NAC Executive Insights

Unfair Contract Provisions

Key Points

- Unfair contract provisions do not serve the construction industry well.
- What makes a contract provision unfair is typically in the eyes of the beholder.
- Writing a commercially balanced contract is more difficult to do than a one-sided one, and requires a certain amount of finesse and thoughtfulness.

Introduction

Unfair contract provisions and one-sided contracts are topics for which almost every construction executive has strongly-held views. In fact, the term "strongly-held views" is an understatement. For every person who insists that a contracting approach is absolutely right and appropriate, it seems someone else is there to argue the contracting approach is absolutely wrong and immoral. This "debate" over unfair and one-sided contracts has been going on for decades. Perhaps even more challenging is that the industry doesn't even have a consensus on what constitutes a one-sided contract or an unfair contract provision.

A great example is the industry's views on "No Damages for Delay" clauses. These clauses preclude a contractor from receiving compensation (e.g., time-related costs) for an excusable delay. They only allow the contractor to obtain a time extension. At a recent industry meeting of nationally-recognized construction lawyers, I asked those lawyers representing general contractors whether they thought it was unreasonable for owners to include this clause in their contracts with general contractors. Almost everyone in the room raised his/her hand in the affirmative. I then asked that same group of lawyers whether they thought it would be unreasonable for general contractors to include this clause in their subcontracts. Predictably, almost every hand went down. Objectively, how can this be? A No Damages for Delay clause is either unreasonable or it's not. The answer really shouldn't depend on who is advocating for the use of this clause in its contracts. Or should it?

Unfair Contract Provisions and Risk Shifting

The fact of the matter is that most of us in the construction industry aren't objective in how we look at the reasonableness of contract clauses and risk shifting in contracts. One would think the right way to frame the question is, "What's in the best interests of the industry or project?" Inevitably, however, we frame the question as, "What's in the best interests of my company or my client?" As a result, the questions of "What is an unfair contract provision?" or "What is a one-sided contract?" are really fake

questions. The assessment of whether a contract is one-sided or a clause unfair seems to be determined purely from the eyes of the beholder. Those in "power positions," e.g., owners in their dealings with contractors and contractors in their dealings with subcontractors, believe with all their heart that it is absolutely appropriate, necessary, and normal to shift substantial risk downstream. After all, "he who has the gold rules." When viewed from the subordinate party in the relationship, however, those risks and contract terms are considered horrible, onerous, and unreasonable. Until, of course, the time comes when the "subordinate party" becomes the "power party" and shifts those same risks and contract terms to its downstream contractors (i.e. the show of hands in the previous "No Damages for Delay" discussion).

How can it be that such smart and experienced people in the industry come to see these issues so differently? Here are some of my random thoughts:

- **The industry has accepted longstanding federal contracting principles as being fair.** We are creatures of our education and experience. Many procurement and contracting specialists, including construction lawyers, studied federal construction contracts and came to believe that these contracts were reasonably balanced. In many respects these contracts are fair and balanced, as these federal principles gave the construction industry remedy-granting provisions like the Differing Site Condition clauses. These federal clauses, however, also gave the industry remedy-restricting provisions that shift substantial risk to contractors. Why should a defective termination for default be converted to a termination for convenience? Why should the costs incurred under a suspension of work not have a profit markup? Why should a contractor be required to advance the funds to implement a disputed change and get paid only *after* litigation? These provisions are part of the fabric of public and private construction contracts. Are they fair? Do you ever stop and think about whether they are fair?

- **The industry has accepted standard form language as being balanced and appropriate.** Most standard form construction contracts have a reasonable degree of balance, and the industry touts this as we use them. Take for example, however, the language in some standard form contracts where a contractor does not receive damages for delays caused by events beyond the control of both parties (e.g., weather, government actions). Why is this fair? Every day on a project site costs the contractor money. Objectively, is this really a risk the contractor should bear? What about "pay when paid" clauses for subcontractors? We know why general contractors want and need this. Is it fair, however, to the subcontractor?

- **The "greater fool" theory.** *"Every other contract has this approach, so why should we change it here? Yes, I know that this is shifting the risk to the contractor, but the market will tell us if we are too far, or they'll just price the risk."* How often have I heard this on my major design-build and P3 projects? And it is hard to argue against, as it always seems that someone will take the risk in these deals. But sometimes we have to do the right thing and protect the industry from itself. Think about what happened in the civil infrastructure arena in 2019, when the construction industry's biggest and most experienced contractors reported huge write-offs for some major design-build and public-private partnership (P3) projects that went bad. The same

thing occurs repeatedly in the industrial sector, as the world's biggest (and presumably best) engineering/construction companies report losses on lump sum engineer-procure-construct (EPC) contracts. Inevitably, this causes these companies to reassess their portfolio of work and whether they will participate on certain projects. These situations create major setbacks for the industry. Are owners happy to have fewer contractors bidding their projects? Yet those advocating for the "greater fool" theory might say, "Let market forces weed out the weak."

