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KEY ISSUES IN NEGOTIATING DESIGN AND CONSTRUCTION CONTRACTS

ACC Real Estate Committee Presentation

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Introduction

- Contracts to be Covered

This presentation covers key issues to be considered in negotiating design and construction contracts from the Owner's perspective. Accompanying this outline are copies of the AIA's standard form of Architect's Agreement (AIA Document B101) and standard form of guaranteed maximum price construction contract (AIA Documents A102 and A201), which have been modified from the Owner's perspective to address certain issues covered in this presentation.¹

¹ Of course, numerous other topics are also of importance in any construction contract, some of which are listed in the last part of this outline. The sample form of contract furnished with this outline would require 3 additional modifications to address those issues and other matters unique to any project.

Introduction

- **AIA Documents: Integrated Series of Documents**
 - The American Institute of Architects (AIA) publishes an integrated series of design and construction contracts and related forms. While there are organizations that publish rival forms, and many owners and contractors have their own forms, of course, the AIA series tends to be the most commonly used.
 - Negotiation of agreements is facilitated because the parties know the base forms well and are able to focus on the changes.

Part One: Architect Agreements

- **Architect Responsibilities – Article 2**
 - Exhibit A - Initial Project Information.
 - Initial information concerning the project is set forth in Exhibit A of the Agreement.
 - Initial information includes the Owner’s budget and scheduling needs, and the project teams for the Owner and the Architect, among other information.
 - The Architect should agree to dedicate a specific project team for the project. Team members should not be replaced without the Owner’s consent. [See Section 12.3]

Part One: Architect Agreements

- Standard of Care.
 - Architect’s liability under the Agreement depends upon whether it performs its services in a negligent manner.
 - It is important to establish the appropriate “standard of care.”
 - The standard of care is generally the level of skill and care ordinarily provided by Architects practicing in the same or similar locality on projects of comparable scope and complexity.

Part One: Architect Agreements

– Insurance.

The insurance provisions should be reviewed by Owner's insurance advisor.

- The Architect should maintain customary general liability, automobile liability and workers' compensation insurance.
- The Architect should also maintain professional liability insurance.
 - Project-based professional liability insurance may be appropriate for projects of sufficient size and complexity.
 - Owners should do due diligence with respect to the Architect's loss history.

Part One: Architect Agreements

- **Scope of Architect's Basic Services – Article 3**
 - Basic Services are generally performed in the following phases:
 - Schematic Design
 - Design Development
 - Construction Documents
 - Bidding or Negotiation
 - Construction

Part One: Architect Agreements

- Schematic Design Phase:
 - Review and prepare a preliminary evaluation of the Owner's program, schedule and budget
 - Prepare a preliminary design illustrating the scale and relationship of the project components
- Design Development Phase:
 - Drawings and other documents to fix and describe the size and character of the project and the architectural, structural, mechanical and electrical systems
 - Prepare outline specifications that identify major materials and systems and establish general quality levels

Part One: Architect Agreements

- Construction Documents Phase:
 - Drawings and Specifications setting forth in detail the quality levels of materials and systems and other requirements for the construction of the work
[See Section 3.4]
 - Assistance in the development and preparation of bid packages
- Bidding or Negotiation Phase:
 - The Architect assists in obtaining and reviewing competitive bids or negotiated proposals and awarding and preparing contracts for construction.

Part One: Architect Agreements

– Construction Phase:

- The Architect provides administration of the Construction Contract.
 - Modifications to the Construction Contract that increase Architect's responsibilities require Architect's consent.
- The Architect visits the site periodically to become familiar with the progress and quality of the work as completed. [See Section 3.6.2.1]
 - The Architect is not required to make exhaustive or continuous on-site inspection.
 - For projects of sufficient size, the Architect may have an on-site office.

