UNDERSTANDING THE EIGHT (8) KEY CONTRACT CLAUSES IN MODERN CONTRACTS

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ABOUT THE AUTHOR

A little bit about Tony M. May, Esq.

- B.S. Civil Engineering, UNLV 1994
- Registered Professional Engineer (CA)
- University of Nevada Las Vegas (UNLV), graduated 1994 with B.S. Civil Engineering (*Magna Cum laude*)
- University of Iowa College of Law, graduated 2001 with Juris Doctor (*with distinction*)
- Admitted to practice law in Nevada and California
- Primary Practice Areas:
  - *Professional Licensing*
  - *Business Formation and Litigation*
  - *Construction Law*
  - *Real Estate Law*
  - *Labor and Employment Law*

ABOUT THE AUTHOR

A little bit about Tony M. May, Esq. (Cont.)

- Co-Author of the book "State-by-state Guide to Construction Contracts and Claims"
- Former Bar Examiner for the State Bar of Nevada
- Selected by *Vegas, Inc.*, in 2012, as one of **Southern Nevada's Top Lawyers**
- Selected by *Desert Companion Magazine*, in 2014, as one of **Las Vegas Valley's Top Lawyers**
- AVVO Rating of Superb (10.0 - highest rating)
- Included within **America's Most Honored Professionals**, 2016

ABOUT THE FIRM

A little bit about the Law Office of Tony M. May, P.C.

- Our Firm takes on business owner's problems, so that they can sleep better at night.
- This firm was created in 2009 so that we could provide better quality and cost effective legal services to our clients. Since that time, we have assisted many clients achieve their legal goals.
- The firm's practice areas include:
  - Administrative law (i.e., Licensing Boards)
  - Business Formation and Business Litigation
  - Construction Law
  - Labor and Employment Law
  - Real Estate Law
  - Trial practice and
  - General Civil Litigation.

PRESENTATION OUTLINE

I. Introduction To Contracts

A. General Overview of Contracts
B. Standard Form Contracts

II. Key Contract Provisions in Modern Contracts

A. Incorporation By Reference Clauses
B. Scope Of Work Provisions
C. Liquidated Damages Clauses
D. Payment Clauses
E. Indemnification Clauses
F. Notice Clauses
G. Change Order Clauses
H. Arbitration Provisions

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GENERAL OVERVIEW OF CONTRACTS

A. REAL FACTS ABOUT CONTRACTS

1. Many individuals treat their contracts and contract negotiations with little thought other than $;
2. Others treat contracts as a necessary evil or a mere formality to get to what they need;
3. More alarming; some individuals enter into contracts with no understanding of the contract language, or the liabilities being assumed;
4. Please Understand, one bad contract can close down a company;
5. Individuals need to pay more attention to the risks and liabilities being assumed in contracts and not just focus on the services being provided;

GENERAL OVERVIEW OF CONTRACTS

A. REAL FACTS ABOUT CONTRACTS (Cont.)

6. The core principles that govern contract negotiations include:
   - ❑ *The trade-off between risk and reward (i.e., to be successful over the long run, risk and reward must be kept in balance);*
   - ❑ *Understand that the profit margin, in most cases, is small relative to assumed risks;*
   - ❑ *The profit margin is limited by the extent of competition.*
   - ❑ *The risk assumed is generally not limited by competition; and*
   - ❑ *For almost every contract, it is possible to lose much more money than it is possible to make.*
7. The first step to continued viability and prosperity of a business is to insure that its liabilities, obligations and profit margin are kept in balance, and not left up to chance;

