

**Second Edition**

# **Understanding and Negotiating Construction Contracts**

**A Contractor's and  
Subcontractor's Guide to  
Protecting Company Assets**

**Kit Werremeyer**



**RSMeans**

**WILEY**



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*Dedicated to all those contractors and subcontractors who are interested in learning how to negotiate more favorable commercial terms and conditions in their construction contracts and thereby better protect the hard-earned assets of their companies.*



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Robert W. Wolfe Esq. has negotiated and reviewed many large and small domestic and international engineering and construction contracts from a legal standpoint for more than 25 years. He kept me straight on the many legal fine points associated with the riskiest commercial terms and conditions found in contracts. He is the most practical and effective lawyer I have ever had the opportunity to deal with in the engineering and construction business.

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And my wife, Marilyn, a former teacher, reviewed every word in the book at least twice and made every effort to ensure my spelling and grammar were generally correct. While she did an excellent job, she told me she never again wants to read anything about indemnities. Amen.

# About the Author

Kit Werremeyer is the owner and president of Southernstar Consultants LLC, of Valrico, Florida, a company that provides training in the understanding and negotiating of construction contracts. The company also offers a broad range of other professional services to United States and international engineering and construction companies.

Mr. Werremeyer's experience includes more than 30 years of sales, contracting, claims settlement, dispute resolution, and EPC project development, including work for a broad range of major U.S. and international companies, such as Bechtel; Kellogg, Brown & Root (KBR); Fluor; J.A. Jones; Black & Veatch; DuPont; Shell Oil; Caltex; Exxon/Mobil; BP/Amoco/ARCO; Air Products and Chemicals; Koch Industries; Florida Power and Light; Chiyoda Corporation (Japan); Japan Gasoline Corp.; Mitsui (Japan); Mitsubishi Heavy Industries (Japan); Petronas (Malaysia); Thai Oil Company; Pertamina (Indonesia); SINOPEC (Peoples Republic of China); Voest-Alpine (Austria); Daelim (Korea); and Hyundai (Korea).

Among prior positions, Mr. Werremeyer served as vice president and area director of sales and marketing in Asia for Chicago Bridge & Iron Company, an international engineering and construction company. This position included responsibility for contracting and the general management of area subsidiaries.

He is a graduate of the University of Illinois at Urbana-Champaign, Illinois, with a master's degree in mechanical engineering.



# Preface

In 1977, I entered a year-long sales training course presented by my company, Chicago Bridge & Iron Company (CBI), an international engineering, procurement, and construction contractor founded in 1889. CBI believed that all of its salespeople must have a strong foundation in understanding, evaluating, and negotiating the commercial terms and conditions typically found in engineering and construction contracts. Specifically, the course was to prepare its future salespeople to provide clients with “one-stop shopping.” This meant being able to work out all the technical and constructability details of the contract with the client, and then negotiating appropriate commercial terms and conditions without necessarily having to go back to CBI’s legal department for advice.

This extra capability—evaluating and negotiating commercial terms and conditions for construction contracts—was designed to give us a clear edge over our competitors. We could work closely with the client on all aspects of the project—both technical and commercial—and then close the deal commercially without ever leaving his side or making an outside telephone call.

The sales training program included a lot of classroom time on such seemingly routine contractual considerations as terms of payment, scope of work, schedule, claims and disputes, termination and suspension, and warranties.

It also introduced us neophyte contractors to such new and mysterious contractual terms as indemnity, additional insured status, force majeure, advance waivers of rights, specialty insurance

coverage, and assurances of performance. The instructors told us horror stories about the financial consequences that arose out of accepting a client's risky commercial terms and conditions for engineering and construction contracts.

This training course set the path of my career as, for the next 25 years, I worked in several different sales offices located on the East Coast and the Midwest of the U.S. and for 13 of those 25 years, in Southeast Asia. I participated in and/or managed the negotiations of the commercial terms and conditions for hundreds of engineering and construction contracts ranging in value from small \$50,000 repair projects, to major engineering, procurement, and construction (EPC) projects worth over \$100 million. Clients ranged from small owners to major international oil, gas, chemical, and petrochemical clients, and major domestic and international EPC contractors from the U.S., Europe, and Asia.