Part One: Architect Agreements

- Architect is responsible for reporting known deviations from the Contract Documents and defects and deficiencies that it observes in the work.
- The Architect is responsible for interpreting and deciding disputes concerning the Contract Documents at the request of either the Owner or the contractor.
 - Architect is supposed to be “neutral” in such circumstances.
- The Architect reviews and certifies amounts due pursuant to Contractor’s requisitions for payment.
[See Section 3.6.3.1]

Part One: Architect Agreements

- The Architect reviews the contractor's submittals, such as shop drawings, product data and samples
 - Architect should be required to perform its review services in a manner that will not delay the progress of the construction work.
- The Architect may authorize "minor changes" in the Work that do not involve an adjustment in the Contract Sum or an extension of the Contract Time. [Section 3.6.5.1]

Part One: Architect Agreements

- The Architect is required to maintain records relative to changes in the Work, including a complete log and copies of all change order requests. [See Section 3.6.5.2]
- The Architect conducts inspections to determine the date of Substantial Completion of the Work and the date of final completion.
 - Architect issues a certificate of Substantial Completion.
 - Architect reviews and approves the “punch list.”

Part One: Architect Agreements

- Coordination.
 - The Architect should be responsible for overall coordination of design of the project.
 - Issues arise when Owner separately retains other consultants.
 - Owner should push Architect to have as much coordination responsibility as is reasonable under the circumstances. [See Section 12.4.1]
 - On alterations of existing facilities, Architect should be responsible for coordination of its work with existing conditions. [See Section 12.4.2]
 - May be treated as an Additional Service.

Part One: Architect Agreements

- Green Building Design.
 - The Agreement should specify the extent to which “green” building design is included in Architect’s Basic Services.
 - Architect may design to meet the requirements for filing of a U.S. Green Building Council LEED Certification as part of its Basic Services, but filing for a LEED Certificate may be treated as an Additional Service.

Part One: Architect Agreements

- Additional Services

- Charges for Additional Services are in addition to the fee for Basic Services.
 - Language should be added to avoid disputes as to whether services are “Basic Services” or “Additional Services.”
 - Architect should not be entitled to compensation for Additional Services unless Owner authorizes these services in writing. [See Section 4.3.1]
 - Services made necessary by any fault of the Architect or any of its consultants should not be treated as Additional Services.

Part One: Architect Agreements

- Services which are reasonably inferable from specified Basic Services should also be treated as “Basic Services.” [See Section 4.3.5]
- Add flexibility for the number of requests for information, site visits and the like may occur before a claim for “Additional Services” arises. [See Section 4.3.3]
- In the event of disputes, Architect should be required to proceed “under protest” so as to maintain the progress of the project.

Part One: Architect Agreements

- Cost of the Work
 - Cost Estimating at Each Phase.
 - At the end of the Schematic Design, Design Development and Construction Documents Phases, the estimated cost of the work should be compared to the Owner's budget.
 - Architect should revise its drawings and specifications to stay within the budget.

Part One: Architect Agreements

- Bidding and Negotiation Phase.
 - If the lowest bona fide exceeds the Owner's budget, then Owner shall:
 - give written approval of an increase in the budget;
 - authorize re-bidding or renegotiating of the Project;
 - terminate the Agreement;
 - in consultation with the Architect, revise the project program, scope, or quality as required to reduce the Cost of the Work; or
 - implement any other mutually acceptable alternative.

Part One: Architect Agreements

- **Ownership of Documents**

- Architect Owns Copyright.

- The Architect is deemed to be the author and owner of its Instruments of Service and retains all common law, statutory and other reserved rights, including copyrights.

- License to Use.

- Architect grants Owner a non-exclusive license to use the Instruments or Service.
 - Permitted purposes are limited to constructing, using, maintaining, altering or adding to the Project.
 - Other use (i.e., for other projects) requires payment of a fee.

Part One: Architect Agreements

- The license should be irrevocable.
 - As drafted, the license is subject to performance of all the Owner’s obligations, including “prompt payment.”
 - Termination of the Agreement should not affect Owner’s license to use the Instruments of Service.
 - Section 11.9 of the standard AIA Agreement should be deleted.

Part One: Architect Agreements

- **Termination or Suspension**

- Default by Owner.

- The Architect has the right to terminate or suspend if the Owner fails to make payments when due.
 - Owners should add a significant grace period for payment, particularly if the Owner is relying on funding from investors or lenders to make progress payments.