GENERAL OVERVIEW OF CONTRACTS

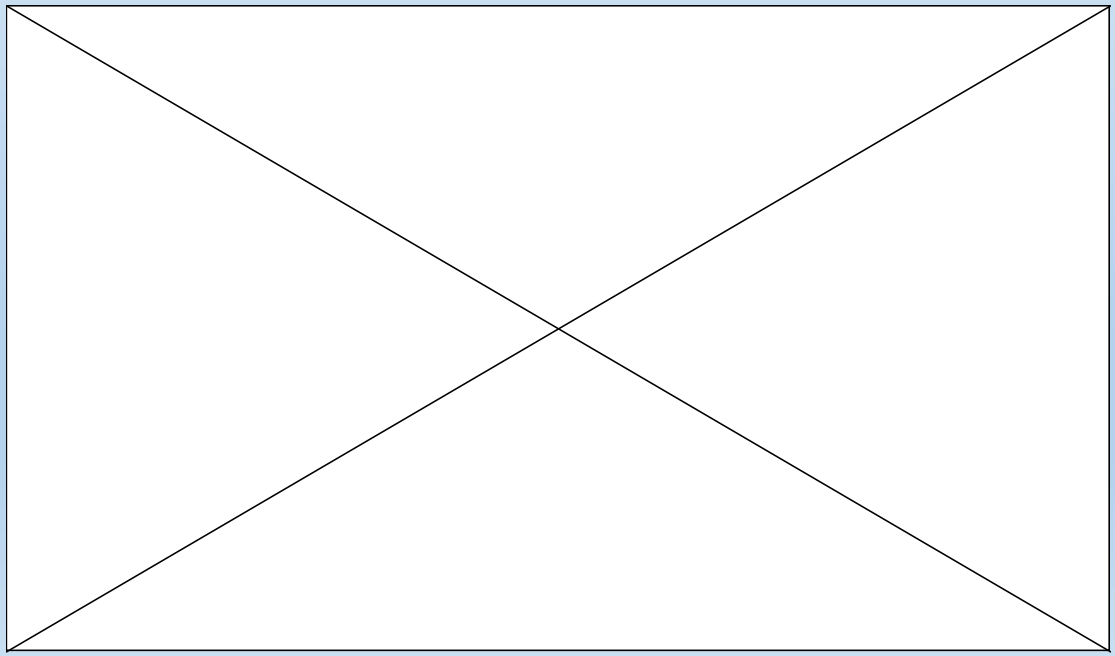
A. REAL FACTS ABOUT CONTRACTS (Cont.)

8. Some lawyers tell businesses to walk away from every contract negotiation where onerous or lopsided contractual provisions are being demanded;
9. This is good legal advice, but it fails to account for real world situations of businesses today.
10. As long as one business is willing to sign an onerous or lopsided contract, these provisions will remain part of the business community.
11. A business' ability to modify its contracts during contract negotiations depends upon the relative bargaining position and persuasiveness of that party.

GENERAL OVERVIEW OF CONTRACTS

A. REAL FACTS ABOUT CONTRACTS (Cont.)

12. Bargaining positions changes over time due to fluctuations in the availability of labor, funds and materials.
13. Business negotiator's golden rule.
    (He who has the gold makes the rules)



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STANDARD FORM CONTRACTS

B. STANDARD FORM CONTRACTS

1. For many years, the construction industry has used standard form contracts.
2. Some of these contracts have been around for many years and have gained widespread acceptance.
3. With the age of the internet, standard form contracts are now being used for other industries and for general business uses.
4. Even though standard form contracts may be widely used, do not just assume that the contracts are fair and impartial and that they cover your needs.
5. Most standard form contracts are created by trade associations who tend to favor their members.
6. Any use of standard form contracts should be done only after a thorough review of the agreement is performed.

STANDARD FORM CONTRACTS

B. STANDARD FORM CONTRACTS (Cont.)

7. It is *extremely* important to **take great care when modifying a standard form contract**, because one simple change can unknowingly cause problems with other parts of the contract. This is especially true when using standard form contracts in multi-party agreements.

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KEY CONTRACT PROVISIONS

A. INCORPORATIONBY REFERENCE CLAUSES

1. The first contractual provision being discussed is many times the most ignored and is generally referred to as the "Incorporation by Reference Clause"
2. Black's Law Dictionary defines "incorporation by reference" as: *A method of making a secondary document part of a primary document by including in the primary document a statement that the secondary document should be treated as if it were contained within the primary one*.
3. Many contracts, by their very nature, include large volumes of documents that are not contained within the official contract documents.

KEY CONTRACT PROVISIONS

A. INCORPORATIONBY REFERENCE CLAUSES (Cont.)

4. **An example of such an Incorporation Clause is as follows:**

The term "Contract Documents" shall include this Agreement, ***as well as any and all attachments*** included hereto ***or identified herein, which documents shall constitute the entire agreement*** between the parties. The Contract Documents ***shall include*** any and all provisions of the ***below listed exhibits***, which are applicable to this Agreement or which in any way affect the work herein described, and ***shall have the same effect as if written in full in this Agreement.***

KEY CONTRACT PROVISIONS

A. **INCORPORATIONBY REFERENCE CLAUSES (Cont.)**

4. **An example of such an Incorporation Clause is as follows (Cont.):**

The Contract Documents associated with this Agreement include, but are not limited to the following:

Exhibit A: General Conditions
Exhibit B: Special Conditions
Exhibit C: Schedule of Contract Drawings & Specifications
Exhibit D: Scope of Work Description
Exhibit E: Project Construction Schedule

KEY CONTRACT PROVISIONS

A. INCORPORATIONBY REFERENCE CLAUSES (Cont.)

5. Most well written multiparty contracts incorporate at least some of the other party's obligations into other party's contracts, especially when the multiple parties includes a subcontract.
6. For example, when a general contractor incorporates its duties and obligations into its subcontract agreements, this Incorporation Clause is sometimes referred to as a ***Flow-Down clause***.
7. When a general contractor assumes the duties and obligations towards the subcontractor that the owner assumes towards the general contractor, this is referred to as a ***Flow-Up clause***.

KEY CONTRACT PROVISIONS

A. INCORPORATIONBY REFERENCE CLAUSES (Cont.)

8. The purpose of a ***Flow-Up Clause*** and/or a ***Flow-Down Clause*** is to ensure that the duties and obligations being assumed by one party to a multiparty contract are passed on to the other sub-parties.
9. Some very important Incorporation Clauses that should always be addressed in contracts include the following provisions:
    - *Dispute resolution clauses;*
    - *Notice procedures; and*
    - *Change order procedures.*
10. Insuring that these provisions are the same for all parties to a multiparty contract will make sure that all parties are playing by the same rules.

KEY CONTRACT PROVISIONS

A. INCORPORATIONBY REFERENCE CLAUSES (Cont.)

11. When an Incorporation Clause is included within any contract, whether multiparty or two party, all parties need to review and understand each and every document incorporated into the contract.
12. Asking for a copy of the other documents in the middle of a heated dispute over a party's duties and obligations will only reinforce the other party's position that YOU did not understand YOUR scope of work.

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KEY CONTRACT PROVISIONS

B. SCOPE OF WORK PROVISIONS

1. One of the most important and most litigated items within contracts are the scope of work provisions.
2. The scope of work provision should includes all of the services and materials to be provided, **as well as what will not be provided.**
3. It is always dangerous to assume that the scope of work provision in the final contract mirrors your previous bid or draft contract, unless you prepared the contract.
4. Further, all businesses should ensure that the scope of work be in writing, within the contract.
5. The buyer of a product or service always wants the Scope of Work Provision to be as broad as possible
6. In contrast, the producer or server always wants this provision to be written as narrow as possible.

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KEY CONTRACT PROVISIONS

C. LIQUIDATED DAMAGES CLAUSE

1. A liquidated damages clause is a contractual provision where the parties to an agreement have determined in advance, the measure of damages one party will incur if the other party breaches the agreement.
2. A liquidated damages clause is used when the parties understand that damages would be hard to Calculate, so they set a price in contract.
3. A liquidated damages provisions may be unenforceable if it is found to be a penalty.
4. A "penalty" is a sum inserted in a contract, not as the measure of compensation for its breach, but rather as a punishment for default, or by way of security for actual damages which may be sustained by reason of non-performance, and it involves the idea of punishment.

KEY CONTRACT PROVISIONS

C. LIQUIDATED DAMAGES CLAUSE (Cont.)

5. Liquidated damages provisions are generally prima facie valid, and the party challenging the provision must establish that the provision amounts to a penalty.
6. This means that liquidated damages provision are initially considered valid and the burden of proof that it is a penalty is on the party challenging the provision.
7. The party challenging the liquidated damages must show that the amounts proscribed by the clause are disproportionate to the actual damages sustained by the non-breaching party and can take into account post-formational events.

KEY CONTRACT PROVISIONS

C. LIQUIDATED DAMAGES CLAUSE (Cont.)

8. Finally, if the liquidated damages clause is valid, the aggrieved party's damages for breach of contract may be limited to the amount specified in a valid liquidated damages clause.

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KEY CONTRACT PROVISIONS

D. PAYMENT CLAUSES

1. All contracts where money is paid should have a clear and unequivocal clause that outlines when and where payments are to be made.
2. In addition to these clauses, there are three basic types of contract clauses that pertain to conditional payment for services/materials provided on multiparty contracts.
3. The first is the so-called "pay-if-paid" clause.
4. The second is the so-called "pay-when-paid" clause.
5. The third is primarily used in construction contracts and it is a "waiver of lien rights" that is agreed upon prior to payment.