There were a huge variety and complexity of commercial terms and conditions in all these contracts over those 25 years. Every owner or EPC contractor had their own favorite idea of what constituted acceptable commercial terms and conditions. Negotiating acceptable terms and conditions for CBI projects was always a challenge; nothing ever was the same. On a few occasions, the client's commercial terms and conditions were so one-sided and unacceptable, and the client was so reluctant to change them, that the only thing left to do was close the file and walk out the door. It was time to let some other poor contractor suffer with those lousy commercial terms and associated risks.

When I retired in 2001 after 32 years with CBI to form my own company, I looked back at all the diverse practical negotiating experience I had with engineering and construction contracts in the U.S. and internationally and felt it was important to write a practical, user-friendly, and non-legalistic book about this subject. It is my hope that my own experience will help contractors, regardless of the size or sophistication of their companies, to negotiate better and less risky commercial terms and conditions for construction contracts—and thereby better protect their assets.

I hope that contractors can learn something from this book and use it as a practical desk reference. If by reading this book, they learn nothing more than to be able to better identify, understand, and evaluate risky commercial terms and conditions, and then negotiate or otherwise seek help to resolve them, I have succeeded.

# Disclaimer

During the course of writing this book, I was reminded on several occasions by my good friends and excellent reviewers that I needed to include a written disclaimer regarding the reader's use of the contracting and negotiating guidance provided—as it is impossible to anticipate all the circumstances that may arise in a construction contract. I have tried my best to provide what, in my experience and opinion, is practical information gained from my over 30 years in the engineering and construction business. My hope is that this book will help contractors and subcontractors understand, evaluate, and favorably negotiate construction and construction-related contracts and thereby help protect their assets.

I do not provide any express or implied warranty on the use of any of the information contained in this book as it may be applied to understanding, evaluating, and negotiating construction contracts. Readers should consult, as needed, with professionals on their particular contracts and circumstances.

– Kit Werremeyer



# Introduction

*There is no price for bad terms.*

~ Construction contractor from Toledo, Ohio

## ***The Goals of This Book***

This book was written with three important goals in mind:

1. Assisting contractors in improving their abilities to identify, understand, and evaluate certain high-risk commercial terms and conditions typically found in all construction contracts.
2. Providing contractors with negotiating suggestions on how to lower or eliminate the risk associated with commercial terms and conditions.
3. Providing straightforward information in as uncomplicated and non-legalistic a manner as possible.

The book will help contractors in their effort to negotiate favorable commercial terms and conditions for their construction contracts. By doing so, this will help lower their commercial risk; assist in improving their terms of payment; and reduce their exposure to claims, disputes, and unnecessary or inappropriate risk transfer and its associated potential financial liability.

## ***What Are the Benefits of This Book?***

Contractors must be able to identify, understand, and evaluate all the commercial risks that are accepted by agreeing to an owner's proposed contract. They must then be able to effectively minimize and manage those commercial risks—mitigating or eliminating them through negotiations—and thereby lessen their exposure to any potential financial liabilities. This will ultimately *protect the assets of their companies*. This is the primary benefit of this book.

## ***Contractor & Owner Conventions***

This book refers to contractors and owners—both in the general sense, and capitalized in actual sample contract clauses. “The contractor” refers to you, the reader of this book—whether general contractor or subcontractor—working hard in the construction business trying to make a living. “The owner” refers to the company that the contractor is providing construction work for, and with whom he will sign a construction contract. **(Note that throughout this book, the masculine singular “he” is used, for simplicity only, and to avoid the more cumbersome “he/she”/“his/her” construction.)**

Also for simplicity, the book refers to the construction contract between the owner and contractor. Often, however, the contractor will have a contract with another construction company who works for the owner, perhaps in the role of the owner’s project manager, or the owner’s main contractor. In this case, the contractor would typically be considered a subcontractor, and his construction contract would likely be called a subcontract with the owner’s project manager or main contractor. It doesn’t matter whether the contract is made directly with the owner, or whether it’s a subcontract with the owner’s PM or main contractor—the information contained in this book about understanding and negotiating construction contracts applies equally to all of these contracting relationships.

