Welcome! **Thank you for purchasing this course either as part of the 60-Hour program or for Continuing Competency. Many of the courses are available in both Video and/or Text. It is not necessary to complete both versions. We offer both versions to ensure your learning style is addressed. You can choose whether you want to watch the video, or read the text, but you DO NOT have to do both. You can use either version for study purposes- just be sure to take the all quizzes in one version OR the other.**

This course explains the principles of contract law and the important elements of a home building and remodeling contract. The difference between various contracts used in the residential construction industry is also described. Requirements and types of insurance are also covered in this course, as well as the details of Workers Compensation.

If you are taking this course as part of the 60-Hour Prelicense Program, please read the information below:

The 60-Hour program is made up of 8 separate courses listed below. Many of the courses are available in both Video and Text/Online. It is not necessary to complete both versions. You can choose whether you want to watch the video version or read the text version. As the videos for the other four courses are completed, they will be added to your registration at no additional charge.

COURSES

1. Business of Building (Video or text)
2. Contracts, Liabilities and Risk Management (Video or text)
3. Project Management for Contractors (Video or text)

4. Marketing for Building Contractors (Video or text)
5. Building Green (Video or text)
6. Residential Code Review (Video coming soon)
7. Michigan Construction Safety (Video or text)
8. Overview of Building Trades (Video or text)

PLEASE CONTINUE READING:

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These are all optional and not required in order to complete the 60-Hour program, but the math tutorial and exam prep are extremely helpful in studying for the State exam.

--3-Hour Math Tutorial video for State exam prep
--Michigan Exam Prep (sample questions for State exam prep)

You will be sent the following via U.S. Postal Service and should receive them within 3-5 business days:

-- Applications to the state of Michigan
-- PSI Testing Information booklet
-- MIOSHA Test Review sheet
-- Books (if ordered)

Contracts, Liabilities, & Risk Management

Chapter 1

Contracts and Contract Terms

CONTRACT CONTENT	DEFINITIONS	FIXED PRICE	COST PLUS

Learning Objectives

Describe the contents of a basic home building contract.

Explain the difference between fixed-price and cost-plus contracts.

Contracts are agreements entered into voluntarily by two or more parties who promise to exchange money, goods or services according to a specified schedule. The following are typical rules to follow when considering a contract.

a. Oral contracts are valid but often difficult to enforce

b. All contracts must be entered into willingly and freely

c. The contract's content has to be legal

d. Minors, the insane and others viewed by law as unable to care for themselves are usually forbidden from signing contracts. Even contracts signed when one party is "under the influence" may be revoked in a court of law.

Clarity of language is one of the most important aspects of interpreting contracts and avoiding disputes. In the event of a conflict in the terms of a contract, these rules apply:

a. Specific provisions over general provisions

b. Hand written provisions over typed provisions

c. Typed provisions over printed provisions

d. Words over numbers

e. Specifications over drawings

Required Contract Elements:

a. Offer and acceptance

b. Consideration

c. Competent parties

d. Legal purpose

Typical Content of a Home Building Contract:

1. NAMES OF ALL PARTIES	***18. SUBSTITUTION POLICY***
2. ADDRESSES OF ALL PARTIES	***19. ALLOWANCES (LABOR AND MATERIALS)***
3. PHONE, FAX, EMAIL CONTACTS	***20. CHANGE ORDER PROCEDURES***
4. DATE OF CONTRACT	***21. EXCLUSIONS TO THE CONTRACT***
5. PROPERTY DESCRIPTION	***22. AUTHORIZED DELAY CONDITIONS***
6. STREET ADDRESS	***23. PENALTIES OR FINES***
7. SUBDIVISION	***24. ACCESS TO THE SITE***
8. HOME OWNERS ASSOCIATION--if any	***25. INSPECTION PROCEDURES***
9. AMOUNT OF CONTRACT	***26. METHODS TO SOLVE DISPUTES***
10. TERMS OF FINANCING	***27. ARBITRATION CLAUSE***
11. DRAW SCHEDULE	***28. SETTLEMENT TERMS***
12. DRAW PROCEDURE	***29. FORMAL NOTIFICATION TIMES AND PROCEDURES***
13. INSURANCE REQUIREMENTS	***30. WARRANTIES AND SERVICE POLICIES***
14. START DATE/DEFINITION	***31. DOCUMENTS REQUIRED BY STATE LAW***
15. COMPLETION DATE/DEFINITION	***32. SIGNATURES OF ALL PARTIES***
16. PLANS, DRAWING, BLUEPRINTS	***33. WITNESSES TO ALL SIGNATURES***

AND SKETCHES	
17. SPECIFICATIONS	

Contract Documents:

a. **Bidding Documents** include the invitation to bid, instructions to bidders and bid forms.

b. **Letter of Intent** is a letter signifying an intention to enter into a formal agreement, but does not create a legal obligation.

c. **Basic Owner-Contractor Agreement** includes identity of the parties, description of the work, time for performance, contract price and payment schedule and lien notice (state law).

d. **General Conditions** are usually on forms with standard provisions including an integration clause that excludes negotiations and representations not specifically made part of the agreement.

e. **Supplementary or Special Conditions** are used to tailor the agreement.

f. **Drawings** are used to describe the physical aspects of the project and to determine the quantities of materials needed for the contract

♦ Contract drawings are prepared by a designer, architect or engineer.

♦ Shop Drawings illustrate the specific assembly and installation methods to be employed and are submitted to the architect, construction manager and building officials.

g. **Specifications** supplement drawings and specify types of materials (mechanical, electrical, etc.)

h. **Addenda** are changes to the contract documents before execution of the Basic Owner-Contractor Agreement.

i. **Modifications** are changes to the contract documents after execution of the Basic Owner-Contractor Agreement and include:

-Written Change Orders

-Bulletins

-Clarifications

-Interpretations of the architect

-Field Memoranda

j. **Claims** are additional amounts that the contractor says are owed by the owner as a result of extra labor or material costs resulting from someone else's mistake.

k. **Standard Form of Agreement** binds all documents into one contract.

l. **Arbitration Agreements** are a common component of construction contracts. Arbitration is an accepted and popular method to resolve disputes between all parties involved in the project. They are generally faster, cheaper, and obviously reduce the burden on the court system.

The general understanding is that all disputes will be mediated by an arbitrator, and that both parties will agree to the

decision/agreement rendered. It is important to note, however, that not all arbitration agreements are binding, and under certain circumstances (The Michigan Arbitration Act, at MCL 600.5001), a dispute can end up in the courts, even though an arbitration agreement was included in the original contract.

CONTRACT TO BUILD A HOUSE AT--

I. **Contract Parties**

Now comes ___*(builder's name)* of ___*(address)*___and ___*(buyer's name)*_____ of ___*(address)*__to hereby agree to build a house on property located at ___*(common address)*__ and legally described as _____*(Insert legal description here.)*_____ .

II. Contract Documents

The terms of this contract include all the documents specifically listed below, and constitute the entire terms of the agreement between the parties. The terms of this contract shall prevail over any conflicting provision in the documents incorporated by reference.

1. Architectural Plans and Drawings dated _____ with _____number of pages is hereby incorporated into this document.

2. Specifications dated _____ with _ number of pages is hereby incorporated into this document.

3. Schedule of Allowance Items dated __ with _____number of pages is hereby incorporated into this document.

4. *Title of document – add any documents not included in the previous samples, delete any of the previous samples no longer needed* dated _

_____ with _ number of pages is hereby incorporated into this document.

III. Building Plans

FIRST OPTION: USE WHEN THE PLANS ARE SUPPLIED BY THE BUYERS

The builder agrees to construct the home in accordance with the plans, including specifications and drawings, supplied by the buyer and incorporated by reference into paragraph II. Contract Documents. The builder assumes no responsibility or liability for defects in the design or engineering in these plans.

The buyer represents to the builder that the buyer is the sole owner of the plans or has the legal right to use the plans. The buyer agrees to indemnify and hold the builder harmless for any copyright action which may be asserted as a result of the use of the plans.

The buyer warrants that the plans are adequate and that the builder can rely on them. The buyer will be liable for any damages caused by defects in the plans, including, but not limited to, additional material costs, additional labor costs, pro rata overhead and profit.

SECOND OPTION: USE WHEN THE PLANS ARE SUPPLIED BY THE BUILDER

The builder has provided the plans, specifications and drawings which are incorporated by reference into paragraph II. Contract Documents, and which are to be used for the construction of the house. The builder makes no representation about the quality of these plans beyond those

specifically provided in the warranties clause of this contract.

IV. Completion Time

Assuming all conditions are satisfied and weather permits, the work to be performed under the contract shall be substantially completed no later than _____ days after the work commences. The work shall commence within _____ days after the permits necessary to start work have been issued, the buyer has supplied the builder with a written notice of financing as described in paragraph V. Financing, and the buyer shall have supplied the builder with a correct statement of the recorded legal title of the property and the buyer's interest in the property.

Any time lost by reason of changes to the contract or changes in plans by the buyer, other acts of the buyer, strikes, weather conditions not reasonably anticipated, or any other condition not within the builder's control shall be added to the specified time for completion. For any delays which are not the builder's responsibility, the contract price shall increase by any increase in the builder's costs caused by the delay.

A claim for an increase in time for the performance of the contract, or an increase in the contract cost shall be made within _____ days after the builder first recognizes the condition giving rise to the claim.

V. Financing

This contract is contingent upon the buyer obtaining a construction loan in the amount of

$_____ dollars. All fees and expenses of obtaining a loan shall be borne by the buyer. The builder is not required to begin

construction until the buyer provides the builder with written notice from the lender confirming the loan.

VI. Contract Price

FIRST OPTION: FIXED PRICE CONTRACT

The buyer agrees to pay a total price of $_____ dollars to the builder for construction of the house, and the builder agrees to provide all the labor, materials, equipment, tools, and other services necessary to construct the house.

Upon the signing of this contract, the buyer agrees to pay $_____dollars to the builder as a deposit. The buyer will make the following interim payments:

(List the amounts and number of the progress payments and what triggers them: for example, specific dates such as the first Monday of every month; or the start or the completion of specific construction events.)

The buyer agrees to make a final payment in the amount of $_____ within _____days of the buyer's final inspection and acceptance of the property (alternative language, such as: "within ___ days after substantial completion"). The buyer is not entitled to possession until after final payment.

VI. Contract Price (cont.)

SECOND OPTION: COST PLUS FEE

The builder agrees to construct the house according to the plans. As consideration for the builder constructing the house, the buyer agrees to pay the builder's full costs and expenses, plus a fixed fee of $ _____ dollars.

Upon signing the documents, the buyer will pay $_____ dollars as a deposit.

Each (at the end of the week or month) the builder shall prepare for the buyer itemized statements of the costs and expenses incurred to date.

The buyer will make a regular payment to the builder on (a regular recurring date such as the first Monday of each week) of the builder's unpaid costs and expenses as stated in the most recent itemized statement.

The builder's costs and expenses include the following:

All gross wages, employment benefits, costs of workers' compensation, and unemployment insurance incurred by the builder as the cost of labor during the performance of this contract, plus all salaries for builder's employees, but only to the extent that their time is spent on work required by this contract;

The cost of all materials, supplies, and equipment consumed in this project, including the cost of delivery and transportation of materials;

Rental charges consistent with those prevailing in the area for the use of machinery and equipment used at the construction site, whether owned by the builder or by others;

All land costs associated with building this house, which are paid by the

builder;

All payments made by the builder for work performed according to subcontracts under this agreement;

All costs incurred for safety and security at the job site;

All costs incurred for building and code compliance;

SECOND OPTION: COST PLUS FEE (cont.)

All landscaping and backfilling costs necessary under the contract documents;

All builder's risk and other insurance costs necessary under the contract documents;

All soil fees and civil engineering fees necessary for this building project;

All costs associated with differing site conditions. A differing site condition is a physical characteristic of the property that materially changes the construction techniques from those reasonably expected at the time of the contract.

The buyer shall also pay to the builder a salary or hourly rate of $ _____ for the builder's actual hours spent on supervision of the construction of this house.

The buyer will make a final payment of all amounts still owing within ____ days of the buyer's final inspection and acceptance of the property (alternative language, such as: "within ____ days after substantial

completion”). The buyer is not entitled to possession until after final payment.

VII. Allowance Items

Upon signing this contract, the buyer shall be given the selection guide that is incorporated by reference into paragraph II. Contract Documents to help the buyer select allowance items, materials, and colors that will be required during the construction process. Exterior selections must be made within _____ days of signing this contract. Interior selections must be made within _____ days of signing this contract.

VIII. Late Payments

Payments not made in a timely fashion shall incur daily interest at the rate of _____% from the day the payment is due.

If the buyer fails to pay the builder within seven days of the date the payment is due, through no fault of the builder, the builder may stop work and may keep the job idle until such time as payments that are due to the builder are paid. If the builder chooses not to stop work after a payment delay, this is not to be construed as a waiver of his rights to stop work if future payments are delayed.

All attorney fees incurred by the builder to collect sums owed by the buyer shall be paid by the buyer, together with interest at the rate of _____%.

IX. Permits and Surveys

The buyer shall obtain and furnish all necessary surveys describing the physical characteristics of the property, the location of all utilities, and the location of all easements to the building that are necessary to allow the builder to complete his performance. If additional easements are necessary to complete the work, the buyer shall obtain those easements promptly.

If no soil report is available, the buyer shall provide one at his own expense.

The builder shall obtain building permits, licenses, building inspections and approvals required by local law.