- **The need to win and look strong and tough.** Do you ever praise your outside lawyers to others by saying, "My lawyer writes really fair and commercially balanced contracts!"? Nope. But how many of you compliment your lawyer by saying, "My lawyer wrote a wicked tough contract that totally protected me!"? Who is considered the better lawyer? Lawyers are truly competitive and want to win. So do our internal procurement and contracting personnel. More importantly, they want to demonstrate their value. Writing a one-sided contract to protect a company's position certainly can accomplish the "win and look strong and tough and add value" goals.

It is not that hard to write a one-sided contract that shifts all risks to the downstream party. It is much harder, however, to write a commercially balanced contract. It requires a certain amount of finesse and thoughtfulness. It also requires telling our colleagues, clients, and senior executives why assuming some risks is in the best interests of the project and industry. Will procurement, contracts, or legal departments want to do this? Are they better off just writing that tough contract and being the "hired guns" that everyone expects?

What Could the Industry Do to Improve This Situation?

The debates and complaints about the construction industry's use of unfair contract provisions and one-sided contracts have been around forever. Private sector owners sometimes change their views when they have to—as has been the case in past years when major engineering and contracting (E&C) companies have pushed back on risk and said, "Enough is enough. If you want to use us, here's the way it will be." Inevitably, as markets soften and memories fade, contractors are then willing to assume more risk and the industry cycles back. I have rarely been associated with anyone that has organizationally taken a position that it will use balanced contracts willingly as opposed to begrudgingly. With that said, the industry might do the following to help temper the problem:

- **Truly understand the business of our contracting partners.** I find it amazing how little owners know about the business of contractors, and specifically, how they work for such small margins. The owner ultimately gets a completed, functioning asset that will have a long, useful life. Contractors are getting paid for delivering the asset and then moving onto the next job. Unquestionably, owners are in a better position to assume major risk than contractors. The return on investment (ROI) may go down a bit or there may be political fallout from overruns, but the owner has the asset. A huge hit to a contractor on one bad job, however, could put him or her out of business. Contractors need to think about the same thing in flowing down risk to their

subcontractors. How can it be that the weakest balance sheets on a project carry the greatest risk?

- **Evaluate whether the unfair contract will be enforced as written.** Those of you involved in contract drafting and negotiation likely understand that the words in a construction industry contract do not always mean what is written and may not be enforced/interpreted as written. This drives non-lawyers crazy. But it is the reality. Courts will find public policy reasons

- against enforcing certain clauses. Case law has created exceptions to certain clauses. Judges, juries, and arbitrators will often see things as they are and decide it would be unfair to penalize someone by enforcing a clause. Given this, might a more
- commercially balanced contract have a better chance of being enforced? Likely yes.

- **Consider using carrots rather than sticks.** The construction industry does a poor job with incentives. Sure, bonuses for early completion or sharing savings are routine. What about *behavioral* incentives? How often do we think about using these in our contracts? What effect might that have on ultimately getting what our clients want? Award fees with federal government contracts have a long and positive history—maybe we should be thinking about those instead of how to just shift contractual risk away.

A Closing Thought

Here's my final thought. I was asked by an owner client to give her a really "owner-friendly" EPC contract as a starting point for her drafting and consideration. Even though I represent only owners, I really don't have such a document. My files have several EPC contracts that I have previously negotiated and executed with various EPC contractors. I stripped out the names of the parties and gave her one of those. In reality, at this point in my life, I find it very hard to distinguish between a "contractor-friendly" and "owner-friendly" contract. Will an "owner-friendly" contract have shorter notice requirements? Will it shift all risk of site conditions to the contractor? Will it impose the risk of consequential damages on the contractor? Maybe. But is the owner better off by doing these types of things? I don't think so. Won't a sophisticated contractor object to these things?

Developing an effective contract is not brain surgery. Put yourself in the position of your counterpart. Figure out what makes the most sense to get the project done, with a relationship that makes both parties reasonably comfortable. From my perspective, unfair and one-sided contracts can easily lead to bad relationships and poor project results. One-sided contracts can give the "power party" the illusion of protection—but rarely does that contract save a project from disaster.

About the Author

Michael C. Loulakis was elected to NAC in 2012. He is president and CEO of Capital Project Strategies, LLC, a Reston, VA-based consulting firm providing procurement, contracting, and risk management services. He holds a civil engineering degree from Tufts University and a law degree from Boston University School of Law. Mike has over 30 years of experience advising public and private sector owners on capital project programs. He has particular expertise with large projects in the transportation, water, and tunneling sectors, and is well known in the private sector on power, petrochemical, and process industry projects. He frequently serves as a neutral in arbitrations, mediations, and dispute resolution boards. He has written numerous books on project delivery and design-build and since 1981 has contributed the legal column for *Civil Engineering* magazine.