"Contractual Risk Shifting Provisions"

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by

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This section covers some risk-shifting contractual provisions often found in contracts and now, given the economic climate, more important than in many previous decades to carefully consider. The first provision (complying with all laws) is considered boilerplate and is seen in virtually every contract. The basic premise is that between an owner and a contractor or between a contractor and a subcontractor the contractor or subcontractor must comply with the law. Sounds simple and generally is considered not to be controversial when a contract is negotiated, but may need some refocused attention in light of our economic downturn. Here is a typical provision in one of the contracts that I negotiated:

1. Comply with All Laws

The contract provision reads:

- "Contractor will not discriminate against any of its employees, other contractors' employees, subcontractors' employees, or Company's employees, and will not discriminate against any applicant for employment because of race, age, color, religion, sex, national origin, or disability, or because of any other factor protected by applicable law. Contractor will not harass, or permit the harassment of, any person on the basis of his race, age, color, religion, sex, national origin, disability, or any other factor protected by applicable law, and will not participate in creating or tolerating a hostile work environment on Company's Premises or an environment which could be perceived as hostile. Contractor agrees to comply with all applicable local, state and federal laws and statutes, Executive Orders and Regulations relating to non-discrimination in employment. Contractor agrees to abide by the following to the extent applicable: (1) all federal prohibitions against discriminating against any employee for employment because of race, age, color, religion, sex, national origin, disability status, or any other factor protected by applicable law; (2) Utilization of Small Business Concerns rules as set forth in 15

> U.S.C. §637; (3) Equal Opportunity laws as set forth in Exec. Order No. 11246, codified with modifications at 42 U.S.C. §2000e, and Federal Acquisition Regulations ("FAR") 48 C.F.R. §§22.802, 52.225-25, 52.222-26, 52-222-28; (4) Affirmative Action for Special Disabled and Vietnam Era Veterans laws as set forth in 38 U.S.C. §4212 and FAR 48 C.F.R. §§22.1301, 60-250, 52.222-35, 52.222-37; (5) Affirmative Action Clause for Individuals with Disabilities set forth at 29 U.S.C. §793 and FAR 48 C.F.R. §52.222-36; (6) Utilization of Women-Owned Businesses laws as set forth in FAR 48 C.F.R. §52.219-8, 52.219-9; (7) Non-Segregated Facilities Certification and Affirmative Program provision set forth in FAR 52.222-21; (8) laws permitting the United States Comptroller General to access a contractor's records under FAR 52.215-2; (9) Water Pollution Control Act (Clean Water Act) laws as set forth in 33 U.S.C. §1251 et seq., and FAR 52.223-1, 52.223-2; (10) Clean Air Act laws as set forth in 42 U.S.C. §7606, and FAR 52.223-1, 52.223-2, 52-223-14; (11) Contract Work Hours and Safety Standards Act as set forth in 40 U.S.C. §§327 et seq. and FAR 48 C.F.R. §52.222-4; (12) Restrictions on Subcontracting Sales to the Government laws as set forth in FAR 48 C.F.R. §52.203-6; Anti-Kickback laws in FAR 203-7; (13) Reporting provisions in FAR 48 C.F.R. §52.222.22; and (14) Disclosure laws in FAR 48 C.F.R. §52.203-11."

(emphasis added)

Sometimes lost in these longer paragraphs is a contractor's or subcontractor's responsibility to comply with all laws. This usually requires a contractor to comply with all "applicable local, state and federal laws and statutes..." What does this really mean? You often see it in contracts. Does it trump all the other provisions to the contrary? Do provisions on preference of causes and which has priority save the importance of this or neutralize it? See Section 5 Order of Preference below. What happens when a creative lawyer finds a statute or case that is contrary to the contract? Does that trump the contract?

2. Liquidated Damages

Liquidated damages are frequently found in contracts. Essentially, they provide that the contractor or subcontractor pay a certain amount per day or during some other period of time to the owner or the contractor respectively for each day beyond contract completion. Lawyers understand that they are generally enforceable and always put in that they are not a penalty but just an assessment of what the damages may be in case of work not being complete when contractually

specified. Courts and arbitrators are not reluctant under the right circumstances to enforce liquidated damage provisions. Here are a couple examples of liquidated damage provisions:

a. First Example:

"If the Project is not completed by August 1, 2010, the Contractor shall pay as a liquidated damage, and not as a penalty, the sum of $1,000,000 per calendar day."

b. Second Example:

Here is an actual contract provision between an owner and its general contractor:

"LIQUIDATED DAMAGES

Time is of the essence for the completion of the work and the whole thereof, and should the Contractor neglect, refuse, or fail to complete the applicable portion of the Work by the dates set forth in the Contract Schedule (as the date may be changed after adding any extensions of time granted by the Owner or provided for in the Contract), the Owner may deduct from the payments due to the Contractor or may collect from the Contractor or the Contractor's surety or sureties the sums described below:"

> The sums will apply for each and every calendar day of delay beyond those specified dates. Said sums per day for such delay, failure or non-completion shall be deemed, taken and treated as liquidated damages which the Owner shall suffer by reason of such default and not by way of penalty. Such liquidated damages are in lieu of all other damages and remedies for delays beyond the specified dates, and shall be the Owner's sole remedy and Contractor's sole obligation for damages, with respect to such delays. The provision for liquidated damages shall not relieve the Contractor or his sureties from any other obligations under the Contract."