If a covenant or architectural review committee requires the approval of plans and specifications, the buyer shall be responsible for obtaining these approvals and paying for any fees connected with them.

X. Change Orders

The buyer may order changes in the work within the terms of this contract, but only by a prior written order and agreement with the builder that states the changes to the contract, the amount of any additional cost, and the additional number of days to be added to the contract completion date.

Any of the buyers may sign the change order and that signature will be binding upon all of the buyers.

The buyers hereby agree to make all requests for change orders to the builder, and not to issue instructions to, or otherwise negotiate for additional or changed work specifications with, the builder’s employees or subcontractors.

XI. Insurance and Risk Management

The builder shall obtain all workers' compensation, commercial general liability insurance and comprehensive liability insurance necessary to protect builder from claims for damages due to bodily injury, including death, and for damages to property that may arise out of and during operations under this contract.

The buyer shall purchase his own liability insurance including fire and casualty insurance to the full insurable value of the house and shall name the builder as an additional insured.

Each party shall issue a certificate of insurance to the other prior to the commencement of construction.

XII. Access to the Property Site

The buyer shall have access to the property and the right to inspect the work in the presence of the builder.

If the buyer enters the property during the course of construction without the permission of the builder, he does so at his own risk, and the buyer hereby releases the builder and does hereby hold the builder harmless from any and all claims for injury or damage to his person or property, and to the person or property of any person accompanying the buyer.

XIII. Inspection, Acceptance, Final Payment and Possession

At the final inspection, the buyer will give the builder a signed and dated list that identifies any alleged deficiencies in the quality of the work or materials. The builder shall correct any items on the buyer's list that are, in the good faith judgment of the builder, deficient in the quality of the work and/or materials according to the standards of construction in the area in which the house is built. The builder shall correct those defects within a reasonable period of time.

After the defects have been corrected according to the standards of construction in the area in which the house is built, the buyer shall sign a certificate of acceptance acknowledging that the defects on the buyer's list have been corrected according to the standards of this contract.

The builder shall provide the buyer with an affidavit stating that all materials and services for which a lien could be filed have been paid, or an affidavit identifying what services and materials for which a lien could be filed have not been paid, and swearing that such amounts will be paid from the proceeds of the final payment. (Some states give the property owners the right to withhold amounts for unpaid potential lien holders, and make those payments directly to those potential lien holders.)

Occupancy will be granted to the buyer when the buyer makes a final inspection of the home, signs a certificate of acceptance, and makes the final payment.

XIV. Warranties

All warranties are limited to the implied warranties of habitability and workmanlike construction and are limited to a period of one year from the date of the issuance of a certificate of occupancy by the local building code enforcement authority. This limited warranty is the only express warranty provided by the builder.

XV. Disputes

Should any dispute arise relative to the performance of this contract that the parties cannot resolve, the dispute shall be referred to a single arbitrator acceptable to the builder and the buyer. If the builder and the buyer cannot agree upon an arbitrator, the dispute shall be referred to the American Arbitration Association for resolution.

All attorney fees that shall be incurred in the resolution of disputes shall be the responsibility of the party not prevailing in the dispute.

XVI. The Governing Law and Assignment

This contract will be construed, interpreted, and applied according to the law of the state where the property is located. This contract shall not be assigned without the written consent of all parties.

XVII. Effective Date and Signature

This contract shall become effective on the date it is signed by both parties.

We, the undersigned, have read, understood, and agree to each of the provisions of this contract and hereby acknowledge receipt of a copy of this contract.

By: *(Builder's name)* on behalf of *(Builder's company name)*

Title: _____ Date:_____

By: _____*(Buyer)*_____ Date:_____

By: _____*(Buyer)*_____ Date:_____

Attached Contract Documents:

Final Contract

1. Plans and Specifications

2. Allowance Schedule

(Describe and include any other documents that have been incorporated by reference into the contract.)

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It is important that you know the meaning and intent of the following contracts and terms related to contracts:

Prime Contractor

A prime contractor is any contractor who has an agreement to provide services *directly* with an owner.

General Contractor

A general contractor is the project manager who has an agreement with the owner to provide this service. The general can be both the general and prime contractor.

Sub-Contractor

A sub-contractor is the individual who has an agreement with a General Contractor to provide services.

Fixed-Price Contracts

Fixed-price contracts, also known as **lump sum** contracts, are when the contractor agrees to complete a contract for a fixed sum of money. It's important to recognize that this type of contract should only be used when the project can be accurately and completely described, so there are no costs that could be unforeseen. If difficulties or excessive costs occur, the contractor must rely on clauses in the contract, which provide for such changes or changed conditions.

Cost-Plus-Fee Contracts

The contractor agrees to a cost for labor and materials, plus an agreed upon fee for the contractor. The prime contractor and owner should pay particular attention to four different considerations:

1. A definite and mutually agreeable subcontract vetting procedure where the owner and contractor will be fully aware of the agreed upon arrangement with each subcontractor.

2. A clearly understood agreement concerning determination and payment of contracted fees.

3. A clear understanding of accounting methods to be followed.

4. The owner and the contractor should agree upon a complete list of reimbursable job costs and overhead costs that would be incurred by the contractor.

Unit-Price Contract

The contractor agrees to be paid based upon a unit of something that can be measured. For example, when laying block for a basement or foundation, the job is priced at the cost per block laid, rather than for the entire job. This type of contract can be advantageous for both the owner and contractor when bidding a job, especially if the number of units cannot be accurately measured. This contract can also be used to give a price on the differing units of construction. For example, a separate price for each task such as lot clearing, excavation, footings, foundation walls, framing etc.

Cost Plus Fixed Fee Contracts

This contract calculates the labor and materials costs, plus an additional fixed fee over and above the actual costs. In other words, the contractor's fee is established as a fixed sum of money that is added to the labor and materials of the job.

Award of Competitive Bid Contract

In residential construction, when an owner has decided on a group of contractors that meet their qualifications, bids will be requested from these select contractors. Usually the job will go to the "lowest responsible bidder". The term "lowest responsible bidder" means the lowest bidder whose offer best responds in quality, fitness and capacity to fulfill the particular requirements of the proposed work and with the necessary qualifications to complete the job in accordance with the terms of the contract.

Liquidated Damages

These are losses experienced by the owner and paid by the contractor if the project is not completed in the specified time frame written in the contract. This can make the contractor liable to the owner for damages. When delays occur in a project, it is important to recognize who caused the delay and document the specifics surrounding the delay.

To avoid litigation, it is a good idea to have a per calendar day amount that is agreed upon by both the owner and the contractor written into the contract. For example, the contractor will pay damages of $100 per day for each day that the project is delayed beyond the agreed upon completion date. Careful attention to change orders can prevent damages from occurring.

Change Orders

If changes to the original contract occur, it is important to write a "Change Order" and have all parties on the contract sign it before the actual changes are made. This order should spell out clearly the cost of the change and the additional time the original contract will have to be extended to perform the change.

If the owner is not available to sign the Change Order, the person acting as an agent that does sign has to be authorized in a formal way by the owner to sign on behalf of the owner. This will ensure that the owner is obligated in the event of a problem.

Change Order

Construction Company
Address
City, State, ZIP
Phone Number

Date: _____
Owner: _____
Contractor: _____
Project name: _____
Change order number: _____

Original contract date: _____

You are directed to make the following changes in this contract:	
The original contract sum was:	$
Net amount of previous change orders:	
Total original contract amount plus or minus net change orders:	
Total amount of this change order:	
The new contract amount including this change order will be:	
The contract time will be changed by the following number of days:	( ) Days
The date of completion as of the date of this change order is:	

Contractor:	Owner:
Company name	Name
Address	Address
City, State, Zip	City, State, Zip
Date	Date
Signature	Signature

Letter of Intent

In the event that an owner may want to start construction before a formal contract is completed, it is common practice for the owner to authorize the start of work by a "Letter of Intent" or "Letter Contract". This letter states the intent of both parties to enter into a suitable contract at a later date. This interim authorization should contain explicit information about settlement costs in the event that a formal contract is never executed.

Retainage

This is a retained percentage of each progress payment. The owner holds the accumulated retainage until the job is 100% complete and a final payment is made. If retainage is part of the contract, the general contractor usually applies retainage to their sub-contractors' payments at the same percentage rate that the owner does to the general contractor. Each subcontractor would not be paid that last 10% until the final payment is made to the general contractor. This can cause some cash flow problems and usually results in a higher bid for the job.

Progress Check

- What is the purpose of a letter of intent?
- List the four primary contract elements.

Fixed-Price or Cost-Plus

How Should You Charge?

Deciding whether to charge for work on a fixed-price contract basis or a cost-plus basis can be risky. A fixed-price contract means forming a contractual agreement to complete the work for a specific amount. That means agreeing to charge a certain price for doing certain specified work before the work has even begun, and it does not come naturally. It is more common with smaller, straightforward projects. Cost-plus contracts are just that, your materials and labor, plus a profit added on top. Some builders will only bid jobs in this fashion because they are so much less risky.

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Fixed-Price Contracts

To become good at determining the amount to charge, constant assessment of completed jobs is crucial. Ideally, you want the job to cover company expenses, your hourly wage and at least a small profit for the company. Carefully scrutinize each job after it is finished to determine whether you charged enough to cover all three objectives. Keep records and notes on where you would have adjusted the contract to make sure you made enough profit. Your goal is to become proficient in bidding and estimating jobs that are intended for fixed-price contracts.

The more complex the job, the harder it is to put a fixed-price on it. Contracts that are primarily product, like new kitchen cabinets, are easier to price based on the product layout and specifications. Once you have the product cost determined, it is just a matter of adding labor and company expenses. Never bid a fixed-price job without close scrutiny of the plans and specifications. If they are not clear, get with the client to add the details necessary to make them clear. Review them with the client to make sure they know exactly what to expect and all details are included.

One thing to remember when bidding work on a fixed-price basis is to get a Change Order whenever there is any deviation from the original contract and increase the dollar figures to compensate for any of the proposed changes. Many builders get blindsided by the cost of making minor adjustments to the original job without

documenting them with a Change Order. It can be difficult to collect for the adjustments at the end of the project. It is surprising how adding little things like a few more electrical outlets, hanging towel racks or throwing up a shelf in the laundry room can add up. Be sure to avoid the pitfalls of "scope creep" that happens on so many jobs.

Scope Creep

Some builders also know this term as scope control and it starts on the first day of the job. Whether you are remodeling a home or writing a software program, it is a common problem when taking on projects of any size. The client will think of little things after the start of the project and ask to have them added. Or change their mind about "little" things like door hinges or cabinet locations. These so-called little details can add up to the point that the builder is bogged down. Extreme situations like this can get out of hand until the scope of the whole project changes.

Here are a few pointers that will help you stay on focus and prevent even the slightest amount of scope creep from occurring:

- Be sure you thoroughly understand the project vision. Don't just review the plans and specifications, be able to visualize the picture in your head.
- Understand the priorities of the project and make sure your client understands them as well. You both want to be on the same page regarding day-to-day expectations. Make a list for the client that can be used in justifying your scheduling decisions.
- Change Orders are crucial. Make sure any deviation from the original plan is documented with the client's signature. If the project is large and the client is making small changes daily, a weekly meeting with the client where you get them to sign off on a group of changes regularly might be considered.

- Break the project down for the client into major and minor milestones. They generally would not understand a Critical Path Schedule, but a project schedule with rough estimates for the major and minor aspects of the project might be in order. Be sure to leave room for error.
- Review the project schedule with your client. This may spark any ideas they have early on so they can be included before that phase of the project begins, rather than having to change an aspect that has already been completed.
- Expect that there will be some "scope creep" and plan for it.

It would be best to perform all of these steps immediately. However, even if you start with just a few, any that you're able to implement will bring you that much closer to avoiding and controlling scope creep.

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Cost-Plus Contract

It would be nice to do every job on a cost-plus basis. Basically, this means you get paid for your time and materials, plus a profit added on top. This type of job is much less risky than a fixed-price contract basis because there is more room for negotiation as you go along. You are not bound to a fixed amount. This allows you to take the time and secure the materials necessary to do the job right.

Some jobs are just too tough to price out ahead of time. This can often be the case when remodeling older homes. You never know what you are going to find behind a wall that has to be moved or taken out. You can find termite infestations, mold or even fire damage that has been covered up. There is no clear definition of

the scope of the work until you get through the "discovery" process where the existing structure and construction quality are revealed. This type of job is a perfect cost-plus candidate. Another cost-plus candidate is when you are working with other trades and there is not a definite line where your job ends and theirs starts.

Sometimes customers will not accept a cost-plus bid and want a specific price for the work, even though you know the job can be risky to put a solid figure on. You may want to propose a "limit cost-plus" where you work on a cost-plus basis up to a certain limit that both you and your client agree on. If the job goes over the limit, or even if it looks like it is going to go over the limit, consult with clients as to how they want to proceed. There is also the pay-as-you-go alternative for those clients that want jobs done as needed.

Progress Check

- What is the advantage of the cost-plus type of contract?
- What is scope creep?

Contracts, Liabilities, & Risk Management

Chapter 2

Request for Proposal

WRITTING RFPs	DECISION MATRIX	LETTER TO DECLINE	LETTER OF INTENT

Learning Objectives

Describe the who, what, where, when and how of a Request for Proposal.

Understand how a decision matrix works.