KEY CONTRACT PROVISIONS

D. PAYMENT CLAUSES (Cont.)

6. All three of these clauses are designed to transfer the risk of loss of payment to another party, so that the first party will not have to pay until it is paid.
7. Note: The difference between a "**pay-when-paid**" clause and "**pay-if-paid**" clause is based on the absoluteness of the one party's duty to pay:
   - ❑ Pay-if-Paid = payment required only if payment is received
   - ❑ Pay-When-Paid = Payment is required at some time, even if other party does not pay
8. Due to the onerous affects of these clauses, many states have passed legislation making the pay-if-paid clause unenforceable, as have some courts.

KEY CONTRACT PROVISIONS

D. PAYMENT CLAUSES (Cont.)

9. For Contractors, the Nevada Legislature has mostly taken care of this problem by stating that lien waiver clause, *prior to receipt of payment*, is against public policy and is void and unenforceable (i.e., NRS 108.221-246)

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KEY CONTRACT PROVISIONS

E. INDEMNIFICATION CLAUSES

1. An indemnification clause, in general, is a contractual provision that shifts liability from one party to another.
2. These clauses are incorporated into most contracts today.
3. In most cases, indemnification provisions are included to make one party liable for the results of its actions, when a second party is sued or is required to pay for damages caused by the other party.
4. However, people should pay close attention to the indemnification clauses in any agreement before they sign.

KEY CONTRACT PROVISIONS

E. INDEMNIFICATION CLAUSES (Cont.)

5. A party should think twice about agreeing to indemnify another, without knowing that how it is going to pay for the liability.
6. Black's Law Dictionary defines Indemnify as:

To restore the victim of a loss, in whole or in party, by payment, repair, or replacement. To save harmless; to secure against loss or damage; to give security for the reimbursement of a person in case of an anticipated loss falling upon him … An undertaking whereby one agrees to indemnify another upon the occurrence of an anticipated loss. A contractual or equitable right under which the entire loss is shifted from a tortfeasor who is only technically or passively at fault to another who is primarily or actively responsible … The term is also used to denote the compensation given to make a person whole from a loss already sustained.

KEY CONTRACT PROVISIONS

E. INDEMNIFICATION CLAUSES (Cont.)

7. In the beginning, indemnification clauses were generally designed to be fair, covering only those damages caused by the performing party's actions.
8. In recent years, these provisions have increasingly become more one-sided and onerous to the benefit of the paying party as a means of limiting liability.
9. These provisions are a fact of life in the world today and will not be going away soon.
10. There are three types of indemnification provisions and they are generally classified as:
    - ❑ Type I,
    - ❑ Type II, and
    - ❑ Type III.

KEY CONTRACT PROVISIONS

E. INDEMNIFICATION CLAUSES (Cont.)

11. A Type I indemnification clause requires the performing party to indemnify the paying party for all damages sustained by that party as a result of the performing parties scope of work, even if the damages sustained by the paying party were the result of its own actions.
12. This is the most onerous and unfair type of indemnification clause and the one in which businesses should avoid if at all possible.
    - *How do you know if this provision is Type I?*
    - Language: "**whether or not the Owner … in any way contributed to the alleged wrongdoing**."
13. **See Example of Type I Indemnification Clause**…

KEY CONTRACT PROVISIONS

E. INDEMNIFICATION CLAUSES (Cont.)

14. A Type II indemnification clause requires the performing party to indemnify the paying party for all damages sustained by that party, unless the paying party is wholly at fault for the damages sustained.
15. This type of indemnification provision is probably the most used indemnification provision today.
16. Here, if the paying party is 99% at fault for its damages and the indemnifying party is only 1% at fault, the indemnifying will still be obligated to reimburse the paying party for all damages sustained by the paying party.
    - *How do you know if this provision is Type II?*
    - Key language: the Subcontractor's indemnification obligations do not arise from the contractor's "**sole negligence or willful misconduct**."
17. **See Example of Type II Indemnification Clause**…