Shifting risk through a liquidated damage provision does not always achieve its intended result. What if the liquidated damage turns out at the time it is assessed to be for far less than the actual damage sustained? While you do not see this typically, you do see it occasionally, and when a contractor facing this assessment can accurately make this determination, is not he or she or the company in question better off actually taking the assessment rather than fighting its enforceability?

What happens if an owner declares the contract to be terminated (either for cause or because of contract expiration) and decides not to assess a liquidated damage? Can the contractor actually force the owner to assess that liquidated damage against the contractor? Usually, the liquidated damage provision states something like the owner "shall assess" or the contractor "shall be subject to" a liquidated damage assessment of a certain amount per day. But what if the contract provision says the contractor is "subject to an assessment of" a certain amount per day?

Let's consider again the liquidated damage provision cited above: "Such liquidated damages are in lieu of all other damages and remedies for delays beyond the specified dates, and shall be the Owner's sole remedy and Contractor's sole obligation for damages, with respect to such delays." Does this eliminate the potential problem of an owner deciding not to assess liquidated damages?

3. Performance Guarantees

In commercial and industrial contracts, it is not uncommon for the owner to insert a performance guarantee provision. This may guarantee the performance of a piece of mechanical equipment, an entire system, or the overall operation of something like a turbine, a sophisticated engine, a pump, a scrubber, or a chilling tower at a nuclear plant. Performance guarantees are sometimes considered to be an alternative form of liquidated damage if the piece of equipment does not perform as contractually specified. There is some contractual relief (usually in the form of a certain amount of damage per day or whatever) that is assessed against the contractor.

- If the contractor faces too much difficulty in completing the project to the degree required by the contract and in achieving by 100% the specified performance guarantees, it is possible that less than 100% performance may be advantageous to the contractor and ironically even advantageous to the owner at the same time. This is a risk shifting provision that is really circumstance-based and sometimes extremely difficult to determine in whose favor it swings until the moment of actual assessment.

Which is more important—performance or the money? Sometimes, this risk-shifting provision has unintended consequences.

4. Force Majeure

More and more, we are seeing unusual weather conditions that are impacting construction projects and even an entire economy on an unprecedented basis. Consider, for example, Katrina and most recently, the offshore oil spill by BP in the Gulf Coast region. Greater attention should be placed by those drafting and negotiating contract provisions on exactly how they want a force majeure provision to read and exactly who is responsible for the risk. Here are a couple examples of force majeure provisions:

Example 1:

§ "If adverse weather conditions are the basis for a Claim for additional time, such Claim shall be documented by data substantiating that weather conditions were abnormal for the period of time, could not have been reasonably anticipated and had an adverse effect on the scheduled construction."

Example 2:

§ "The term 'Force Majeure' means fire, unusually severe weather, flood, earthquake, epidemic, civil disturbance, war, riot, sabotage (by persons other than Contractor, its Subcontractors or any other person under Contractor's control), and any action or inaction by a governmental agency impacting the Project. In each case only to the extent the event in question is beyond the control of and without the fault or negligence of Contractor or its Subcontractors."

Some contracts specify by day, week or month weather days.

What Happens When You Use a Calendar?

Typically, weather does not follow any calendar set in the contract. The contract—in retrospect—either provides too many days for adverse weather in a given month, or more typically it seems, too few days. The parties and their counsel should take great care in examining what they have provided in terms of weather days that are expected and additional weather days that can cause an extension of either time or money or both.

In addition, typical force majeure provisions include many other events beyond the control of the owner and the contractor, such as war, terrorism or government intervention. Recently, since terrorism has become of overriding concern and unfortunate reality, more and more

contracts should be considered in light of a terrorist act and who bears the risk if one happens.

5. Order of Preference

As briefly discussed earlier, many contracts, especially contracts involving complex construction projects, contain a clause setting forth the order of preference for the contract documents should there be any inconsistency in them. This can become extremely important where the contract was negotiated over an extended period of time and involved many people drafting or proposing language for portions of the contract. Many cooks in the kitchen often lead to potential inconsistency between various contract documents. An order of preference attempts to fix that potential problem and also to focus the parties on exactly what contract documents are really important and in what order.

The order of preference clause can completely undo one side's hard work in getting the terms and conditions part of the contract documents to read exactly as they want. This can happen simply by placing some other contract document (such as the specifications) ahead of the terms and conditions.

Generally speaking, if there is no conflict or inconsistency, all the various contract documents should be read together and no provision should have any greater importance over another. An order of preference shifts the risks in case of inconsistency and many times becomes important between the general conditions that are typically drafted by the lawyers and the technical specifications that are typically drafted by the parties or their design professionals.

Conclusion

No contract is perfect. All contracts of any substance are the product of compromise between the negotiating parties. Consequently, in this time when money is tight, economic projects are fewer in number and the potential for conflict has increased, greater emphasis and focus needs to be placed on who bears the risk at any point in time.

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