A request for proposal **(RFP)**, also known as an "invitation to bid" is an invitation for subcontractors to bid on project specifications. The builder or general contractor would send out RFP's to companies that they feel can fulfill a need. There are several aspects to the RFP proposal process and we are going to define each phase of the

process. Your building business will fall into at least one of the areas, and maybe all areas as you continue to grow.

Keep in mind that the intent of an RFP is to foster competition, not encourage favoritism. If there is any question regarding legal ramifications anywhere in the RFP process, consulting an attorney may be an option to consider.

Writing an RFP

Always put your RFP's on company letterhead and make sure they are typed - never handwritten. Most RFP's are more than one page, or even several pages, because you want to be specific enough for subcontractors to get the full scope of the project. By answering the basic questions of Who, What, Where, When, Why and How, you can usually portray your specific needs. Following is an outline of the types of information to include:

Who - give a description of your company and the services you provide. This includes the size of your company and your average client base. Include contact information for the people who will be handling the bids and proposals.

What - describe the scope of the project, including specific duties and expected outcomes. What is the square footage, number of stories and type of construction of the project, as well as the budget? Is this a commercial or residential project? Be sure to include performance standards, methods for monitoring these standards and the process of implementing corrective measures. Include a detailed list of responsibilities, particularly when subcontractors are involved. Provide a list of all products to be delivered and propose a delivery schedule.

Where - where is the project location and what type of construction surrounds the project. Include description of surrounding

environment with any zoning or noise ordinance requests or restrictions. Include any safety issues that you feel apply like a playground or school across the street.

When - what are the timetables of the project: starting and ending times. Also include your selection timetable. List the various deadlines for submitting letters of intent, sending questions, reviewing specifications and submitting proposals or bids. Also, state timeframes for contesting decision results.

How - How you plan to make the decision regarding subcontractors. Describe the terms and conditions of the contract, incentives if there are any, requirements, and how you plan to make your decision. Attach standard contracting forms, certifications and assurances.

RFP Cover Letter

We highly recommend including a cover letter with your RFP for several reasons:

- Shows a higher level of professionalism.
- Allows you to personally invite the subcontractors to the pre-proposal meeting.
- Gives opportunity to reiterate deadlines. Missing due dates are the main cause of delays.
- Allows you to present your project and emphasize areas of concern.
- It is the polite thing to do and you can thank them ahead of time for their effort.

Send the same cover letter and RFP to all vendors or subcontractors so you don't show partiality. Close the letter formally with "sincerely" or a similar polite closing, specifying your name and

title. Sign the cover letter in blue or black ink, making your signature stand out so it gives a personal touch.

Pre-Proposal Meeting

Always hold a pre-proposal meeting and make it mandatory that in order to be considered, subcontractors must attend. If the size of the meeting is limited, state in the RFP cover letter that reservations are required because seating is limited.

For convenience and time savings, you may want to have a list of questions and answers pre-printed to hand out at the pre-proposal meeting. This leaves less room for error or someone hearing an incorrect response, as well as saves time by not answering the same question over and over again. If you have a web site, you may want to direct subcontractors to it and have this list of questions/answers listed on the site. You can add any additional questions/answers to the web site after the meeting. Include an email address for easy correspondence.

Review the project timelines at the meeting, stating the importance of meeting deadlines. Be forceful in your opinion that meeting deadlines will prevent disqualification. Most of us have a nature to procrastinate. Be sure to explain the difference between subcontractors submitting a proposal and you receiving the proposal. There is a difference between "submit the bid no later than" and "receive the bid no later than".

Sample Cover Letter

(Your company name)

(Your company address)

Dear Subcontractor,

You are invited to submit a bid/proposal for our Saginaw Hills Project in accordance with the requirements set forth in the attached request for proposal/invitation to bid, which is also available at our web site **www.siteURL.com**.

Give a brief description of your company.

Give a brief description of the project.

I will hold a mandatory pre-proposal meeting on (*date, meeting time*) at (*location*). If you plan to attend the meeting, you must RSVP by (*date)*. Your RSVP and questions can be submitted to me in writing, by fax or by email. Questions, answers and modifications to the RFP will be posted on the web site and will be debated publicly during the meeting.

(If the meeting is not mandatory, include a paragraph here specifying deadlines for submitting Letters of Intent. Include that the Letter of Intent is not binding, but will greatly assist in planning for proposal evaluation. State that you will not accept Letters of Intent after *date*).

I anticipate that the accepted bid/proposal for the Saginaw Hills Project will be selected on (*date*). We will notify all providers, whether successful or

not, of our decision within five days of our selection.

I will be the single point of contact for all inquiries and correspondences.

I thank you for your time, effort and interest in our Saginaw Hills Project.

Sincerely,

Signature

Name

Title

Complete address

Email address

Attachment

cc: list of persons copied

Progress Check

- Name three reasons to write a cover letter.
- What is the purpose of a pre-proposal meeting?

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The Decision Matrix

It can sometimes be difficult to make the decision of whose proposal or bid to accept. Two, three or even four providers may sufficiently fulfill the need, but one does not specifically jump out at you as being the best. When this happens, you may want to use a Decision Matrix. This type of matrix allows decision makers to structure the process by breaking it down into three steps:

1. Specify and prioritize your list of project criteria

2. Evaluate, rank and compare the list of criteria

3. Select the best match to the project criteria

A decision matrix is a tool used by decision makers in all industries. It allows you to objectively make a selection based on specific criteria. A brief sample matrix is provided below. Refer to this sample as you review each of the following steps in creating your decision matrix:

1. List the important criteria down the left side of your paper. It is best to list them in order of importance.

2. Assign a weight to each item listed.

3. List the alternative companies along the top (i.e. ABC Roofing. . .)

4. Decide on a rating system to use. For example 0-5 with 5 being the best fit for your needs, or 0-10 if the rating needs to be more specific.

5. Fill in the rating to each criteria for each alternative company.

6. Multiply each rating by the weight to give you the score to each criteria item.

7. Total up the columns to determine which company has the highest rating

Decision Matrix Example

Decision Model		ALTERNATIVES					
		ABC Roofing		Rainbow Roofing		Quality Roofing	
Criterion	Weight	Rating	Score	Rating	Score	Rating	Score
Price per sq. ft.	2	5	10	2	4	4	8
Shingle quality	4	2	8	3	12	2	8
Meets Timetable	5	0	0	4	20	3	15
Total	11	7	18	9	36	9	31

Score = Rating X Weight

When determining your list of criteria, it can be as long of a list as you deem necessary and can include such items as integrity and reputation, along with tangible items.

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Letter to Decline or Reject RFP Bid/Proposal

The letter to decline or reject an RFP Bid or proposal is sent to a prospective provider in order to decline the proposal that was submitted in response to an RFP. As with most situations in our world today, when rejecting something, there is always fear of complaint. In worse case scenarios, legal ramifications may apply. No one likes to be denied or rejected, but some people can truly get offended. That is why you should craft the Letter to Decline very

carefully. Here are a few rules on how to write a complaint proof letter:

1. Use formal company letterhead and type the letter. No handwritten letters.

2. First, thank the person for submitting the bid or proposal.

3. Notify the provider that you are declining the proposal because it is not the best possible solution for the project. If you have specific reasons, be sure to state and substantiate them.

4. Let the provider know that they have the right to formally contest the non-selection decision within the timeframe specified in the original RFP.

5. You are not required to tell or give any information regarding the proposal that was accepted unless requested. If requested, you must provide all information except trade secrets.

6. Be sure to provide contact information if it is different that the person sending the letter.

7. Close the letter with a polite expression such as "sincerely" and sign your name.

8. Always send the letter via Certified Mail.

Documenting the reasons why a proposal is rejected is far more difficult than merely identifying the proposal as non-compliant. Spend the time needed to honestly and properly communicate the reasons for the rejection. The more specific, exhaustive and honest the reasons for rejection are, the more difficult it becomes for the provider to contest your decision to reject the bid or proposal. However, it is never wise to offend the provider in any way. Make

sure your letter is written as tactfully as possible so as to leave the door open for future business relationships.

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RFP Letter of Intent (LOI)

You may be on the receiving end of an RFP or Invitation to Bid. If that is the case, you will first need to decide if bidding on the project is a good option for you and do you stand a realistic chance of winning the bid. If the decision is to bid, you will need to write a Letter of Intent (LOI) which tells the company issuing the RFP that you are interested in the project. You will want to be sure to let the issuing company know that you are not only interested in submitting a proposal in response, but you would also like to receive all updates and modifications. Here are the general ground rules when writing a Letter of Intent:

- Use your company letterhead and always type the LOI. Do not handwrite.
- First, indicate your interest in the project and acknowledge the deadline for submitting your bid.
- Include a non-binding statement making sure the receiver is not confusing the LOI with a binding agreement. Make sure the statement is written in positive form, so as not to scare the issuer with legal jargon.

- Let the RFP issuer know that you would like to be kept informed of any updates or modifications related the project.
- Close the LOI formally with "sincerely" or a similarly polite closing and sign your name and title. Be sure to include correct and complete contact information.
- Always send an LOI via certified mail with Return Receipt Requested.

Here is a brief example of a non-binding Letter of Intent:

(Your company Name)

(Complete Address)

Letter of Intent

Request for Proposal for (Project Title)

RFP# (RFP identification number)

Dear (Contact):

I would like to indicate our interest in the above Request for Proposal (RFP) and to be notified for any updates and amendments to the RFP. The terms of this letter of intent will become effective when a definitive agreement is executed.

Sincerely,

[Signature]

[Contact name]

[Complete address of the prospective provider]

[Phone and fax]

[Email address, an alias or distribution list dedicated to the RFP process]

No Bid Letter

If you are invited to submit a bid or proposal on a project, and you decide that it would not be in your best interest to take the project on at this time, it is best to respond with a No-Bid Letter. This is nothing more than a brief letter to the organization that invited you, notifying them that you will not be submitting a bid or proposal. The No-Bid Letter allows you to state your reasons for declining the invitation and to let them know that you would still be interested in being involved in future opportunities. Be sure to always thank the issuer and request to remain on the prospective bidder list. As with all letters involved with RFP's or Invitations to bid, use your company letterhead and end the letter with "sincerely".

NOTE: When submitting the actual proposal, the cover letter should always end with "Respectfully submitted" or a closure of equal respect.

Contract documents will be unique to each Owner's requirements and Lifestyle. This is why standardized forms should be avoided but this doesn't mean something cannot be gained from examining documents from the American Institute of Architects and the Associated General Contractors. A useful approach is to take standard contracts from the AIA or AGC, cut them up into the various clauses, group clauses together so you can compare and contrast similar issues, and adapt standard contracts to your situation by addition or deletion. Be sure this is completed PRIOR TO any meetings with architects, trade contractors, or suppliers in order to become familiar with the many issues which need to be considered and what questions you would like to ask. **Contracts are available from:**

American Institute of Architects

1735 New York Ave., NW

Washington, D.C. 20006

(202) 626-7300

www.AIA.org

Associated General Contractors

333 John Carlyle St., Suite 200

Alexandria, VA 22314

(703) 837-5300

www.AGC.org

Progress Check

- What is the benefit of using a Decision Matrix?
- Describe some basic components of a Letter to Decline or Reject an RFP Bid/Proposal.

Contracts, Liabilities, & Risk Management

Chapter 3

Fundamentals of Contract Law

How to Know When You've "Got a Deal"

CONTRACT LANGUAGE	WRITTEN/ORAL CONTRACTS	OFFER AND ACCEPTANCE	IN CONSIDERATION

Learning Objectives

Interpret and explain basic contract terms and language.

Differentiate written contracts from oral contracts.

Identify what exactly constitutes "offer and acceptance", and the consideration that will form the contract.

Having an appreciation for the fundamental principles of contract law will enable you to answer many of your own questions about everyday consumer transactions, and will enhance your ability to use other parts of this book.

A **contract** consists of voluntary promises, which the law will enforce, between competent parties to do, or not to do, something. These binding promises may be oral or written. Depending on the situation, a contract could obligate someone even if he or she wants to call the deal off before receiving anything from the other side. The details of the contract -- who, how, what, how much, how many, when, etc. -- are called its **provisions** or **terms**.

You don’t need a lawyer to form a contract. If you satisfy the maturity and mental capacity requirements, discussed below, you don't need anyone else (besides the other party). But it probably is a good idea to see a lawyer before you sign complex contracts, such as business deals or contracts involving large amounts of money.

In order for a promise to qualify as a contract, it has to be supported by the exchange of something of value between the participants or parties. This something is called **consideration**. Consideration is most often money, in exchange for property or services, but can be some other bargained-for benefit or detriment (as explained more fully below). The final qualification for a contract is that the subject of the promise (including the consideration) may not be illegal.

An example:

Suppose a friend agrees to buy your car, an Edsel in less-than-mint condition, for $1,000. That is the promise. The money is the consideration for the sale. You benefit by getting the cash. Your friend benefits by getting the Edsel. Since it is your car, the sale is legal, and you and

your friend have a contract.

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CONTRACT LANGUAGE

A valid contract does not have to be a printed, legalistic-looking document. Nor does it have to be called a contract. A typed or even handwritten "agreement," "letter of agreement" or "letter of understanding" signed by the parties or even e-mailed between them will be valid if it meets the legal requirements of a contract. Don't sign something assuming it's not a contract and therefore not important.

It is also common for the word "contract" to be used as a verb meaning "to enter into a contract." And we speak of **contractual relationships** to refer to the whole of sometimes complex relationships or transactions, which may comprise one or many contracts.