## ***Private Contracts or Government Contracts?***

The contracting concepts presented in this book apply to contractors working with private U.S. owners, and not federal or state government owners. Construction contracts with U.S. federal, state, and local governments may have different commercial contracting challenges. Sometimes, for instance, government contracts are, by law, nonnegotiable with respect to the types of commercial terms and conditions a contractor must accept. However, the concepts and suggestions in this book can be used to help better understand and manage similar commercial issues in government construction contracts, and can assist the contractor, particularly in those situations where negotiation is an acceptable part of the government’s contracting process. In Chapter 16, “International Contracting,” the additional concepts presented also apply to contracts between a private contractor and a private owner. Contracting with foreign governments and their various departments often presents exceptional contracting challenges that are beyond the scope of this book.

## ***Key Contracting Concepts***

Throughout this book, two key contracting issues with construction contracts are discussed:

- **Commercial Risk:** The risk associated with the potential for the contractor to be harmed in some way by accepting the wording

in an owner's construction contract's commercial terms and conditions.

- **Potential Financial Liability:** The possibility of having to pay money, which would arise from the obligations that a contractor agrees to accept in the owner's construction contract's commercial terms and conditions, and that might arise also from the contractor's common law obligations. Common law is the body of law that develops out of decisions made by courts—called precedence—rather than law that is created by statute.

## Examples of Commercial Risk

Commercial risk creates an exposure to the potential for financial liability and flows directly from the commercial terms and conditions contained in the owner's construction contract. Commercial risk is probably the risk a contractor finds most difficult to understand and manage. Some typical examples of a contractor's exposure to commercial risk found in a construction contract's commercial terms and conditions are:

- Exposure to the financial liability to pay liquidated damages or other consequences of contractor's late performance.
- Exposure to the financial liability to pay for damages that are caused by the owner's negligence.
- Not being paid for legitimate changes for additional work.
- Not being able to settle legitimate disputes in favor of the contractor.
- Exposure to an owner cashing in a contractor's performance or payment bond without legitimate reasons.
- Exposure to the financial consequences—not enough cash to pay bills—of not being paid by the owner on time for progress payments.
- Exposure to the financial liability that may arise out of lengthy warranty periods or requests by an owner to perform warranty work that is really not warranty work.
- Exposure to the financial liability that may arise out of other risks encountered on a construction project, such as differing site conditions and force majeure.

## *Two Types of Commercial Terms & Conditions*

The commercial terms and conditions typically found in a construction contract can be split generally into two categories:

- Administrative terms
- Financial liability terms

Administrative terms are those commercial terms and conditions that have a low probability of creating a significant financial liability for the contractor. Financial liability terms have a high probability of doing so. The focus of this book is to improve the contractor's ability to understand and evaluate these financial liability terms and conditions and learn ways to lower or eliminate the commercial risk associated with them through effective negotiations.

A typical construction contract can be divided between administrative and financial liability terms as shown in Figure 1.

This book will discuss only those commercial terms and conditions that tend to create a high probability of financial liability for the contractor. This doesn't mean, however, that other terms and conditions should be ignored or taken lightly. It just means that if the contractor has to focus his effort primarily on one of these sets of commercial terms, it should be on the commercial terms that have the greatest potential for harm.