Part One: Architect Agreements

- Owner's Right to Terminate or Suspend.
 - Owner has the right to suspend the project at any time.
 - If the suspension lasts beyond a prescribed period (90 cumulative days under Section 9.3) other than due to default of Architect, then Architect has the right to terminate.
 - Under Section 9.5, Owner has the right to terminate at any time on seven days' notice for convenience and without cause.

Part One: Architect Agreements

- “Termination Expenses”
 - Section 9.7 of standard AIA Agreement defines “Termination Expenses” to include compensation for anticipated profit on services not performed.
 - Architects will usually agree to waive compensation for unperformed services and limit Termination Expenses to reasonable out-of-pocket costs associated with termination.

Part One: Architect Agreements

- **Financing Issues - Collateral Assignment to Lender**
 - Section 10.3 permits collateral assignment to construction lenders.
 - Some lenders will not assume liability for obligations accruing prior to assumption by the lender. [See proposed modifications to Section 10.3]

Part One: Architect Agreements

- **VIII. Compensation: Article II**
 - Compensation for Basic Services.
 - Architect's compensation may be a stipulated sum, or it may be based upon a percentage of the cost of construction or hourly rates for Basic Services.
 - Compensation based on cost of the work or hourly rates may not properly align the interests of the Owner and the Architect.

Part One: Architect Agreements

- Compensation for Additional Services.
 - Compensation for Additional Services by Architect is typically based on hourly rates. A schedule of hourly rates should be attached to the Agreement. [See Section 11.2]
 - Additional Services of Architect's consultants are usually charged at the amount invoiced by the consultant, plus a markup for the Architect (generally 5-15%). [See Section 11.4]
 - For Owners, hourly rates for the Architect and its consultants should be set for as long as possible. If there are adjustments, they should be made on a company-wide basis, and not for the specific project in question. [See Section 11.7]

Part One: Architect Agreements

- Schedule of Payments.
 - When compensation is based on a stipulated sum or percentage of the Cost of the Work, compensation is paid in phases (i.e., the Schematic Design, Design Development, Construction Documents, Bidding or Negotiation, and Construction Phases).
 - The schedule of payments should not be disproportionately loaded to the early Phases of the project.

Part Two: Architect Agreements

- Reimbursable Expenses.
 - Owner should try to limit the scope of Reimbursable Expenses. [See Section 11.8.1]
 - For example, charges for computer aided design time, cellular phone charges and certain transportation expenses may be limited.
 - Architects usually charge a markup on Reimbursable Expenses of 5-15%.

Part Two: Construction Contracts

- Key Forms

- The primary forms of construction contracts are:
 - Lump Sum/Fixed Price (AIA A101);
 - Guaranteed Maximum Price (AIA A102);
 - Construction Management Where Construction Manager is also the Constructor (AIA A133); and
 - Design/Build Agreement (AIA A141).

Part Two: Construction Contracts

- The A101, A102 and A133 forms set forth the primary business terms for the contract. The boilerplate “General Conditions” are set forth in the A201.
- The AIA also has a series of small project forms that work well for routine office buildouts and the like.
- A rider of key provisions (progress payments, insurance, indemnification) is useful to attach to contractor proposals if negotiation time is short and the project is of limited scope.

Part Two: Construction Contracts

- **Construction Management Format**

- Preconstruction Phase.

- Under the Construction Management Agreement (AIA Document A133), the Construction Manager provides various preconstruction services.
 - The Construction Manager works with the Owner and the Architect regarding site use and improvements, selection of materials, building systems and equipment.
 - The Construction Manager also works with the Owner and the Architect to develop a preliminary project schedule, develop preliminary cost estimates, develop subcontractor interests in the Project, make recommendations with respect to long lead time items.

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Part Two: Construction Contracts

- Construction Manager’s Guaranteed Maximum Price Proposal.
 - Construction Manager proposes a Guaranteed Maximum Price for the Work.
 - The Guaranteed Maximum Price is the estimated Cost of the Work plus the Construction Manager’s fee.

Part Two: Construction Contracts

- The Guaranteed Maximum Price proposal includes various components, including:
 - The list of Drawings and Specifications and other documents upon which the proposal is based.
 - A list of allowances.
 - A list of clarifications and assumptions.
 - The proposed Guaranteed Maximum Price (on a line item basis).
 - The date of Substantial Completion for the Work.