Capacity

Not just anyone can enter into a contract. In order to make an enforceable contact, people have to be able to understand what they're doing. That requires both **maturity** and **mental capacity**. Without both of these, one party could be at a disadvantage in the bargaining process, which could invalidate the contract.

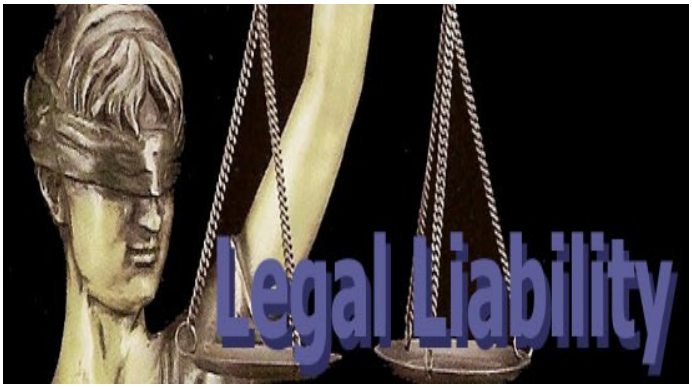
In this sense, maturity is defined as a certain age a person reaches -- regardless of whether he or she is in fact "mature." State laws permit persons to make contracts if they have reached the **age of majority** (the end of being a minor), which is usually age eighteen.

That doesn't mean minors can't make contracts, by the way. But courts may choose not to enforce some of them. The law presumes that minors need to be protected from their lack of maturity, and won't allow, for example, a Porsche salesman to exploit a minor's naiveté by enforcing a signed sales contract whose real implications a young person is unlikely to have comprehended. Sometimes this results in minors receiving benefits (such as goods or services) and not having to pay for them, though they would have to return any goods still in their possession. This would apply even to minors who are **emancipated** -- living entirely on their own -- who get involved in contractual relationships, as well as to a minor who lives at home but is unsupervised long enough to get into a contractual fix.

A court may require a minor or the minor's parents to pay the fair market value (not necessarily the contract price) for what courts call **necessaries** (what you and I would likely call "necessities"). The definition of a "necessary" depends entirely on the person and the situation. It probably will always include food and probably will never include CD's, Nintendo cartridges or Porsches. Minors who reach full age and do not disavow their contracts may then have to comply with all their terms, and in some states, courts may require

a minor to pay the fair value of goods or services purchased and received under a contract that minor has disavowed.

Parents who give their children access to home computers hooked up to the Internet should consider the situation that may arise if a child uses their credit card information online. This includes information that may be stored in the computer or at a website that recognizes your home computer and, of course, doesn't know that a minor is the actual "shopper." From the point of view of the website owner, the parent is the customer, and you may have a hard time avoiding liability for a contract (such as for the purchase of merchandise) that your children have entered into using your Internet identity.



There are other people, besides minors, who may not be able to form enforceable contracts. While the age test for legal maturity is easy to determine, the standards for determining mental capacity are remarkably complex and differ widely from one state to another. One common test is whether someone has the capacity to understand what he or she was doing and to appreciate its effects

when the deal was made. Another approach is evaluating whether someone has self-control, regardless of his or her understanding. That brings up the question of whether an intoxicated person can be held to a contract. Very often someone who is "under the influence" can get out of a contract. The courts don't like to let a voluntarily intoxicated person revoke a contract with innocent parties this way -- but if the evidence shows that someone acted like a drunk when making a contract, a court may well assume that the other party probably was trying to take advantage. On the other hand, if someone doesn't appear to be intoxicated, he or she probably will have to follow the terms of the contract. (The key in this area may be a person's medical history. Someone who can show a history of alcohol abuse, blackouts, and the like, may be able to void the contract, regardless of his or her appearance when the contract is made. This is true especially if the other party involved knew about the prior medical history.)

CAPACITY

We've discussed the fundamental requirements for competence to make a contract -- maturity and mental capacity. Of course, it should go without saying that there's an even more fundamental requirement: that both parties be people. In the case of a corporation or other legal entity, which the law considers a "person," this could be an issue. A problem in the formation or

status of the entity could cause it to cease existing legally, thus making it impossible to enter into a contract.

> ***In that case, however, the individuals who signed the contract on behalf of the legally nonexistent entity could be personally liable for fulfilling the contract.***

Historically, the law has had other criteria for capacity. Slaves, married women and convicts were at one time not considered capable of entering into contracts in most states. Even today, certain American Indians are regarded as **wards** of the U.S. government for many purposes, and their contract-law status is similar to that of minors.

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WRITTEN AND ORAL CONTRACTS

Some people mistakenly believe that an oral contract isn't worth the paper it's printed on. But many types of contracts don't have to be written to be enforceable. An example is purchasing an item in a retail store. You pay money in exchange for an item that the store warrants (by implication, as discussed later) will perform a certain function. Your receipt is proof of the contract.

As with a written contract, the existence of an oral contract must be proved before the courts will enforce it. But as you can imagine, an oral contract can be very hard to prove -- you seldom have it on video. An oral contract is usually proved by showing that outside circumstances would lead a reasonable observer to conclude that a contract most likely existed. Even then, there is always the problem of what the terms of the oral contract were.

Although most states recognize and enforce oral contracts, the safest practice is to put any substantial agreement in writing. Get any promise from a salesperson or an agent in writing, especially if there already is a written document that might arguably be a contract covering any part of the same deal. If the court concludes that the parties intended the written document--a handwritten "letter of agreement" or "understanding," an e-mail, or even an order form--to contain all its terms and be a complete statement of all understandings between the parties, then the court will be very hesitant to add words or terms to the document. This is the important **parol evidence rule**, under which courts typically look only to **unrefuted**

(uncontested) testimony to help them "fill in the blanks" of a contract. Anything not in that written contract would be deemed not to be part of the deal.

Writing down the terms of a good-faith agreement is the best way to ensure that all parties are aware of their rights and duties -- even if no party intends to lie about the provisions of the agreement.

Having said that, know that there are some contracts which are completely unenforceable if they're not in writing. This requirement, which exists in varying forms in nearly all the states, had its origins in the famous **statute of frauds,** an English law dating from 1677. It refers to "frauds" because it attempts to prevent fraudulent testimony in support of nonexistent agreements. In most states, the courts will enforce certain contracts only if they are in writing and are signed by the parties who are going to be obligated to fulfill them. These contracts often include:

- ***any promise to be responsible for someone else's debts -- often called a surety contract or a guaranty; one example would be an agreement by parents to guarantee payment of a loan made by a bank to their child;***
- ***any promise, made with consideration, to marry (though this rule has been eliminated in many states);***
- ***any promise that the parties cannot possibly fulfill within***

one year from when they made the promise;

- ***any promise involving the change of ownership of land or interests in land such as leases;***
- ***any promise to pay a broker a commission for the sale of real estate;***
- ***any promise for the sale of goods worth more than $500 or lease of goods worth more than $1,000 (the amounts may vary from state to state);***
- ***any promise to bequeath property (give it after death);***
- ***any promise to sell stocks and bonds (this provision is eliminated in some states).***

Some states have additional requirements for written contracts. These statutes are designed to prevent fraudulent claims in areas where it is uniquely difficult to prove that oral contracts have been made, or where important policies are at stake, such as the dependability of real estate ownership rights. Promises to extend credit are often in this category. One typical area of state regulation is automobile repairs; many states require that estimates for repair work be given in writing. If they aren't, and the repair is done anyway, the contract may not be enforceable, and the repair shop may not be able to get its money if the customer disputes authorizing the repairs.

Where a written contract is required, a signature by **the party to be charged**--that is, the person who the other party wants to hold to the contract--is also necessary. A signature can be handwritten,

but a stamped, photocopied, or engraved signature is often valid as well, as are signatures written by electronic pens. Even a simple mark or other indication of a name may be enough. What matters is whether the signature is authorized and intended to authenticate a writing, that is, indicate the signer's **execution** (completion and acceptance) of it. That means that you can authorize someone else to sign for you as well. But the least risky and most persuasive evidence of assent is your own handwritten signature.

Incidentally, hardly any contracts require notarization today. Notary publics or notaries, once important officials who were specially authorized to draw up contracts and transcribe official proceedings, act now mostly to administer oaths and to authenticate documents by attesting or certifying that a signature is genuine. Many commercial contracts, such as promissory notes or loan contracts, are routinely notarized with the notary's signature and seal to ensure that they are authentic, even where this is not strictly

required. Many technical documents required by law, such as certificates of incorporation and real property deeds, must be notarized if they are going to be recorded in a local or state filing office.

Progress Check

- Define capacity as it relates to contract law.
- How do you usually prove an oral contract?

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OFFER AND ACCEPTANCE

Offer and acceptance are the fundamental parts of a contract, once capacity is established. An **offer** is a communication by an offeror of a present intention to enter a contract, or more simply--a promise to do something. (The **offeror** is the person making the offer.) It is not simply an invitation to bargain or negotiate. For the communication to be effective, the **offeree** (the one who is receiving the offer) must receive it. In a contract to buy and sell, for an offer to be valid, all of the following must be clear:

- Who is making the offer?
- What is the subject matter of the offer?
- How many of the subject matter does the offer involve (quantity)?
- How much is offered (price)?

Let's say you told your friend, "I'll sell you my mauve-colored Edsel for one thousand dollars." You're making the offer, your friend is receiving it, and the car is the subject matter. Describing the car as a mauve Edsel makes your friend reasonably sure that both of you are talking about the same car (and only one of them). Finally, the price is $1,000. It's a perfectly good offer.

Advertisements are not offers, as much as they seem like it. Instead, courts usually consider advertisements an "expression of intent to sell" or an invitation to bargain.

GIVE AND TAKE

A contract can only come about through the bargaining process, which may take many forms. This chapter discusses the definitions

of consideration, offer, and acceptance. All the principles discussed here will have to be present, in some form, in any contract.

An offer doesn't stay open indefinitely, unless the offeree has an **option**, which is an irrevocable offer (discussed below). Otherwise, an offer ends when:

- The time to accept is up--either a "reasonable" amount of time or the deadline stated in the offer;
- The offeror cancels (revokes) the offer;
- The offeree rejects the offer;
- The offeree dies or is incapacitated.

An offer is also closed, even if the offeree has an option, if:

- A change in the law makes the contract illegal;
- Something destroys the subject matter of the contract (see below)

Note that there are special kinds of contracts called options. An option is an agreement, made for consideration, to keep an offer open for a certain period.

For example, in return for a fifty-dollar payment today, you might agree to give your friend until next Friday to accept your offer to sell her your Edsel for $1,000. Now you have an option contract. The fifty dollars is not a down payment or a deposit, but the price of

the option. Selling an option puts a limit on your ability to revoke an offer, a limit that the **optionee** (the option-holder) bargains for with you in return for the fifty dollars.

Acceptance

A contract is not complete unless an offer is accepted. But what, exactly constitutes the acceptance of an offer? **Acceptance** is the offeree's voluntary, communicated agreement or assent to the terms and conditions of the offer. **Assent** is some act or promise of agreement. An easy example of an assent might be your friend saying, "I agree to buy your mauve Edsel for one thousand dollars."

Generally, a valid acceptance requires that every material term agreed to be the same as in the offer. In addition, if the offer requires acceptance by mail, you must accept by mail for the offer to be effective. Be aware that under the **mailbox rule**, an offer accepted by mail is usually effective when you put the letter in the mailbox, not when it is received -- unless the terms for acceptance state otherwise. If there's no such requirement, you just have to communicate your

acceptance by some reasonable means (not by carrier pigeon, smoke signals or channeling but by telephone, mail, email or facsimile). On the other hand, an assent that is not quite so specific but is crystal-clear in its meaning would also suffice -- such as, in the Edsel example, saying, "It's a deal. I'll pick it up tomorrow." The standard is whether a reasonable observer would think there was an assent.

In most cases, silence does not constitute acceptance of an offer. It isn't fair to allow someone to impose a contract on you unless you go out of your way to stop it. Hence, your cable TV company cannot force a contract for additional services simply because you failed to reject its offer.

Yet there are circumstances where failure to respond may have a contractual effect. Past dealings between the parties, for example, can create a situation in which silence constitutes acceptance. Suppose a fire insurance company, according to past practice to which you have assented, sends you a renewal policy (which is in effect a new contract for insurance) and bills you for the premium. If you kept the policy but later refused to pay the premium, you would be liable for the premium. This works to everyone's benefit: if your house burned down after the original insurance policy had expired but before you had paid the renewal premium, you obviously would want the policy still to be effective. And the insurer is protected from your deciding to pay the premium only when you know you have sustained a casualty loss.

On the other hand, speechless acts *can* constitute an acceptance. Any conduct that would lead a reasonable observer to believe that the offeree had accepted the offer qualifies as an acceptance. Suppose you say, "Ed, I will pay you fifty dollars to clean my garage on Sunday at nine o'clock a.m." If Ed shows up at nine o'clock a.m. on Sunday and begins cleaning, he adequately shows acceptance (assuming you are home or you otherwise would know he showed up).

To take another example, you don't normally have to pay for goods shipped to you that you didn't order (a later section will discuss this in more detail). You otherwise would only have to allow them to be taken back at no cost to you. But if you owned a shop and you put them on display in your store and sold them, you would have accepted the offer to buy them from the wholesaler and you would be obligated to pay the invoice price. Sometimes this is called an **implied** (as opposed to an **express**) contract. Either one is a genuine contract.

The Reasonable Person

Throughout this and any other law book, the word "reasonable" will appear many times. Very often you'll see references to the **reasonable man** or the **reasonable person**. Why is the law so preoccupied with this mythical being?