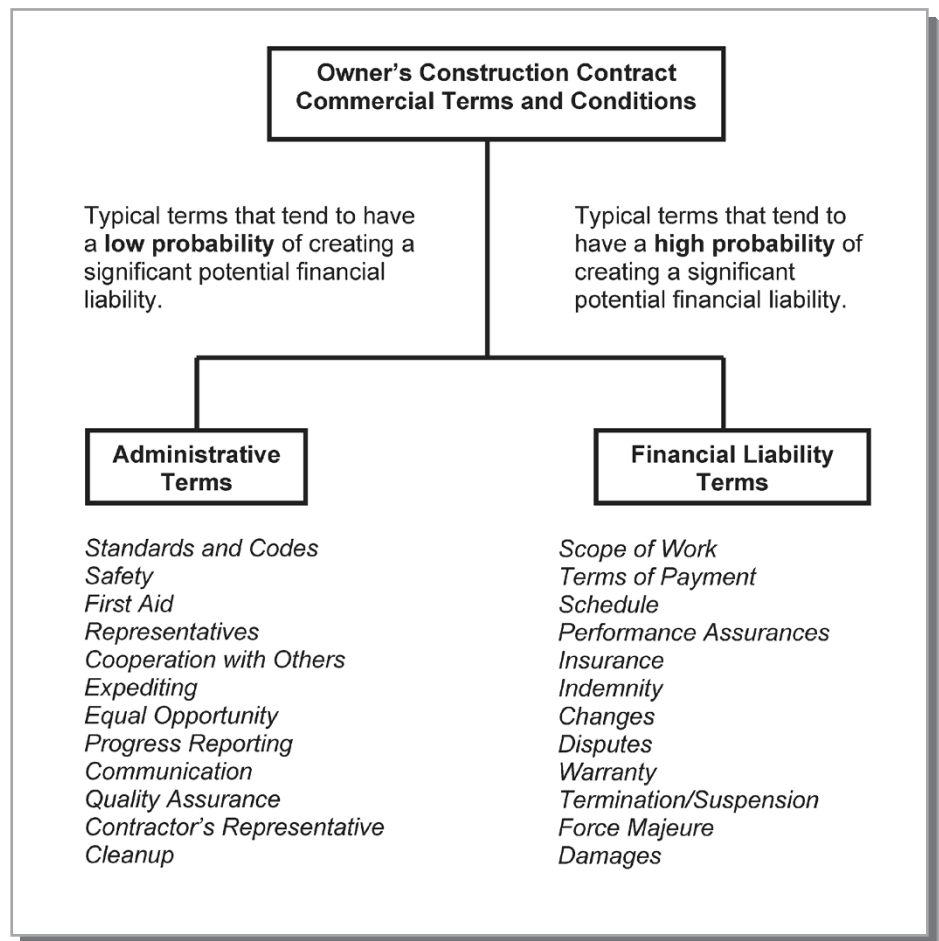


Figure 1: Types of Contract Terms

## ***The Most Important Commercial Terms & Conditions***

The three most important commercial terms and conditions contained in all construction contracts are:

1. Scope of work
2. Pricing and terms of payment
3. Schedule

These commercial terms are the *three foundation stones* of all contracts, as shown in Figure 2.

## ***The Contracting Process***

Here's a bold statement: *There is no difference between a construction contract for a new one-story office building worth \$500,000 and a new grassroots oil refinery worth \$1 billion.* Think about this for moment. The contractor for each project must have a written construction contract to perform the work described. Each contract will have a scope of work section, terms of payment, and a schedule. Further, each contract will likely have contractual obligations for insurance, warranty, changes, dispute resolution, termination and suspension, damages, indemnity, and assurances of performance.

Certainly, the complexities of the two projects are significantly different, but the contracting process of understanding and negotiating commercial risk issues and potential financial liability issues are the same, and must be properly dealt with by each contractor in order to protect the assets of their companies.

## ***Excuses for Not Negotiating Better Commercial Terms & Conditions***

What are the typical excuses given by contractors when faced with the prospect of having to try to negotiate better commercial terms and conditions in the owner's construction contract? Some of the most common:

- "It's too hard to deal with the owner and his lawyers."
- "The owner will disqualify me if I take exception to his terms and conditions."

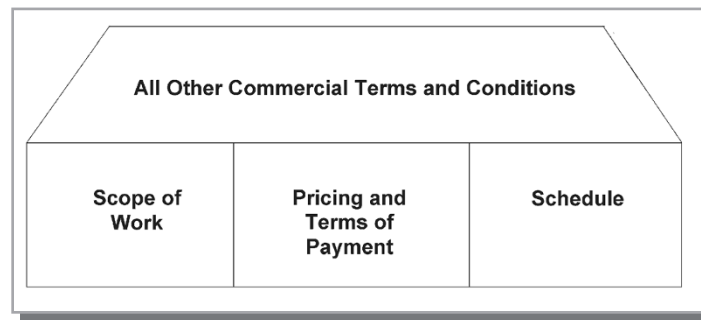


Figure 2: Three Foundation Stones of a Contract

- “I don’t understand the terms and conditions well enough to negotiate better ones, and I don’t want to hire a contracts expert or a lawyer.”
- “The competition accepts the owner’s terms and conditions all the time, so I don’t have much of a chance.”
- “I don’t like to negotiate. Maybe the best thing to do is just sign the contract, put it in the bottom drawer of the desk, and hope nothing happens.”