Part Two: Construction Contracts

- Owner has the right to terminate the Agreement if it does not accept the Guaranteed Maximum Price proposal.
- If Owner accepts the Guaranteed Maximum Price proposal, then the Agreement essentially “flips” into a Guaranteed Maximum Price Contract, on the same basic terms as the AIA Document A102.

Part Two: Construction Contracts

- **Keeping the Project on Budget**
 - **Contract Sum or Guaranteed Maximum Price.**
 - The contract provides that the total compensation to the Contractor for the cost of the work plus overhead and profit will either be equal to a lump sum price (AIA Document A101) or will not exceed the Guaranteed Maximum Price (“GMP”) (AIA Documents A102 and A133).
 - However, there are provisions that enable the Contractor’s compensation to exceed the Lump Sum or GMP. The Owner’s objective is to plug those holes.

Part Two: Construction Contracts

- **Incomplete or Inconsistent Documentation**

- The Contractor is responsible for constructing the Work described in the Contract Documents, which include the A101, A102 or A133, the A201, Drawings, Specifications, and other documents enumerated in the contract. However, the Contract Documents may be incomplete or inconsistent.
- Section 1.2.1 of the A201 should be modified to establish a priority among the Contract Documents and to resolve inconsistencies within Contract Documents.

Part Two: Construction Contracts

- The higher quantity and greater quantity should prevail in the event of conflict.
- Consider adding language such as Section 7.1.4 of the modified A201 included in the materials, which acknowledges that there may be details to complete in the Drawings and clarifies that the Work includes any work that is “reasonably inferable” from the Contract Documents.

Part Two: Construction Contracts

- **Clarifications and Qualifications**

- “Clarifications and Qualifications” concerning the basis upon which it determined the Contract Sum and the Contract Time requires careful review.
- This schedule is of critical importance and should be carefully reviewed by the project manager and Architect. It creates significant openings for the Contractor to make claims for additional time and compensation.

Part Two: Construction Contracts

- **Allowances**

- An “Allowance” is a plug number or placeholder for a portion of the Work for which drawings and specifications are not complete, or which has for any other reason not been bid out at the time that the Contract Sum is established.
- Owner is responsible for any excess if the actual costs exceed the allowance amount. [See A201, Section 3.8]

Part Two: Construction Contracts

- **Cost of the Work**

- In a Lump Sum Contract, the Owner pays the lump sum price, whether the Contractor's actual costs are more or less than the lump sum. In a GMP Contract, however, the Owner pays for the actual Cost of the Work, plus a fee for overhead and profit. As a result, limiting the allowed Cost of the Work in Article 6 in a GMP Contract is important.

Part Two: Construction Contracts

- Section 8.1 of A102 as to “Costs Not To Be Reimbursed” should be modified by expanding the list of exclusions to cover negligence, costs of bonding subcontractor liens, fines and penalties, overtime to achieve schedule.
- Limiting the Costs of the Work is less critical when the Owner has a high degree of confidence that the GMP is tight.
- Modify the AIA language to require at least three bids for Subcontracts. [A102, Section 10.1]

Part Two: Construction Contracts

- Tighten the AIA language concerning Owner’s audit rights and include a hold back until the Owner’s audit is complete. [A102, Section 11]
- Specify whether the Contractor may share in “Savings.” Many Owners believe that adding a Savings clause incentivizes the Contractor to keep the Cost of the Work below budget. [See A102, Section 5.2.1]

Part Two: Construction Contracts

- **Change Orders**

- A Change Order is a written agreement that increases (or decreases) the Contract Sum, extends (or reduces) the Contract Time, or both. Some Owners see Change Orders as a profit center for the Contractor.
- An Owner may initiate a Change Order, or a Change Order may result from a Claim made by the Contractor.