The answer is that no contract can possibly predict the infinite number of disputes that might arise under it. Similarly, no set of laws regulating liability for personal or property injury can possibly foresee the countless ways human beings and their property can harm other people or property. Since the law can't provide for every possibility, it has developed the standard of the "reasonable person" to furnish some uniform standards and to guide the courts.

Through the fiction of the "reasonable person", the law creates a standard that the judge or jury may apply to each set of circumstances. It is a standard that reflects community values, rather than the judgment of the people involved in the actual case.

Thus a court might decide whether an oral contract was formed by asking whether a "reasonable person" would conclude from people's actions that one did exist. Or the court might decide an automobile accident case by asking what a "reasonable person" might have done in a particular traffic or hazard situation.

A contract usually is in effect as soon as the offeree transmits or communicates the acceptance -- unless the offer has expired or the

offeror has specified that the acceptance must be *received* before it is effective, or before an option expires (as discussed previously). In these situations, there's no contract until the offeror receives the answer, and in the way specified, if any.

NON-ACCEPTANCE

An **agreement to agree** is seldom a contract**,** because it suggests that important terms are still missing. Rarely will a court supply those terms itself. An agreement to agree is another way of saying that there has not yet been a meeting of the minds, although the parties would like there to be.

Another common question people have, as funny as it sounds, is whether a joke can be an offer. That depends on whether a reasonable observer would know it's a joke, and on whether the acceptance was adequate. In our Edsel example, you probably couldn't get out of the contract by saying, "How could you think I'd sell this for $1,000? I meant it as a joke!" On the other hand, if someone sued you because you "backed out" on your "promise" to sell her France for fifteen dollars, the joke would be on her -- no one could have reasonably thought you were serious.

Conditions

Most contracts have conditions. People often use the word "condition" to mean one of the terms of a contract. But a more precise definition is that a **condition** is an event that has to occur before one or both parties must perform. A condition can be a promise.

> ***For example, if your friend, from our earlier case, had said, "I'll buy your mauve Edsel only if you deliver it to me by midnight," and you accept that condition, you have both promised him delivery by midnight and made that a condition of the contract.***

On the other hand, many conditions involve uncertain events not under the direct control of the parties to the contract. Thus neither of them can promise anything about the condition, but the conditions still must be fulfilled for the contract to go forward. Examples are conditioning a home purchase on obtaining financing, on the sale of the buyer's present home, or on an acceptable home inspection report.

Consideration

In order for a contract to exist, both sides must give some consideration, or exchange something of value. There is a crucial principle in contract law called **mutuality of obligations**. It means that both sides have to be committed to giving up something or

doing something. If either party reserves an unqualified right to bail out, that person's promise is illusory: no promise at all**.**

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IN CONSIDERATION

The doctrine that consideration is critical to formation of a contract came about in the last few centuries. Until then elaborate formality rather than consideration was the chief requirement. The necessary formalities were a sufficient signed writing, a seal or other testation of authenticity, and delivery to whomever would have the rights under the contract. A seal could be an impression on wax or some other surface, bearing the mark (often found on a signet ring) of the person making the promise. The vestiges of the seal remain in some contracts, where the initials "L.S." (for the Latin *locus sigilli*, "place of the seal"), or simply the word "seal," is printed to represent symbolically the authentication of the contract's execution. Even today, traditional Jewish wedding contracts are made on these formal bases: a writing by the groom, an attestation by witnesses, and delivery (also witnessed) to the bride.

There is no minimum amount of consideration required to effect a contract. A price is only how people agree to value

something, so there's no absolute standard of whether a price is fair or reasonable.

The courts presume that people will only make deals that they consider worthwhile. So if you make a contract to sell your car for one dollar, a court will probably enforce it. (But don't sell it for $1,000 and just report a one-dollar sale to the state to avoid paying the full sales tax. It's unethical, illegal, and dangerous: many states have systems in place to check for just such abuses.) The exception is something that would "shock the conscience of the court."

Consideration is any promise, act or transfer of value that induces a party to enter a contract. Consideration is a bargained-for benefit or advantage, or disadvantage.

A benefit might be receiving $10. First dibs on Super Bowl tickets might be an advantage. A disadvantage may involve promising not to do something, such as a promise not to sue someone. For these purposes, even quitting smoking, done with the reasonable expectation of some reward or benefit from someone else, is

regarded as a detriment: even though it's good for your health, it costs you effort that you otherwise would not have made. And even if it were effortless, your commitment to forbear from engaging in lawful conduct would still constitute consideration. For example, you could agree to give your car to your friend in exchange for her promise that she'll stop letting her schnauzer out late at night. Your friend is giving up what is presumably her right to let her dog out any time she wants. In return, you are giving up that Edsel. Other types of consideration include a promise to compromise an existing dispute.

Consideration has to be a *new* obligation, because someone who promises to do what he or she is already obligated to do hasn't suffered any detriment, or bestowed anything the other party wasn’t already entitled to.

For example, suppose you agree to have a contractor paint your house this Thursday for $500. Before starting, though, his workers demand higher wages. He tells you on Wednesday night that he settled the strike but now the job will cost $650. You need the house painted before you leave town on Friday, and there's no time to hire another contractor, so you agree to the new price. But the new "agreement" (the new price) is not enforceable by him. Under the original contract, he already had to paint your house for $500. He should have figured the possible increased costs into the original price. You didn't get anything of benefit from the modified "contract," since you already had his promise to paint the house.

There is no new contract because there is no new consideration. Therefore, you only owe $500 -- the old agreement remains in effect. Along the same lines, police officers are never entitled to reward money posted for catching fugitives or turning in information leading to someone's conviction. That's their job.

Just because consideration has to be new doesn't mean a contract can never be voluntarily renegotiated. It only means that no one can force another party to renegotiate by taking advantage of an existing agreement. In the house painting example, you may agree to a renegotiation even though it would technically not be enforceable. Perhaps you think the painter "deserved" more than he had agreed to take, or want to maintain a good to relationship with him.

Considerations like these are what motivate many sports teams to "renegotiate" their stars' salaries. Though they have no legal obligation to do so, they nonetheless may decide to keep their stars "happy."

While it's true you can go to the other party and ask for more money, keep in mind that whenever you get involved in a deal, you are taking a risk that it might be less beneficial than you planned when you agreed to the contract terms. The other party doesn't have to ensure your profit, unless the two of you included that in your bargain.

Based on the rule of consideration, a promise to make a gift is not usually enforceable, if it truly is only a promise to make a gift, because a gift lacks the two-sided obligation discussed above. But if the person promising the gift is asking for anything in return, even by implication, a contract may be formed. The key, again, is consideration.

Reliance

We said earlier that consideration is a two-way street, and that both parties must get some for a contract to be formed. There is an exception to that rule. Sometimes a contract will be formed by the reliance of one party on another person's promise, even if the one making the promise hasn't gained to anything. The concept of **reliance** is that a contract may be formed if one party reasonably relies on the other's promise. That means that he or she does more than expect to receive what was promised. He or she has to do something that wouldn't have been done, or fail to do something that would have been done, but for the promise. If that reliance causes some loss, he or she may have an enforceable contract.

Suppose that rich Aunt Alice loves your kids. On previous occasions she has asked you to buy them expensive presents and has reimbursed you for them. This past summer, she told you she would like you to build a swimming pool for the kids, and send her the bill.

You did so, but moody Aunt Alice changed her mind. Now she refuses to pay for the pool, and claims you can't enforce a promise to make a gift. The pool, however, is no longer considered a gift. You acted to your detriment in reasonable reliance on her promise, by taking on the duty to pay for a swimming pool you would not normally have built. Aunt Alice has to pay if you prove that she induced you to build the pool, especially if this understanding was consistent with many previous gifts. Remember, however, that you still have to live with your Aunt Alice.

Agents

You can have someone enter into a contract on your behalf, but only with your permission. The law refers to such an arrangement as **agency**. We couldn't do business without it. For example, when you buy a car, you bargain and finally cut a deal with the salesperson. But she doesn't own the car she's selling you. She might not even have a car. She is an **agent**, someone with the authority to bind someone else -- in this case, the car dealership -- by contract. The law refers to that someone else as the **principal**. Most of the sales people you deal with are agents.

As long as agents do not exceed the authority granted them by their principals, contracts they make bind their principals as if the principals had made the contracts themselves.

If something went wrong with the contract, you would sue the principal -- not the agent -- if you couldn't resolve the dispute in a friendly manner. An agent normally does not have any personal obligation.

While acting on behalf of principals, agents are required to put their own interests after those of the principal. Therefore, they may not personally profit beyond what the principal and agent have agreed to in their agency contract. That means they cannot take advantage of any opportunity which, under the terms of the agency, should be exploited for the principal.

When an agent exceeds her authority, there are a number of factors that determine whether the contract can be enforced against the principal. Under the doctrine of apparent authority, if the person she's dealing with doesn't reasonably understand that she's exceeding her authority, the principal may be bound by the contract negotiated by the agent. If the other person was not being reasonable in believing that the agent was acting within her authority, the contract will only be enforceable against the principal if the principal has knowingly permitted the agent to do this sort of thing in the past.

What is reasonable belief in the scope of the agent's authority? Suppose the teenage boy wearing a service-station uniform and a nose-ring who fills your gas tank and checks your oil – and who

appears to be an agent, to some limited degree, of the service station -- offers to sell you the whole service station in return for the sleek mauve Edsel you are driving. It's not reasonable for you to assume he has that power when common sense tells you he can only sell you his boss's gasoline and oil for a fixed price.

In contrast, if an insurance agent wrote you an insurance policy from her company that exceeded the policy amount she was authorized to write, but the insurer never told you this, you would be acting reasonably to assume she was authorized, and you probably would be entitled to collect on a claim above his limit.

AGENTS WHO EXCEED THEIR AUTHORITY

On occasion, while making a contract, an agent might exceed the authority granted by the principal. An example might involve an automobile salesperson who signs a contract on behalf of a car dealer which, without the dealer's authority, gives the customer a warranty for 40,000 extra miles. In that case, the dealer might very well be bound by the contract.

Delegations and Assignments

You can transfer your duties under a contract to someone else, unless the contract specifically prohibits such a transfer. The law refers to a transfer of duties or responsibilities as a **delegation**. If, however, someone contracts with you because of a special skill or talent only you have, you may not be able to transfer your duty. Such cases are quite rare. There are arguably no car mechanics who are so good at tuning an engine that they may not delegate someone else to do it for them – unless they specifically promise to do it themselves. On the other hand, if you hire specific entertainers to perform at your wedding, they may not send other entertainers (no matter how talented) as substitutes without your permission.

A transfer of rights, called an **assignment**, is more flexible than a transfer of duties. For example, you may wish to transfer the right to receive money from a buyer for something you have sold. Generally, a contract right is yours to do as you wish with it, as long as you didn't agree in the contract not to assign the right. You can sell it or give it away, though most states require you to put an assignment in writing, especially if it is a gift.

There are exceptions to the rule that assignments may be made freely. If an assignment would substantially increase the risk, or materially change the duty of the other party to the contract, the contract may not be assignable, even if its terms contain no explicit agreement to the contrary. Such an assignment would be regarded as unfairly upsetting the expectations the other party had when he

or she entered the contract, and so that party would no longer be obligated by the terms of the contract.

For example, suppose you made a contract for fire insurance on a garage for your Edsel. Then a notorious convicted arsonist and insurance cheat contacted you upon release from prison and asked you to sell him the garage and assign him your rights under the garage's fire insurance policy. You would probably both be in for a disappointment, even if the insurance policy didn't prohibit assignment. Since the insurer made its decision to insure in part based on your solid citizenship, insuring the arsonist would greatly increase the insurer's burden by exposing it to a risk it never anticipated.

We've discussed some very basic ideas in contracts. But this is only half the story. The next chapter deals with situations where a contract may be unenforceable even when the elements of capacity, offer, acceptance and consideration are present, but something fundamentally unfair or illegal is going on.

Progress Check

- List what elements must be present in an offer.
- What is an agreement to agree?
- Give an example of an agent who exceeds their authority.

Contracts, Liabilities, & Risk Management

Chapter 4

Bars To A Contract

How to Know When It's "No Deal"

CONTRACTS	BUYER BEWARE	GETTING OUT	3 DAY RULE

Learning Objective

Explain how certain contract defenses can help you avoid being held to an unfair or illegal contract.

Understand the Michigan Home Solicitation Act and how it impacts the construction industry.

Excerpted from American Bar Association Guide to Consumer Law: Everything You Need to Know About Buying, Selling, Contracts, and Guarantees, 1997, by Ronald D. Coleman, published by the American Bar Association Division for Public

WHEN IS A CONTRACT NOT A CONTRACT? In the last chapter we discussed what you need to make a contract. Now we'll consider what kinds of things could still prevent a legally-enforceable contract from being formed. These are often described as **contract defenses**. You should understand them because if one or more of them is present, and provable, you might be in much better shape if you're having trouble with the terms of a "deal" you might have thought you were stuck with.

Illegality

Illegal contracts -- such as a contract on someone's life -- are not enforceable. Courts will not help someone collect an illegal gambling debt, or payment for illegal drugs or prostitution. The law treats these contracts as if they never existed -- they are **unenforceable** or **void**. This is the contract defense of illegality.

Similarly, some contracts that are not specifically outlawed nonetheless will not be enforced if a court determines that enforcement would violate public policy. An example would be a contract to become a slave, which may not be prohibited by any specific statute but offends the law's view of what kinds of contracts society will permit.