The last excuse basically says this: “sign, do nothing, and pray for the best.” This strategy works fine as long as nothing goes wrong during the execution of the contract. However, things often do go wrong during the course of executing construction contracts!

Let’s say the owner creates lengthy delays to the construction schedule, refuses to acknowledge his fault, then penalizes the contractor by imposing liquidated damages for late performance. Once something like this happens to a contractor just once in his lifetime, he will wish he had made the effort to negotiate more favorable commercial terms and conditions prior to signing the contract.

One good reason to negotiate changes to the owner’s commercial terms and conditions is simply to improve the contract for the benefit of the contractor, and to lower the contractor’s exposure to potential financial liability at the same time.

For example, creating a detailed scope of work document that carefully outlines what the contractor, owner, and all other parties involved in the contract are obligated to do will *always* serve to minimize misunderstandings and disputes over the scope of work. Often the contractor has the best experience and background to assist the owner with developing a detailed and comprehensive scope of work document.

## ***The Concept of Risk Transfer***

Another contracting concept that will be discussed throughout the book is the concept of risk transfer. Commercial terms and conditions, such as those associated with insurance and indemnity clauses, transfer the risk of potential financial liability for certain events from one organization to another. Insurance transfers the risk of certain potential financial liabilities from the contractor—the named insured—to the insurance company in return for the payment of a premium. An indemnity clause in a construction contract can transfer to the contractor the risk of certain potential financial liabilities that may arise due to the negligence of the owner—in return for nothing!

Contractors must understand the consequences of accepting risk transfer clauses in a construction contract. Negotiating changes to risk transfer clauses can significantly lower exposure to the possibility of unnecessary or unwarranted financial loss.

# *This Is a Book Developed Just for Contractors*

*Before the contractor signs the contract, he needs to understand the commercial risks and their possible financial consequences. The contractor's assets are at stake.*

*This book is not designed to be anti-lawyer or anti-owner. It is designed to be pro-contractor.*

Every attempt has been made to write this book in as non-legalistic a manner as possible. It was written for those contractors who have no legal training in contract law and are simply in business to engineer, procure, and safely build construction projects.

Anyone who is willing to take the time to understand the basic concepts of construction contracting can become effective in understanding, evaluating, and managing commercial risk and negotiating more favorable commercial terms and conditions. Can a lawyer who specializes in construction contracting help a contractor understand and negotiate a construction contract? Certainly he can, but that assistance, and cost, is not always necessary.

The book features samples of actual contract language—both the good and the bad, the fair and the unfair. Each chapter contains these easy-to-understand clauses, in boxes for quick reference, which show contractors the kind of language that should be used, as well as jargon and unreasonable terms that should be avoided. Having a good working knowledge of the major commercial issues involved in construction contracting will help a contractor understand what he is getting into, the risks he is taking, and the risks he doesn't want to take.

Is the contractor agreeing to a fair contract, or taking on a lot of unnecessary responsibilities and commercial risks? Will he get paid on time? These are the types of questions a contractor will be able to answer and resolve after reading this book—before signing a construction contract.

It may appear when reading through this book that owners are cast in a bad light, and that all too often they demand unacceptable commercial terms and conditions. This is not true. Some progressive owners have, or will negotiate, commercial terms and conditions that are fair and balanced for both parties—the owner and the contractor. The contractual issues covered in this book are meant to raise the awareness of contractors to worst-case situations that can arise from accepting certain commercial terms and conditions in a construction contract—and how to edit and reword unfair clauses.

## *Three Final Suggestions*

Finally, contractors should remember these three important things:

1. Read and understand everything in the construction contract.
2. Negotiate better commercial terms and conditions with the goal of reducing commercial risk and the associated exposure to potential financial liability.
3. Get all agreements in writing from an authorized representative of the owner!

