

Owner Remedies in Construction Agreements

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This article presents a discussion of the issues surrounding certain remedies available to an owner or developer of a project (“Owner”) under a construction agreement with a prime contractor (i.e., general contractor or construction manager, hereinafter “Contractor”), some of which is also applicable to the remedies available to the Contractor under its agreement with a subcontractor. This discussion will highlight the main issues pertaining to principal remedies, but is not intended to serve as an exhaustive survey of all issues and remedies. Also, the article is based on New York State law, though most of the discussion is likely applicable to contracts governed by other state laws.

Termination for Cause

In the contract provision entitling the Owner to terminate the contract “for cause” (i.e., breach of contract and other events), the term “cause” (or any other term used in its place, such as “breach” or “event of default”) should be defined with specificity to avoid any ambiguity when the Owner exercises its termination right. Grace periods for curing a default

are customary, but should not be granted for defaults incapable of being cured, such as a bankruptcy filing by the Contractor. Moreover, the grace period should be for a fixed period of time, not an open-ended period deferring the contract termination indefinitely—that is, for as long as the Contractor is diligently working towards remedying the default.

The Owner’s initial contract draft may provide that all payments due to the Contractor are forfeited if the contract has been terminated for cause. The Contractor will likely request payment of any amounts earned through the date of termination. As a compromise, the contract can allow any earned payments to be made to the Contractor, but only after the project has been completed and only if and to the extent those payments exceed the damages the Owner incurred as a result of the Contractor’s default.

It is important for the Owner to collect the Contractor’s project documents on a regular basis during the course of the project (such as, for example, subcontracts, as-built drawings, and subcontractor warranties/

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guaranties), because it may be difficult to do so if the Owner terminates the contract for cause, or is battling with the Contractor over defaults that may lead to a termination.

It is also imperative that the prime contract provides that, at the Owner's election upon a termination of the prime contract, any or all of the subcontracts will be deemed assigned to the Owner, without the need for the Contractor to take any action. The subcontracts should contain a corollary provision. The subcontractors will likely want assurance that any payment default by the Contractor will be cured by the Owner upon any such deemed assignment. This requirement can be problematic for the Owner because of the possibility that, at the time of the deemed assignment, the Contractor will not have paid the subcontractors from funds it received from the Owner. The best way to mitigate this problem is to procure monthly lien waivers from the subcontractors so that there should be only a one-month deficit between the payment made to the Contractor and the payments received by the subcontractors.

Termination for Convenience

In addition to the standard right the Owner has to terminate the prime contract for cause, the prime contract should also allow the Owner to terminate the contract without cause. Given the need to move quickly when faced with an unsatisfactory Contractor (especially one not technically in default), it is important that the Owner have a termination right which does not require demonstrating that a default has occurred or waiting for grace periods to expire. Of course, the Contractor may require a termination or break-up fee, but such a fee may be less expensive than the additional

costs potentially incurred by the Owner due to the delay resulting from a default-based termination.

Continuing to Work Despite a Dispute

It is essential for any construction project that the prime contract requires the Contractor to continue working even if there is a dispute with the Owner over payment or another matter. In exchange, the Contractor will likely want the Owner to agree to pay any undisputed amounts.

Indemnification

The indemnification clause in a prime contract may require the Contractor to indemnify the Owner from any liability or losses arising from the Contractor's work. In response, the Contractor may seek to limit the scope of its indemnification to liability or losses arising from personal injury or property damage claims. Such a limitation will exclude contract breaches from the indemnification coverage. As common law affords the Owner the right to recover damages for contract breaches, however, limiting the indemnification remedy in this manner should not be objectionable. The one difference is that, under a standard indemnification provision, the Owner has the right to recover its legal fees as part of the indemnified damages, while common law does not similarly provide for such recovery. Therefore, without a contractual provision awarding legal fees to the prevailing party, omitting contractual breaches from the indemnification coverage would preclude the Owner from recovering those fees.

Liquidated Damages

A liquidated damages provision in a contract

will fix the amount of damages to which the Owner is entitled if the Contractor fails to timely complete its work or certain phases of the work. The principal issue with respect to a liquidated damages remedy is that it is generally the sole remedy available for delays; if the Owner's actual damages ultimately exceed the fixed liquidated damages amount, the Owner will not be able to recover the higher amount. On the other hand, a liquidated damages remedy allows the Owner to avoid proving its damages, or proceeding to court in order to recover the damages (as long as there is enough withheld from the Contractor to fund the liquidated damages). It is important to keep in mind that the amount of liquidated damages must be a reasonable approximation of the actual damages the Owner would incur by reason of the Contractor's delay.