There are some situations where a contract was legal when entered into, but the law changes before it is executed by all parties. Generally speaking, the Constitution forbids lawmakers from passing laws that would impair the rights people bargain for in contracts, but there are many law books filled with exceptions to this general rule.

Therefore, a contract is usually considered by courts in light

of the law that applied at the time the contract was made -- unless the change in the law involves a compelling public policy.

The key, then, is whether the new law reflects an important public policy. Here's an example of a law that did not involve such a policy. A contract between a railroad and a property owner who leased a right-of-way to the railroad provided that the railroad was not responsible for any fire damage to the property caused by locomotives. Later, the state legislature required certain precautions against fire damaging an adjoining property. The court held that, even if that law would have made the contract illegal (because it didn't include the newly-required precautions), because it was passed after the contract was made the law did not affect the contract.

Typically, however, courts say that because of a change in ***public policy*** as a result of the change in the law, they will not enforce the old contract. Obviously, a contract to sell someone a slave could not be enforced after slavery became illegal; neither could you enforce a contract to purchase a banned assault rifle that was made before the ban went into effect. This works both ways: a contract that was illegal when made usually will not be enforced, even though it would be legal if entered into today. After World War II, one party wanted to enforce a contract that violated wartime price-controls.

The court ruled that a contract that was so damaging to the public good when made (and when no change in the law was anticipated) should never be enforced. To do so would have been to provide an incentive to enter into illegal contracts in the hope that they will someday be enforceable -- a bad prescription for effective public policy.

Remember that an illegal contract is different from an immoral contract. The courts will only enforce a moral code that the law (or "public policy") already reflects, such as laws against prostitution or

stealing. You may feel that X-rated movies or fur coats are immoral, but as long as they're legal, they can be the subjects of enforceable contracts. What if it is illegal to gamble in your state, but you go on line and gamble over the Internet using your credit card? Chances are you will still have to pay your losses. The website operator may be in violation of local law, and you may be also. But your credit card agreement probably requires you to pay your gambling debts regardless, and until this area is regulated and controlled you must assume that when you put your money on the line, online, that you may never see it again - exactly the bargain you make whenever you gamble.

IS IT OR ISN'T IT A CONTRACT?

You now know that a contract has to be made between willing, competent parties. Also, the contract must concern a legal subject matter. The preceding chapter also discussed many aspects of consideration. But applying these principles isn't always easy. Sometimes special protections in the law complicate matters. If successfully invoked, only one of these may be needed to provide a complete defense against someone claiming you owe him or her money or something else you supposedly promised. It would prompt a court to resolve the dispute as if there never were a contract. Since the contract is void, neither party may enforce its terms in court against the other.

Other contracts are **voidable**, but not automatically **void**. What's the difference? A contract produced by fraud is not automatically

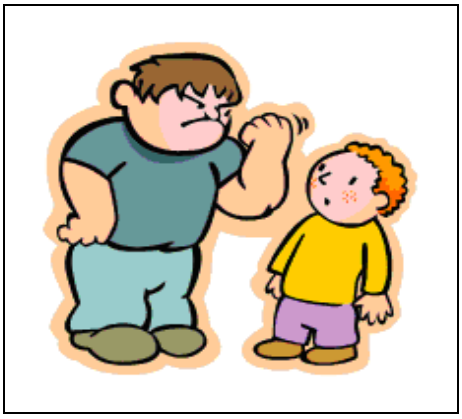
void. People who are victimized by fraud may have the choice of asking a court to declare the contract void or to **reform** (rewrite) it. On the other hand, if they went along with the contract for a substantial period of time, they could lose their right to get out of it. This is called **ratification**, and is based on the idea that they have, by their actions, made it clear that they are able to live with the terms.

A checklist of contract defenses appears in this chapter:

1. **Duress**

You don't usually have to worry about being held to a contract that you entered into against your will. A contract that someone agrees to under duress is void. **Duress** is a threat or act that overcomes someone's free will. The classic case of duress is a contract signed by someone "with a gun to his head." That means *literally*. **Since this kind of duress is very rare -- and often very hard to prove - the defense of duress is rarely successful.**

Duress is more than persuasion or hard selling. Persuasion in bargaining is perfectly legal. It also isn't duress when your friend says, "I would never pay that much for a Edsel if I had a choice." She does have a choice: buy a nice Taurus instead. But if she wants that mauve Edsel, she "has to" pay what the owner demands. In contrast, duress involves actual coercion, such as a threat of violence or imprisonment.



Besides being done by threats of physical violence, it may be duress to threaten to abuse the court system to coerce your agreement, i.e., to tell someone that I'll tie you up in litigation for ten years. There is also economic duress. That was alluded to earlier when the contractor demanded more money after his workers went on strike and you needed your house painted before you left the country. This isn't the same as "driving a hard bargain." Rather, the contractor had already made a deal. When the contractor threatened to withhold his part of the deal, he left you with no practical choice but to agree. The classic case is where the supplier of a necessary ingredient or material threatens, on short notice and at a critical time, not to deliver it -- in violation of an existing contract -- unless he or she gets more favorable terms. Courts have set aside contracts made under such economic duress.

A lawyer can tell you how to protect yourself, helping you determine whether you have assumed any obligation, and what legal rights you might have besides disavowing the contract. With duress, it's important to act quickly, since the courts are especially skeptical of a claim of duress made long after the danger has passed.

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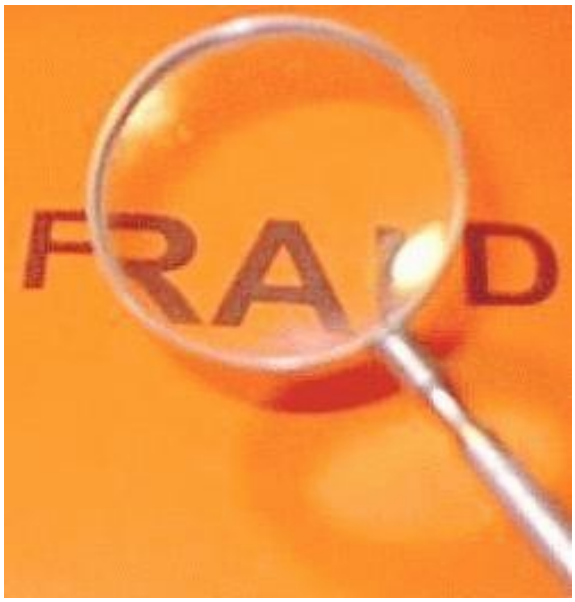
2. Undue Influence

There are other uses of unfair pressure, less severe than duress, that void a contract. One contract defense is called **undue influence**, which doesn't involve a threat. Rather, it's the unfair use of a relationship of trust to pressure someone into an unbalanced contract. Undue influence cases usually involve someone who starts out at a disadvantage, perhaps due to illness, age, or emotional

vulnerability. The other person often has some duty to look out for the weaker one's interests.

An example would be an adult child who "persuades" his elderly, failing mother to sell him the family homestead for a pittance. The sale contract would be unenforceable because of undue influence, regardless of whether the mother otherwise had the capacity to make a contract.

3. Fraud



A contract can also be canceled by a court because of fraud. **Fraud** is when one person knowingly makes a material misrepresentation that the other person reasonably relied on and that disadvantaged that other person. A **material misrepresentation** is an untrue statement of "fact" that is important to the deal, "material" meaning it would affect the terms you'd agree to it if you knew the truth. In many states, this misrepresentation doesn't have to be made on purpose to make the contract voidable.

Consider our earlier example involving a car sale. You offered to sell your Edsel to a friend. Suppose you knew it had no transmission, and you knew she wanted it for the usual purpose of driving it. You told her it was working fine, and she relied on your statement. Then the contract you made may be set aside on the grounds of fraud. Here, there is no issue of the statement being merely the seller's opinion, or exaggerated "sales talk" or puffery that people know not to believe literally. You didn't merely say it was a great car when

really it was a mediocre car. Saying it's "great" is just an opinion, while fraud requires an outright lie, or a substantial failure to state a material fact about an important part of the contract. For that reason - and because dishonest people often know well the fine line between fraud and puffing -- actual fraud that will invalidate a contract is a lot less common than people think.

WHEN SOMEONE FORCES YOU TO SIGN

Between the defenses of duress and undue influence, you should never have to fear a court holding you liable for a contract that someone forces you to sign. Both concepts are hard to define, though, and people often use them interchangeably. Also, their limits vary from one state to another. If you think either might apply to an agreement you want to get out of, see a lawyer.

4. Mistake

Sometimes it seems unfair to hold a party to a contract they entered into by mistake, but this is a slender reed indeed on which to seek to avoid a contract. The other party's fraud is very different from your mistake, assuming the other party didn't know about your mistake. The defense of **unilateral mistake** is almost impossible to prove, even if the mistake is about the most important terms of the contract. If allowed liberally, it would lead to a lot of abuse. People would claim they made a mistake in order to get out of a contract they didn't like, even though they had no valid legal defense. Therefore, courts hardly ever permit such a defense, and even then, mostly in specialized business cases.

Courts have permitted a mistake defense most commonly if there has been an honest error in calculations. The calculations must be material to the contract, and the overall effect must be to make the contract unconscionable (discussed below), that is, unfairly burdensome.

Such mistakes often happen when a unit of government puts public work out for bid. If a contractor mistakenly bids five million dollars to construct a bridge and a road, when the true cost to build the bridge alone was five million dollars, he or she might be able to raise this defense. Even then, however, if several months have elapsed and the government has materially relied on the mistaken figures before the mistake is discovered (for example, by taking a number of steps to move the process forward), then it would be unfair to the government to cancel the deal, and the defense would probably fail.

Of course, if you explicitly state your mistaken idea, the other party has a duty to correct you. Then the issue is no longer one of mistake but of fraud. In our car-sale example, suppose the car's heater worked, but not too well, and you, the seller, knew that. Under contract law, if you and your friend hadn't discussed it, you probably wouldn't have to tell your friend about it. But suppose your friend told you, "The best thing about this car is that it's so hard to find an Edsel with a perfect heater."

Then you would be obliged to tell your friend that the heater was faulty. If you didn't, many states would permit your friend to set aside the contract, or would allow your friend to collect damages for repairs required on the heater.

Having said this, the best defense is a good offense. Don't assume anything important or questionable. Ask the questions now -- before you sign.

On the other hand, if *both* sides make a mistake, they share an erroneous basic assumption. Then, in order to avoid injustice, the court will sometimes set aside the contract, under the theory of a **mutual mistake**.

The classic case of mutual mistake occurred when someone sold a supposedly infertile cow for eighty dollars. It turned out soon afterward that the cow was pregnant, which made her worth $800. The court ruled that since both parties thought they were dealing with a barren cow, the contract could be set aside.

This does not mean that contracts always have a built-in guarantee against mistakes. As you can imagine, this is a very tricky and unpredictable area. After all, many people make purchases on the understanding that the object is worth more to one person than to the other. You wouldn't pay $80 for a cow if she were not worth at least $80.01 to you. That is, you figure you're somewhat better off with the cow than with the $80, given your circumstances and opportunities. (Economists call this amount the "marginal benefit.") Similarly, the seller would not sell her if she were worth more than $79.99 to the seller, given the seller's circumstances and opportunities. Both people have to be getting some benefit to agree to the sale. In the case of the cow, both buyer and seller understood clearly -- but mistakenly -- that the cow could not get pregnant. It's as if they made the contract for a subject that turned out not to exist.

How serious does a mutual mistake have to be before a court will set aside a contract for that reason? To take our example, various courts would draw the line on mistake between $80.01 and $800 at different places, if they would be willing to draw it at all. Competent legal advice about the law in your state is crucial if you are considering voiding a contract because of a mistake.

5. Statutes of Limitations

You should also be aware of **statutes of limitations**. These are laws setting time limits during which a lawsuit can be brought. The typical deadline for bringing a contract action is six years from the time the breach occurs. The idea of this policy is that everyone is entitled, at some point, to "close the book" on a transaction. It encourages people to move on and reduces the uncertainty that, for example, businesses would face if they could be sued for breaching contracts that no one alive in the organization remembers.

6. Changing Situations

Sometimes changing circumstances make a contract impossible to perform. Suppose that you hire a contractor to paint your house on Thursday, and it burns down Wednesday night through no fault of your own. Then the contract will be set aside, because there's no way to perform it. You won't have to pay the painter, under the doctrine of **impossibility of performance**. Both of you are out of luck. The same is true if the contract covers a specific kind of product, and it becomes unavailable because of an act of God, such as an earthquake or blizzard. Courts usually will not enforce such a contract.

For example, suppose you contract to deliver one hundred barrels of a specific grade of oil from a specific Arabian oil field by a certain date. Then an earthquake devastates the oil field, making recovery of the oil impossible. You're probably off the hook under these circumstances. This doctrine is also known as **impracticability of performance**, which reflects the fact that it may apply even if

performance is not literally impossible, but is still seriously impractical.

Sometimes changed circumstances radically change the costs of performing a contract, without making it literally impossible to do so. Courts probably would enforce the contract, on the grounds that the new circumstances were foreseeable, and that the possibility of increased costs was or could have been built into the contract. For instance, suppose again that you contract to deliver one hundred barrels of Arabian oil. This time, fighting breaks out in the Persian Gulf, interrupting shipping and greatly increasing the cost of the oil. When a court considers these facts, it's likely to say that you should have foreseen the possibility of fighting and built that risk into the price. The contract will stand.

