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Ten Points to Consider in Negotiating with a Contractor

Many property owners don't feel the need to have their construction contracts reviewed by an attorney or owner's representative, especially when they come in the form of a "standardized" document prepared by AIA (The American Institute of Architects) or AGC (The Associated General Contractors of America) or DBIA (Design-Build Institute of America). No matter what the value of the contract, though, the owner should always consider the following ten key issues when negotiating with a contractor.

1. **Financial Strength and Reputation of the Contractor**. In today's economic climate, the financial strength of an owner's contractor deserves great scrutiny. No owner wants to get started on a construction project only to discover partially through the project that the contractor is having financial problems and may not be able to complete the project. The ramifications can be endless, including delay, potential for liens, likelihood of defective work and increased costs. Risk can be better assessed by simply taking the time to review a proposed contractor's financial statements. Further, we recommend contacting recent past customers of the contractor to identify potential financial problems. It may become necessary to bond the project to minimize risk associated with possible financial failure of the contractor.
2. **Outstanding Litigation and Arbitration Matters Involving the Contractor**. It is easy to find out whether a contractor is involved in litigation in the State of Wisconsin. A quick check on the Wisconsin Circuit Courts website can put the owner's mind at ease, or give it cause to investigate matters further. However, many contractors insist on arbitration as the sole binding dispute resolution method. Unfortunately, arbitrations are private and are not disclosed in any public records. Every owner should request from a proposed contractor a certified list of matters under or threatened to be under litigation or arbitration within a specified period in order to better evaluate the owner's decision on contractor selection.
3. **Recovery of Consequential Damages in the Event of a Delay by the Contractor**. In most cases, the major source of damages incurred by an owner comes from delay caused by the contractor. Most of those damages

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come from lost profits, which are consequential damages. Not surprisingly, most construction contracts include a waiver of an owner's right to seek consequential damages. Owners should insist on either a right to recover consequential damages (which would likely require the removal of the waiver of consequential damages language from the contract) or, alternatively, inclusion of a liquidated damages provision that provides for recovery of a pre-specified amount for each day, week or month of delay in the completion of the project or specific milestones within a project. Often, contractors are willing to agree to a liquidated damages clause only if they receive a bonus for early completion. This exchange may or may not make sense. It will not make sense, for example, if the owner cannot use the project earlier than the expected delivery. Often, graduating the per day damages or providing for a grace period can address the contractor's likely immediate reaction to a request for liquidated damages. Liquidated damage clauses must be drafted in a manner to avoid being characterized as an unenforceable penalty clause.

4. **Insurance Coverage and Limits Carried by the Contractor**. To protect the owner, the contract must specify who carries the insurance, the types of insurance, the limits of the insurance and the amount of any deductibles. Typical coverages for consideration are: builder's risk, general liability, workers compensation, automobile liability, errors and omissions (for design/engineering services), property insurance for tools and equipment, pollution insurance and other insurance which may be project-specific. The determination of the minimum limits often will be based upon the overall value of the project. Further, industry practices may play a role in capping the amount of insurance or setting the size of deductible your contractor is willing to carry without passing through certain costs to the owner. Finally, owners should always have their risk manager or insurance provider review the proposed insurance provisions to make sure the provisions are appropriate in light of the insurance the owner carries.
5. **Right to Audit Costs and Change Orders for Cost-Plus Contracts**. Often, the owner and the contractor agree to base the contract sum upon the total cost of the work. While this sounds simple, such agreements frequently lack: (a) the detail sufficient to calculate those amounts with any specificity; and (b) the owner's right to audit the figures used to calculate the cost of the work. The right to audit should include, at a minimum, a method for recuperating the cost of the audit, especially if there is a discrepancy in favor of the contractor over a specified percentage. If the owner intends to hire an owner's representative to review the construction

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costs, the owner should consult the representative when the contract is being negotiated to make sure that the audit provisions and the formula for determining the cost of the project are adequate. This can result in significant cost savings.

6. **Litigation as the Ultimate Dispute Resolution Tool**. As mentioned above, many contractors prefer to resolve all disputes by use of arbitration. This may make sense when a specific dispute needs to be resolved immediately during the course of construction. If there is an argument, for example, about whether a given component of the electrical system meets the requirements of the plans and specifications, an architect acting as the arbitrator can make the decision on the spot. As the issues and dollars in dispute increase, however, arbitration becomes less attractive. Full-blown arbitrations over major issues frequently: (a) cost as much as litigation; (b) lack the rules and procedures of litigation; and (c) take as long as litigation. In one case, the issue of whether a dispute was subject to arbitration went all the way to the state supreme court before the arbitration could commence. Once the arbitration commenced, the issue of whether one of the three arbitrators was biased led to a lawsuit that went to the court of appeals. Only after those two court actions were concluded could the arbitration begin. So, far from saving time and money, the arbitration cost in this case actually led to three separate, expensive proceedings. In considering arbitration, the owner should consider whether arbitration should be limited to particular types of disputes (*e.g.*, those involving less than a specified dollar amount).
7. **Ownership of Plans and Specifications**. This issue usually arises in negotiating the contract between the architect and the owner. With the increasing popularity of design-build contracts, this issue now arises in negotiating a design-build construction contract as well. Owners should make every effort to retain ownership of the plans and specifications for their project, including the copyright for such plans and specifications. Ownership, or lack thereof, can have major consequences if a project becomes delayed for an extended period or at the time of a future remodeling project. If, for example, the owner is forced to hire a new contractor, it will still need the plans and specifications from the original contractor to provide to the new contractor.
8. **Nonprofit Sales Tax Issues**. Owners who are exempt from sales tax (such as nonprofit associations) must follow certain tax rules in purchasing their construction materials and equipment for the project. For efficiency purposes, this typically involves using a purchasing agent to serve on behalf

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of the owner which is an entity owned by the contractor. Recent tax rulings have indicated that the purchasing agent cannot be an entity that is "pass-through" for tax purposes, to the contractor. This means that the purchasing agent entity cannot be a limited liability company wholly owned by the contractor unless certain elections are made and certain requirements are met. Further, care must be taken in identifying with specificity what items are to be purchased by the owner's purchasing agent and how such items come under the control of the contractor. Ownership and control of the materials and equipment can play a critical role on whether sales tax will be recognized. Obviously, for these owners, the language in the contract with respect to administering the contract to avoid sales tax obligations is very important.

9. **Owner Responsibilities for Deadlines**. A contractor may claim that it is entitled to additional funds or an extension of the completion date because of delays caused by the owner failing to timely respond to a request for approval. To avoid giving a contractor an opportunity to point fingers at the owner for delays, owners should prepare their own timeline or flowchart for turning around requested approvals or information. Further, damages can be limited in the contract itself by setting thresholds for owner-caused delays before additional time or money will be rewarded.
10. **Inspection**. In nearly all cases, construction contracts provide for the owner's right to inspect the project during construction. Often, those rights require compliance with safety requirements. Typically, owners and their representatives must be accompanied by contractor personnel during such an inspection. Frequently, though, owners rely on their title company's or their mortgage lenders' inspection and do not conduct a meaningful inspection of their own. Title company and mortgage lender inspections are usually too limited in scope to be of much use to the owner. Where the owner is not a construction expert, the owner should engage a representative with construction experience to make the inspections. A good representative can save the owner from significant expense.

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