The Contractor will likely request a cap on the total amount of liquidated damages, which may further increase the gap between the liquidated damages amount and the actual damages amount. One other potential problem is that the Contractor, when threatened with the assessment of liquidated damages, may sacrifice quality for speed in order to avoid being assessed.

Warranty/Guaranty

The Owner is, of course, the direct beneficiary under the guaranty and warranty provisions in the prime contract. The prime contract should require that the Owner be named a third-party beneficiary under the guaranties and warranties provided by each subcontractor (whether in its subcontract or a separate warranty/guaranty document). The Owner should also have the option of enforcing its rights against the Contractor or the

subcontractors. If the Owner elects to proceed directly against a subcontractor while its warranty or guaranty rights against the Contractor have not yet lapsed, the Owner should involve the Contractor in the process in order to preserve its warranty and/ or guaranty claims against the Contractor. In fact, the prime contract should provide that the Contractor must, at the Owner's discretion, either enforce the warranties and guaranties against the subcontractors, or assist the Owner in its enforcement of the warranties and guaranties.

Even though the Owner will have recourse against the Contractor, it is important for the following reasons that the Owner ensure that the warranty and guaranty benefits it expected to receive from the subcontractors are actually memorialized and the documents granting such benefits are delivered to the Owner:

- The warranty or guaranty periods in the prime contract may be shorter than the periods afforded by a particular subcontractor.
- If the Contractor becomes insolvent or otherwise ceases to operate its business, the only recourse available to the Owner may be against a subcontractor.
- There may be an independent business relationship between the Owner and the Contractor, making it inadvisable for the Owner to seek recourse against the Contractor.

When assessing the Contractor's responsibilities, the enforcing party should make sure it reviews any warranties or guaranties contained in the design specifications, in addition to those set forth in the contract.

It is also important to note that if a warranty breach is discovered during the “guaranty” period, then the breaching party should be given the opportunity to remedy the defective work; otherwise, that party may have a defense to a damage claim under the warranty provision (at least as to the amount of damages sought), arguing that it could have mitigated the damages if it had corrected the defect itself. After the guaranty period has expired, there is no obligation to afford the breaching party the right to repair the work itself, but there may be business or practical reasons to do so.

Prompt Payment Act

The Owner’s rights and remedies may be limited by a Prompt Payment Act, which may override provisions in the prime contract, affecting such issues as the time period for payment to the Contractor, the Contractor’s right to suspend its work for non-payment, interest chargeable on late payments to the Contractor, and other contractual matters.

Waiver of Consequential Damages

If the Contractor requests a waiver of its liability for consequential damages incurred by the Owner, and the Owner acquiesces, then, at the very least, there should be a reciprocal waiver benefitting the Owner. Also, the Owner should consider excluding damages arising from such actions as willful misconduct, gross negligence, or breach of confidentiality provisions.

Force Majeure

A prime contract’s *force majeure* provision

entitles the Contractor to a time extension upon the occurrence of a *force majeure* event (and possibly reimbursement of additional costs incurred). One of the key issues for the Owner is to ensure that the Contractor provides notice of the purported *force majeure* within a designated period of time. The Owner does not want to receive a notice months after the occurrence of such an event, when it would be much more difficult to confirm the existence and duration of the event and assess the validity of the Contractor’s delay claim. The Contractor should also be required to provide a statement as to how the *force majeure* event created a delay in the Contractor’s work or caused the Contractor to incur additional costs, and specifying the duration of such a delay or the amount of such additional costs. If the time or cost impact on the Contractor’s work cannot be ascertained at the time the Contractor’s notice of the event is due, then the Contractor should be required to deliver such a statement promptly after the event concludes or the impact becomes known. Finally, the Contractor should be obligated to mitigate, if possible, such time or cost impact.

Conclusion

There are many considerations that an Owner must take into account in drafting the remedy provisions in its construction contracts, and the enforcement of these remedies must adhere closely to the requirements of those provisions. Your lawyer should help you craft remedies that address these considerations, and are capable of being enforced expeditiously.