KEY CONTRACT PROVISIONS

E. INDEMNIFICATION CLAUSES

18. Finally, a Type III indemnification clause requires the performing party to indemnify the paying party for all damages sustained by that party in proportion to the performing party's percentage of fault.
19. This type of indemnification provision is obviously the most fair in that the performing party will only be required to reimburse the paying party in proportion to the performing party's actual fault.
20. Here, if the performing party is twenty five percent at fault for the paying party's damages, it will only be required to pay twenty five percent of the damages.
    - *How do you know a provision is Type II?*
    - Key language: "**only to the extent of the negligent acts or omissions of the party**."
21. **See Example of Type III Indemnification Clause…**

KEY CONTRACT PROVISIONS

E. INDEMNIFICATION CLAUSES

22. In addition to evaluating the Type of an Indemnification clause, business owners must also look carefully to determine if the indemnification clause requires it to indemnify third parties (i.e., individuals/businesses who are not parties to the agreement).
    - ❑ These provisions are included in many multiparty contracts like construction contracts;
    - ❑ Make sure that the contract ***does not require you*** to indemnify another party for ***claims that are outside the coverage*** of your insurance policies
    - ❑ Example: General Contractor ("GC") requirement that engineer or architect indemnify GC for GC's negligent actions.

KEY CONTRACT PROVISIONS

E. INDEMNIFICATION CLAUSES

23. A failure to recognize a duty to indemnify another for claims outside its own insurance policy, especially when coupled with a Type I indemnification clause, can force parties to pay for the entire lawsuit without any assistance from its insurance company or the other party.
24. If an individual has a question on the scope of its liability, it should seek advice from an attorney and/or its insurance broker.

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KEY CONTRACT PROVISIONS

F. NOTICE CLAUSES

1. Written contracts are riddled with notice provisions.
2. Some examples of notice provisions include:
   - ❑ Notice for payment;
   - ❑ Notice for termination;
   - ❑ Notice for default;
   - ❑ Notice for renewal;
   - ❑ Notice for change orders;

3. Notice provision can be problematic.
   - ❑ Notice provisions can cause parties to loose rights
   - ❑ Notice provisions can cause parties to forfeit valid claims;
   - ❑ Notice provisions can be required before a party defaults;

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KEY CONTRACT PROVISIONS

G. CHANGE ORDER CLAUSES

1. A change order clause allows the parties to modify their obligations without being forced to go through the entire negotiation process
   - ❑ Without this clause, any variation from the contractual obligations would likely constitute a breach
   - ❑ This would result on the possibility of stopping the contract performance each time an unanticipated change occurs
2. These provisions are vital to most long-term or complex contracts since the business world is not stationary.
3. When dealing with change order clauses, businesses needed to pay close attention to the timing and processing requirements.

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KEY CONTRACT PROVISIONS

H. ARBITRATION CLAUSES

1. Arbitration was initially frowned upon by the courts back at a time when Judges were paid for their time on the bench;
2. With the general increase in litigation and case loads, courts have accepted and embraced arbitration;
3. In Nevada, most civil litigation cases that have a probable value of damages of less than $50,000 are required to participate in a court-mandated arbitration program.

KEY CONTRACT PROVISIONS

H. ARBITRATION CLAUSES

4. General benefits to Arbitration, over court:
   - ❑ The parties' ability to select arbitrators with some expertise within the area of dispute,;
   - ❑ The relaxing of evidentiary rules; and
   - ❑ The ability to reach a conclusion to the dispute much faster than through the overburdened court system.
5. General drawbacks to arbitration:
   - ❑ The inability to challenge an improper arbitration award through the appeal process;
   - ❑ The relaxing of the evidentiary rules; and
   - ❑ The requirement to pay the arbitrator a fee to perform his/her services.

KEY CONTRACT PROVISIONS

H. ARBITRATION CLAUSES

6. Regardless of good or bad, the modern world has embraced arbitration clauses;
7. Arbitration clauses should be tailored to the situation and not simply included in a contract because the other party wants it;
8. The biggest problem with Arbitration Clauses: Most of the time you don't know if it is a good idea to arbitrate until after the dispute occurs.

KEY CONTRACT PROVISIONS

H. ARBITRATION CLAUSES

9. Notes:
   - ❑ Except for court-mandated arbitration, arbitration is a creature of contract law;
   - ❑ In general, a third-party cannot be compelled to participate in arbitration when it did not agree to do so;
   - ❑ This results in the possibility of multiple arbitrations or an arbitration and trial with the possibility of conflicting verdicts;
   - ❑ Example: owner is required to pay for and pursue two separate claims, one against the architect and one against the contractor (and loses both arbitrations).
   - ❑ This problem can also be used as a negotiating tool.

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