On the other hand, sometimes a change in conditions doesn't make performance impossible or impractical, but it does make performance meaningless. The legal term for this is **frustration of purpose**. One famous case decided around the turn of the century involved a man who rented an apartment in London to view the processions to be held in connection with the coronation of the King of England. Because of the King's illness, the coronation was canceled. The court excused the renter from paying for the room. Through no fault of his own, the whole purpose of renting it -- which the people who owned the room knew -- had disappeared. Such cases, though, are rare indeed. More typically, you take your chances when you make a contract in expectation of some third party's or outside force's action; many contracts have a term excusing the parties from performance if any of a number of specified events occur.

There are three important criteria for a contract to be set aside for frustration of purpose.

1. First, the frustration must be substantial -- nearly total, and with almost no chance at improved benefit.

2. Second, the change in circumstances must not be reasonably foreseeable.

3. Third, the frustration must not have been your fault.

Progress Check

- How is an illegal contract different from an immoral contract?
- Provide an example of undue influence.
- Give an example of a mutual mistake.

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SHOULD THE BUYER STILL BEWARE?

The well-known Latin maxim *caveat emptor* -- "let the buyer beware" -- is a strict rule placing the risk in a transaction with the buyer. Under this rule each party is protected only by inspecting and analyzing a potential transaction, because there is no remedy if there is a hidden problem. In fact, this "ancient" law really predominated only in the 19th and early 20th centuries, when the idea of "the sanctity of the contract" reigned. More common are the principles of "just prices" and fair dealing in transactions. They are part of religious law, medieval law, and more recently statutory law -- particularly the consumer fraud acts prohibiting unfair or deceptive acts and practices. Having said that, every buyer should recognize that the first line of defense is common sense, and not depend on an expensive lawsuit and a sympathetic judge to save him or her from a bad deal or sharp practice.

Unconscionability

On rare occasions, a court may let a party out of a contract because the court deems it "unconscionable" (from the word "conscience"). **Unconscionability** means that the bargaining

process or the contract's provisions "shock the conscience of the court." An example would be selling thousands of dollars of rhumba lessons to a ninety-five-year-old invalid on social security. An unconscionable contract is one that produces a result unfairly surprising due to hidden or obscure language, or, as in the example given above, is grossly unfair, perhaps due to a lack of bargaining power. Its terms suggest that one party took unfair advantage over the other one when they negotiated it. The courts are reluctant to use this weapon, but consumers have a better chance with it than anyone else, especially in installment contracts.

The important thing to remember is that you shouldn't rely on unconscionability in making a contract. Though courts sometimes will void contracts on these grounds, the application of unconscionability is uncommon, uneven, and unpredictable.

Make the effort to understand all the terms of a contract and don't enter into it if it seems too one sided. After all, it's also "unconscionable" to let someone take advantage of you.

FILL IN THE BLANKS

There are many kinds of form contracts. One is the kind you simply have to sign if you want to get insurance or a loan, or if you're financing a car. These are called contracts of adhesion -- if you want the deal, you have to "adhere" or stick to the terms. "Click box" contracts for software or other computer-related merchandise, or access to websites, are also contracts of adhesion.

Another common kind of form contract is one with numerous blanks on it, which can be filled in with the names of the parties, the monetary terms, dates, etc. These are used commonly for the sale of homes and for leases on real estate. There are two main points to be aware of regarding these forms, which can be purchased at stationery stores:

First, while they may be standardized, there's no such thing as a "standard contract." Many innocuous-looking forms are available in several different versions, each fulfilling the same function - for example, an apartment lease - but each subtly different. One might be a "landlord's" contract, where the preprinted terms are more favorable to the landlord, while a nearly identical one is a "tenant's" contract.

In any event, don't let anyone tell you it's "standard." Insist on crossing out or changing any term you don't like. If the other party refuses to accept changes that are important to you, then don't sign the contract. In today's economy, there is usually more than one source for the product or service you want.

Second, fill in all the blanks! A contract with your original signature but containing blank spaces can be like a blank check if altered unscrupulously. Be sure all blanks are filled, either with specific terms or straight lines to indicate that nothing goes there. And insist on your own copy with the other side's original signature. If it's a computerized "click box" situation, print out a copy of what you're agreeing to. If you can't, at least consider this a red flag.

Third, if the contract involves a significant amount of money to you or your family, take it to a lawyer before you sign. This is especially important in real estate transactions, where there is typically plenty of room to bargain. There is no such thing as a "preliminary" agreement. An "agreement" is just that -- a contract.

PRACTICAL CONTRACTS

Sometimes you look at a form contract, throw up your hands, and decide not to read it. There doesn't seem to be much room to negotiate with a form contract. Believe it or not, it pays to read them. **Failure to read a contract is virtually never a valid legal defense**. In most states the courts have held that people are bound by all the terms in a contract, even if they didn't read the contract before signing it (unless the other party engaged in fraud or

unconscionable conduct). Don't trust the other party to tell you what it means; even with good intentions, he or she could be mistaken.

Also, be suspicious if the salesperson urges you to "never mind, it's not important." (Ask the salesperson, "If it's not important, is it okay to cross out the whole paragraph?") Where a substantial amount of money is at stake, take the time to sit down with the form, and underline parts you do not understand. Then find out what they mean from someone you trust.

At the same time, you have to be realistic about exercising your right to read a form contract. At the car rental counter at the airport, you probably don't have time to read the contract and get an explanation of the terms you don't understand. Even if you did take the time, with whom would you negotiate? The sales clerk almost certainly doesn't have the authority to change the contract. Similarly, while you should know "what you are getting into" when agreeing to the license terms of a commercially sold software program, no negotiation is possible. If you want the program, you have to agree.

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GETTING OUT OF A CONTRACT

A contract may be set aside if competent parties have not made it voluntarily. It also may be set aside if there was grossly insufficient consideration. In addition, certain contracts must be in writing, or they are also unenforceable. Here is a list of other contract defenses discussed in this chapter.

- illegality;

- duress;
- undue influence;
- fraud;
- mistake;
- unconscionability;
- impossibility and impracticability of performance;
- frustration of purpose.

If you can prove any of these, the contract will probably be deemed void or voidable. In either case it is practically as if there never were a contract. If either party paid money, it would have to be returned.

Don't ever rush to sign on the dotted line because you're afraid to lose the bargain of a lifetime. Rarely will a truly great bargain not be there tomorrow. For all the great deals you rush into that work out fine, the one you will remember is the one that went sour -- where they socked you with the fine print you didn't bother to read. A great bargain won't fall into your lap, anyway. It requires a lot of footwork, research, and comparison shopping. If you've done all that, it's unlikely that someone else is right behind you who has done it also.

While working out the terms of a written contract, you may sometimes see or hear reference to a contract **rider**.

A rider is a sheet of paper (or several pages) reflecting an addition or amendment (change) to the main body of a contract.

Often it's simpler to put changes in a rider, which supersedes any contradictory parts of the main contract, than to try to incorporate the changes on the original form.

People are often intimidated by fine print. It's a good idea to get over that, because often the fine print contains terms that could greatly affect your personal finances beyond what the actual deal would lead you to believe. It may contain details about credit terms, your right to sue and your right to a jury in a lawsuit.

You don't need a law degree to at least try to read the fine print. Often if you sit down with it, sentence by sentence, you'll find that you can understand a lot more than you expect, especially in states that have passed "plain English" laws requiring that consumer contracts use non-technical, easy-to-understand words. You will at least, by expending the effort, identify which terms raise questions for you. The trick is not to be intimidated by the salesperson or the fine print in the contract.

BREACH OF CONTRACT

A **material breach of contract** gives rise to a cause of action in court. A material breach is a serious one; it is a breach that goes to the heart of the contract. The injured party can seek damages; that is, a money payment adequate to cover economic losses resulting from the breach of contract. For example, a violinist who shows up at a concert but doesn't bring his violin has materially breached the contract to perform if he cannot play.

An **immaterial breach of contract** is a trivial breach of contract and does not kill the contract. For example, assume a service contract for a heating system under

which the service person agrees to inspect the system each month on Thursday. Contrary to the contract, the service person makes inspections on Mondays. This act is a technical breach of the contract but it is immaterial, unless for some reason the inspections needed to be done on Thursday as opposed to any other day.

READ THE FINE PRINT

Perhaps the most unpleasant part of making contracts comes after negotiating your best deal. It occurs when a salesperson presents you with a form contract, which is often one or two pages of tiny print that you might not understand even if you could read it. But the law usually assumes that you read and, to a reasonable extent, understand any contract you sign.

Once you've divined the meaning of a contract, it's in your hands to decide whether the bargain is one you want to enter into. You never have to accept a contract. Every part of a contract is open for negotiation, at least in theory. Just because the salesperson gave you a form contract doesn't mean that you have to stick to the form. You can cross out parts you don't like. You can write in terms that the contract doesn't include, such as oral promises by a salesperson. (Make sure that all changes to the form appear on all copies that will have your

signature; initial altered but unsigned pages and have the other party do the same.)

That doesn't mean the other side has to agree to your changes. You have no more power to dictate terms than they do. But if you get a lot of resistance on what seem to be reasonable issues, take a hard look at with whom you are dealing -- especially if they resist your request to put oral promises in writing.

Having said all that, there will be times when a contract is just too inscrutable to understand. Legalese most often occurs in contracts that include some type of credit terms, such as when you buy something on installment payments. It's just this kind of legalese that could threaten your property rights in your house or other important property, so it pays to make sure you know what you're signing. The parts of this book on consumer credit and automobiles explain many of these terms. If you still have questions, ask someone you trust (not the salespeople) to explain the terms to you. That could be someone experienced with the kind of contract you are considering, a state or local consumer agency, or a lawyer.

GET IT IN WRITING

When dealing with a written contract, a court will almost always treat the contract's terms as the final, complete contract. The court usually will not even consider oral promises that are not in the contract. The main exception to this is when oral promises are used fraudulently to induce one party into signing the contract in the first place. That is, the party is persuaded by the fraudulent oral promise to enter into a contract he or she otherwise would have avoided. The general rule prohibiting evidence of oral promises in all other cases protects both parties, since they know that once they sign the contract, they have clearly and finally set the terms.

Don't be swayed if the salesperson orally promises you an extended warranty or a full refund if you're not completely satisfied. Get it in

writing. If the sales person refuses to put it in writing, walk away from the deal.

Many states now require plain-English consumer contracts, with potentially confusing sections or clauses in precise, standard terms that nearly anyone can understand. Even if not legally required, more and more merchants are having contracts prepared this way for customer relations. Federal and state truth-in-lending laws require providers (or grantors) of credit to furnish specific information about credit contracts in clearly understandable form.

Finally, the legal doctrine regarding contracts of adhesion may protect you. As mentioned briefly earlier, these are contracts in which you have little or no bargaining power, as often is the case in many of the form contracts discussed above, such as loan documents, insurance contracts, and automobile leases.

The consumer has some protection, however. Courts generally assume that such contracts have been drafted to provide maximum benefit to lender, lessor, or insurance company. So when a dispute arises over terms or language, the courts usually interpret them in the way most favorable to the consumer.

In one case, for example, a woman tried to collect on an airline trip insurance policy she had purchased. The insurance company held that the policy applied only to a trip on a "scheduled airline" and that "technically" under some obscure regulations the woman's flight was not "scheduled," even though she had every reason to believe that it was. The court held in favor of the woman, saying the ordinary insurance buyer's understanding should apply.

There is a further protection for consumers. Even contracts that are not contracts of adhesion are interpreted or construed to favor the party who didn't draft them. Like the doctrines of unconscionability and fraud discussed earlier, this rule isn't something to depend on

prior to signing a contract. Rather it's a defense that you and your lawyer may raise if a problem arises and the situation warrants.

In the last two chapters we've considered how you make a contract, and how certain contract defenses can help you avoid being held to an unfair or illegal contract. These contracts only scratch the surface of the topic of contract law, and don't deal with the millions of transactions between merchants that take place every day, or the more complex subjects in contract law that will require the assistance of a lawyer.

Progress Check

- Name two kinds of contracts of adhesion.
- List four contract defenses that may help disqualify a contract.

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CAN I CANCEL THIS CONTRACT?

GENERAL PRINCIPLE: **You have no right to cancel most contracts!**

Perhaps because so many large retailers voluntarily allow consumers to return merchandise with no questions asked, many consumers assume that they have a right to cancel a contract or to ask a retailer to take back an item and refund the consumer's money.

As a general matter of contract law, consumers do not have a right to cancel a sale of goods or services. In the case of defective, damaged, or undelivered goods, consumers may be able to demand their money back. And those merchants who choose to offer consumers a "money-back guarantee" must live up to their promises. But where the merchant has provided the goods or services that the consumer agreed to buy, the consumer generally may not insist on canceling a transaction after the fact.

If a seller who is not required by law to allow for cancellation of a contract nevertheless does so, any reasonable seller costs may be passed on to the buyer. The contract may call for a certain agreed-upon amount of damages ("liquidated damages") if the buyer cancels. A term fixing unreasonably large liquidated damages is void as a penalty.

There are certain circumstances, however, when consumers do have a legal right to a "cooling-off period." During an applicable cooling-off period, the contract may be cancelled but consumers must carefully follow written instructions that sellers are required to provide at the time the contract is signed.

There are certain circumstances, however, when consumers do have a legal right to a "cooling-off period." During an applicable cooling-off period, the contract may be cancelled but consumers must

carefully follow written instructions that sellers are required to provide at the time the contract is signed.