Part Two: Construction Contracts

- Change Orders must be in writing and signed by Owner and Contractor in order to be effective.
[A201 – Section 7.2.1]
- Minor change orders not affecting the Contract Sum or the Contract Time may be issued by Architect.
- Contractors may claim that a change in the Work was authorized based upon minutes of meetings, course of dealing, emails from the Owner’s project representative or otherwise.
- Consider adding language to avoid such end runs. Sample language is provided in Section 7.5 of the model form of A201.

Part Two: Construction Contracts

- Owners should add language to reduce exposure to Claims that lead to Change Orders.
 - Tighten AIA language requiring that Claims be made within a prescribed period. [See A201, Section 15.1.2]
 - Consider adding language making each application for payment an estoppel with respect to Claims not then made. [See A201 – Section 15.1.5]

Part Two: Construction Contracts

- **Progress Payments: Monthly Requisitions**

- Two key issues to cover are retainage and lien waivers.
- Retainage: While there is no set rule, retainage is often set at 5-10% of the amount of the requisition. Common variations include:
 - Reducing retainage after the Work is 50% complete
 - If used, add language such as in A102, Section 12.1.7, entitling Owner to continue to hold previously accrued retainage.
 - Excluding retainage on the Contractor's fee and so-called "general conditions" expenses.
 - Reducing retainage to some multiple (e.g., 125-200%) of the value of any punch list work at Substantial Completion.

Part Two: Construction Contracts

- Lien Waivers

- Should be obtained from the Contractor and all subcontractors (or at least major subcontractors) with each application for payment.
- Lien waivers may be in a statutory form.

Part Three: Keeping The Project On Schedule

- **“Substantial Completion”**
 - Substantial Completion is a critical milestone.
 - Unlike final completion, at Substantial Completion there may be a punch list of items that remain to be complete but that do not materially interfere with beneficial use or occupancy.

Part Three: Keeping The Project On Schedule

- The date of Substantial Completion relates to numerous provisions of the contract, including:
 - Calculating liquidated damages. [See A102, Article 4]
 - Commencement of warranty periods. [See A201, Section 12.2.1]
 - Commencement of period for filing mechanics' and materialmen's liens.
 - Reduction of retainage.

Part Three: Keeping The Project On Schedule

- **Liquidated Damages**

- Liquidated Damages are not always required.
- Liquidated Damages may be especially important for non-profit institutional Owners, such as universities, where direct damages are difficult to prove. [See A102, Section 4.3 for a sample clause.]
- If liquidated damages are included, it is important to specify the damages early in negotiations with the Contractor.
 - It may be hard to impose a requirement for liquidated damages after the Contractor has solicited bids from subcontractors.

Part Three: Keeping The Project On Schedule

- **Claims for Extensions of Contract Time**
 - To avoid liquidated or other damages, Contractors will try to make Claims that extend the Substantial Completion Date. See above regarding language to limit the Contractor's ability to make such claims.

Part Four: Other Key Contract Issues

- **Insurance**

- Line up third party (lender and landlord) requirements and consult with insurance adviser early in the negotiation process.
- Liability insurance coverage includes general liability, worker's compensation, automobile liability, and excess/umbrella coverage.
- Property insurance includes builder's risk.
- In some circumstances (such as a design/build project), professional liability/errors and omissions coverage may be needed.
- For large projects, an "Owner Controlled Insurance Program" ("OCIP") or Contractor Controlled Insurance Program ("CCIP") may be advisable.

Part Four: Other Key Contract Issues

- Bonds

- Owner may desire a payment and performance bond, and the Owner's lender or landlord may require it.
- There are various types of bonds (payment bonds, performance bonds, lien bonds) and bonds may be procured by the general contractor or one or more subcontractors.
- Subguard insurance may be an alternative to bonding.

Part Four: Other Key Contract Issues

- Termination Rights

- The AIA language concerning defaults that trigger termination rights are vague and should be tightened. [See A201, Section 14.2]
- Owner may try for a right to terminate without cause, without being obligated to pay overhead or profit on Work not performed. [See A201, Section 14.4]

Part Four: Other Key Contract Issues

- **Assignment**
 - Owners should try to broaden the AIA language on permitted assignments in A201, Section 13.2.2.
 - The standard form treats lenders as permitted assignees.
 - Add landlords and purchasers as permitted assignees when appropriate.

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