insurance coverage for the cost of a subcontractor default. Unlike other insurance, SDI is not first dollar coverage and typically is subject to high deductibles. With SDI, the contractor prequalifies the subcontractor and the contractor has a high degree of flexibility and control over the use of SDI. The use of SDI arose from contractors' concerns with the perceived delayed response of sureties under performance bonds and the perceived lack of flexibility and control when a default occurs. Typically, SDI is utilized by sophisticated contractors with the financial ability to absorb the deductible and front the costs of dealing with the default.

Coverage for SDI is triggered by the default of a subcontractor. Should a subcontractor fail to perform, the general contractor declares the subcontractor in default. Subsequent to the default, the contractor proceeds as it deems appropriate to best mitigate the default. In lieu of waiting for a surety to respond and address the default, the contractor has complete control over the process. Once the policy deductible is paid by the contractor, the SDI insurer reimburses the contractor for those sums in excess of the deductible.

While SDI provides certain advantages to a contractor, the primary disadvantages are as follows: (1) increased financial risk, (2) increased responsibility, (3) lack of legal precedence, and (4) owner unfamiliarity. However, this insurance product does provide the contractor with risk mitigation in the unfortunate event of a subcontractor default and allows the project to continue moving forward.

Bonded Subcontractors

Another method of mitigating risk of a subcontractor default is through a performance bond. This is the more traditional and well known method. With a subcontractor performance bond, the contractor receives an assurance from the surety that the subcontractor will perform. In the event the subcontractor fails to perform, the surety will step in and ensure performance of the subcontractor's work.

In order to issue the bond, a surety will prequalify the subcontractor and perform a risk assessment of the subcontractor, including an evaluation of the subcontractor's financial performance, accounts receivable, work in progress, management experience, business plan, contract terms, and project particulars. Thus, where a surety issues a bond on behalf of a subcontractor, it provides piece of mind to the contractor that the subcontractor is a low risk for default.

The advantages to surety bonds are: (1) prequalification, (2) performance protection, (3) first dollar coverage, and (4) claim service. The disadvantages to surety bonds are: (1) extended/delayed response by the surety, (2) lack of contractor control, and (3) impact to schedule and costs.

III. Change Conditions and Compliance with Notice Requirements

A key component to risk management of any project is the reduction or limitation of change orders. Contract provisions have been developed which require certain conditions precedent to be satisfied before a contractor can perfect a change order claim. Understanding these provisions and the nuanced requirements contained within them are crucial to mitigating the impact of change orders on a project.

Standard Contract Provisions

Many of the industry construction contract documents contain provisions dealing with the notice and content requirements that must be met before a change order claim can be perfected. For example, the AIA A 201-2007 General Conditions require a claim to be initiated within twenty-one (21) days after the occurrence giving rise to the claim. See, Article 15.1.2. Similarly, in the ConsensusDocs 200 (2007), the contract requires the contractor to provide notice to the owner within fourteen (14) days after the contractor first recognizes the condition giving rise to the claim. The notice must then be followed by written documentation of the claim within twenty-one (21) days after submission of the notice. See, Articles 6.4 and 8.4.

In addition, many owners are utilizing their own version of the notice requirements that are very stringent and mandate strict compliance. To the extent the contractor fails to satisfy the notice requirements, they are deemed to have waived the entitlement to a change order.

Key Cases:

California

The seminal case on the subject in California is *Greg Opinski Construction, Inc. v. City of Oakdale* (2011) 199 Cal.App.4th 1107. In that case, the general contractor, Greg Opinski Construction, entered into a construction contract with the City of Oakdale. The contract required any changes to the contract to be in writing and that any notice of change be submitted by Opinski within thirty (30) days of the event giving rise to the change. The contract further indicated that if the change procedures were not followed, "no claim for an adjustment in contract price will be valid."

In this case, the Court of Appeal held that Opinski had waived its right to a change order for delays that were admittedly solely caused by the owner because it failed to comply with the notice requirements. The Court of Appeal specifically held as follows:

"If the contractor wished to claim it needed an extension of time because of delays caused by the city, the contractor was required to obtain a written change order by mutual consent or submit a claim in writing requesting a formal decision by the engineer. It did neither. The court was correct to rely on its failure and enforce the terms of the contract. It makes no difference whether Opinski's timely performance was possible or impossible under these circumstances." *Id.* at 1117-1118.

This requirement for compliance with the notice provisions is equally applicable to design professionals in seeking extra work claims against an owner. See, *P&D Consultants, Inc. v. City of Carlsbad* (2010) 190 Cal.App.4th 1332. There is an exception to the rule set forth in *Opinski Construction* where the basis of the change order claim is defective plans and specifications issued by the owner. See, *G. Voskanian Construction, Inc. v. Alhambra Unified School District* (2012) 204 Cal.App.4th 981.

Texas

The case of *Interstate Contracting Corp. v. City of Dallas* (5th Cir. 2005) 407 F.3d 708, applies a similar rationale to a contractor's failure to comply with the mandatory notice requirements. In *Interstate Contracting*, the contract required the contractor to strictly comply with the notice provisions for a changed condition. The City argued that strict compliance with these procedures was a condition precedent to payment on the claims. During trial, the jury determined that while the contractor did not strictly comply with the notice requirements, it did substantially comply with the procedures. The trial court awarded damages to the contractor for the changed conditions.

The City appealed and argued that strict compliance was required and the Court of Appeal agreed. The Court of Appeal held that "[b]ecause [the contractor] failed to comply with the contractually required claim procedures, its remaining claims were barred." *Id.* at 728.

However, other cases in Texas have held that where the owner breached the contract, it has relinquished its contractual rights to enforce the change order notice requirements. See, *North Harris County Junior College District v. Fleetwood Construction Co.* (1980) 604 S.W.2d 247; *City of Baytown v. Bayshore Constructors, Inc.* (1980) 615 S.W.2d 792.

The foregoing cases demonstrate that strict compliance with the contractual notice requirements for a change order must be complied with by contractors. There are very few exceptions to the rule and there is a growing trend across the country for courts to strictly enforce these provisions, despite the harsh results. See, *Old Colony Construction, LLC v. Town of Southington* (2015) 316 Conn. 202; *K-Con Building Systems, Inc. v. United States* (Fed. Cir. 2015) 778 F.3d 1000. As part of risk management and claims avoidance, contractors should be well versed in the mandatory notice provisions of the contract and ensure strict compliance with them or risk waiving any right to a change order. There is a growing trend among owners to include these provisions in construction contracts, to deny the change order claim, and then seek to dismiss the claims by way of summary judgment during the litigation process.

As provided above, there are a variety of tools that can be utilized to reduce risk on a construction project. From key terms of the contract, to the type of delivery method, to mitigating the impacts of a subcontractor default. Best practices in risk management dictate that some or all of the foregoing should be evaluated, negotiated and implemented amongst the project participants. While there is no way to completely avoid all risk on construction projects, use of these methods will mitigate against that risk in today's commercial construction climate.