This Consumer Alert provides an abbreviated summary of four laws that provide consumers a right to cancel a contract. To read the Michigan laws in their entirety, refer to the Attorney General's website under the Consumer Protection Link: www.michigan.gov/ag/0,1607,7-164-17337_18270---,00.html. Other laws not mentioned in this Consumer Alert may also provide a cooling-off period. Promptly consult with your own private attorney to discuss your particular circumstances and determine whether a right to cancel may apply.

OVERVIEW OF CERTAIN LAWS ALLOWING LATER CANCELLATION OF A CONTRACT--

You have **THREE** business days to cancel a contract if:

♦ The sale was solicited in the consumer's home; or

♦ A gift was offered for attending a sales presentation that led to the contract; or

♦ A consumer's primary home is used as security and the loan is not used to purchase or construct the home.

You have **ONE** business day to cancel a contract if:

♦ The contract is for home improvement and the consumer agrees to make payments over time to the contractor.

Because these laws can be tricky, the Attorney General advises consumers who think their situation may be covered to read their contracts thoroughly and, if you have questions whether the law applies, promptly seek legal advice-**BEFORE YOUR CANCELLATION PERIOD EXPIRES.**

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THE THREE-DAY CANCELLATION RULES

1. Three Day Cancellation Rule 1 - The Home Solicitation Sales Act

Michigan's Home Solicitation Sales Act (HSSA) gives consumers who are solicited in their homes three business days to decide whether to cancel a contract. Here are some basic points about the HSSA.

You are protected by Michigan's HSSA when:

♦ The solicitation for the sale was initiated by the seller, through a personal, written, or telephone contact;

♦ The solicitation was received at your home (this includes mail or telephone calls, but not newspaper ads);

♦ Your agreement to purchase (contract) was given to the salesperson at your home, **AND**

♦ The goods or services purchased are worth more than $25.

Emergency situations and the Home Solicitation Sales Act

A buyer may not cancel a home solicitation sale if the buyer requests
the seller to provide goods or services without delay because of an emergency, and all of the following conditions are met:

(a) The seller in good faith makes a substantial beginning of performance of the contract before the buyer gives notice of cancellation.

(b) The buyer furnishes the seller with a separate dated and signed personal statement in the buyer's handwriting describing the

situation
requiring immediate remedy and expressly acknowledging and waiving the right to cancel the sale within 3 business days.

(c) In the case of goods, the goods cannot be returned to the seller in
substantially as good condition as when received by the buyer.

The Federal Trade Commission has a similar provision: **FTC Rule Concerning Cooling-Off Period for Sales Made at Homes or at Certain Other Locations, 16 CFR 429.**

2. Three Day Cancellation Rule 2 - The Gift Promotion Act

Under Michigan's Gift Promotion Act consumers also have three business days to cancel a contract if they have a change of heart when:

♦ The seller offers anything worth $25.00 or more in exchange for attending a sales presentation; and

♦ The buyer purchases goods, services, or memberships whose value equals or exceeds $500.00.

3. Three Day Cancellation Rule 3 - Home Equity Loans (Not for Construction)

Under the Federal Truth in Lending Act, consumers also have a three-day right to change their mind after they enter into:

♦ A loan for personal, household or family purposes; AND

♦ A lien or security interest is placed on the consumer's principal dwelling to secure payment.

If both of these conditions apply and the loan will not be used to purchase or construct a home, then the contract you entered is

probably covered by the Federal Truth in Lending Act. This Act is complex and it is recommended that you consult your own lawyer to discuss your particular circumstances and how to provide notice of cancellation.

WHAT TO DO IF YOUR TRANSACTION IS COVERED BY A CANCELLATION RULE

1. <u>Read your contract thoroughly</u>. Merchants are required to provide written notice in the contract that you have a right to cancel and explain what you must do in order to provide notice of your decision to cancel. If this information is not provided, then the length of time to cancel may be extended.

2. <u>Exercise your right to cancel</u> in the manner required under the law that applies.

a. Under the HSSA or Gift Promotion Act:

•Mail or deliver written notice of your election to cancel within 3 business days from the date that you signed the contract, to the address provided by the seller.
•The seller must return any payment made by the buyer within ten days after cancellation. In a sale that is covered by the HSSA, the seller has twenty days after cancellation to demand return of any goods already delivered. If the seller fails to make a timely demand for the return of goods, they become the property of the buyer, without obligation.

b. Under the Home Improvement Finance Act:

•Send written notice of your election to cancel by certified mail by no later than 5:00 on the next business day after signing the contract, to the address provided by the merchant.

3. <u>If the contract does not tell you of your right to cancel.</u>

•Send certified and regular mail to the seller giving notice that you wish to cancel (be sure to put your return address on the envelope and retain a copy of the notice and proof of mailing.)

Consumers may contact the Attorney General's Consumer Protection Division at:

Consumer Protection Division
P.O. Box 30213
Lansing, MI 48909
517-373-1110
Fax: 517-373-3042

www.michigan.gov/ag

Progress Check

- Under what circumstances can a contract be CANCELLED?
- What specific Michigan law, or act, covers the Three Day Cancellation Rule?

Contracts, Liabilities, & Risk Management

Chapter 5

Insurance Overview

INSURANCE OVERVIEW	WORKERS COMPENSATION	GLOSSARY

Learning Objectives

Gain a basic understanding of the various types of insurance available to builders.

Describe who is and who is not covered by workers compensation.

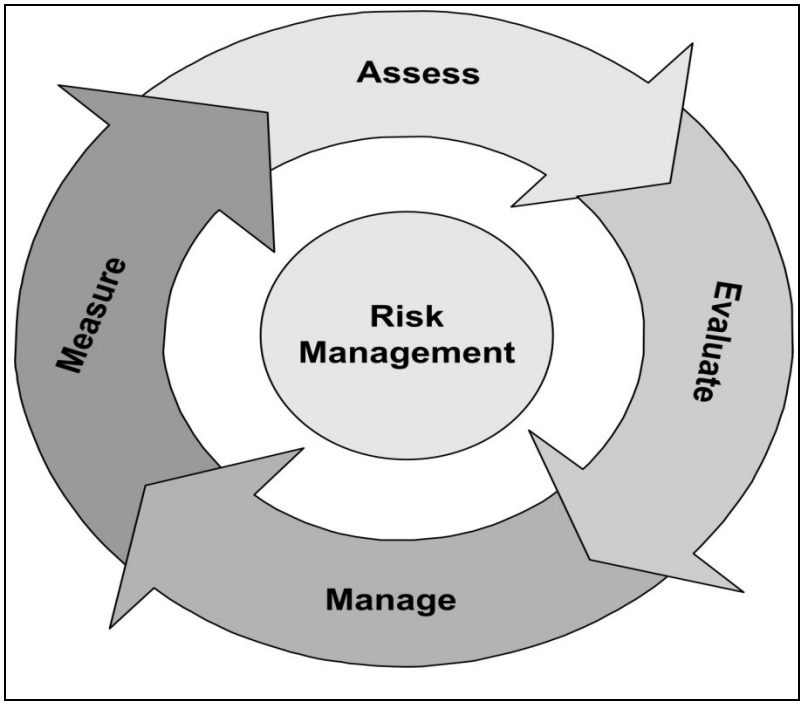
Risk Management

Natural disasters, fire, theft and accidents are all possible factors that should not be ignored. As contractors, we should manage these risks by purchasing insurance to help protect our business from possible disasters.

A. **Assessing Risk** - consider the job or project to assess any risk involved.

B. **Identify Risk** - pinpoint severity and frequency of the losses that could occur from each identified risk.

C. **Determine Measure of Protection** - consider contractual agreements that may eliminate or reduce risk. Determine which insurance or bonding plans will best protect the project.



Insurance

Insurance is a protective measure that reduces the contractor's losses due to exposure to risk (Financial Safety Net).

Typical construction contracts place total liability on the contractor in a number of important areas:

A. Contractor-caused delays to the project (liquidated damages)

B. Substandard work

C. Contractor-caused added work

D. Project accidents

Builders Risk Insurance

This is also known as **property damage insurance**. This type of insurance protects the construction project or project materials. It does not cover workmanship or design defects. You will not be able to borrow money from a lender for construction projects without a Builders Risk insurance policy. This type of insurance does not cover workmanship or design defects. It provides property coverage for a building during the course of construction.

Here are a few practical tips to follow when purchasing a **builders risk insurance** policy

- Make sure your insurance broker or agent is familiar with this type of coverage. This is considered a specialty coverage and has details that an inexperienced broker may not recognize.
- Make sure the agent has the most recent cost estimates when preparing the policy. If the project costs increase, make sure your agent is informed.
- Have detailed information available on the project contractor or subcontractor and any losses they may have in their work history.

- Give the agent a copy of the building contract to review. They are familiar with insurance-related terms and will be able to make sure all terms are covered. They will be able to tell the contract holders if they are liable for any items that are not covered under the insurance policy.
- Have the various beginning and end dates available for your agent. There are some portions of the project that may hold more risk than others. Also you will want the policy to end when the project ends.
- Be sure to make your agent aware of all the construction safety features that are incorporated into the project. This may help keep the premiums as low as possible by applying the appropriate credits for safety. These items may include such things as fencing around the project or materials being locked up at night.

Even though most builders risk policies only cover hard costs, which are the building and materials during the course of construction, it would still be a good idea to ask if any soft costs are covered. Soft costs are expenses that are not directly related to building the structure, such as legal, architectural and accountant fees or interest and penalties.

Property Insurance on Contractor's Property

This type of insurance covers the company office, buildings, storage facilities, grounds and personal property. It also generally covers property under the care of the contractor.

Public Liability Insurance

This insurance will protect the contractor against claims brought by third parties who are not employed by the contractor. This type of policy does not cover a contractor for their own losses; only losses suffered by others that may have been caused by the contractor, their employees or subcontractors. This includes any damage to their property.

One aspect of coverage included in most Public Liability policies that can be most useful in our era of litigation is reimbursement for money paid as legal charges for defending against damage claims. Even if a court does not award any damages, you may still need to pay extensive legal fees.

Comprehensive General Liability

This is coverage against all liability exposures of a business *unless specifically excluded.* Coverage includes products, completed operations, premises and operations, elevators, and independent contractors.

Products coverage insures when a liability suit is brought against the manufacturer and/or distributor of a product because of someone incurring bodily injury or property damage through use of the product. (The manufacturer of the product must use all reasonable means to make certain that the product is free from any inherent defect.)

Completed operations coverage for bodily injury or property damage incurred because of a defect in a completed project of the insured.

Premises and operations coverage for bodily injury incurred on the premises of the insured, and/or as the result of the insured's business operations.

Elevator coverage for bodily injury incurred in an elevator or escalator on the insured's premises.

Independent contractor coverage for bodily injury incurred as

the result of negligent acts and omissions of an independent contractor employed by the insured.

Professional Liability

This type of liability policy protects the contractor from liability arising from error or neglect in performance of their duties. It is sometimes referred to as Errors and Omissions. Professional Liability insurance provides protection against claims that the policyholder becomes legally obligated to pay as a result of an error or omission in his professional work.

Liability Insurance on Employees

This type of liability insurance provides coverage over and above Worker's Compensation Insurance in case of injury or death of an employee.

Contract Surety Bond

This is an agreement with a surety company making the surety company financially liable to the customer for non-performance of the contractors. The surety agreement may perform the following:

A. May finance the contractor until job completion

B. Employ another contractor

C. Pay outstanding debts

D. Allow the owner to finish project

Essentially, a surety bond is a written agreement where one party

(the surety) obligates itself to a second party (the oblige) to answer for the default of a third party (the principal).

Contract Surety Bonds provide financial security and construction assurance on building and construction projects by assuring the project owner (obligee) that the contractor (principal) is qualified to perform the work and will pay certain subcontractors, laborers, and material suppliers.

A Contract Surety Bond general includes the following five types of bonds:

bid bonds -- provides financial assurance that the bid has been submitted in good faith, and that the contractor intends to enter into the contract at the price bid and provide the required performance and payment bonds.

performance bonds -- protects the owner from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions. This is sometimes known as a Completion Bond.

payment bonds -- guarantees that the contractor will pay certain subcontractors, laborers, and material suppliers associated with the project.

maintenance bonds -- normally guarantees against defective workmanship or materials for a specified period.

subdivision bonds -- guarantees to a city, county, or state that the principal will finance and construct certain improvements such as street, sidewalks, curbs, gutters, sewer, and drainage system.

Surety bonds are issued through surety bond producers, also known as agents and brokers, who are knowledgeable about the surety and construction industries. Surety bond producers usually work in agencies that specialize in surety bonds or in insurance agencies that have a sub-specialty in surety bonds.

The professional surety bond producer usually maintains a business relationship with several surety companies, which enables the producer to match a contractor with an appropriate surety company. A good surety company and surety bond producer will help a contractor maintain and increase its surety capacity.

Progress Check

- List the five types of bonds included in Contract Surety Bonds.
- What type of insurance protects the construction project and materials

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Workers' Compensation Insurance

1. What is Workers' Compensation?

a. This is the State's system used to provide wage replacement, medical, and rehabilitation benefits to employees who are injured while at work.

2. Who must provide Workers' Compensation Insurance coverage?

a. All private employers who regularly employ one or more employees, 35 hours or more per week for 13 weeks or longer during the preceding 52 weeks.

b. All private employers who have three or more employees at any one time and this includes part time employees.

3. Where do you purchase Workers' Compensation Insurance and what does it cost?

a. Workers' Compensation Insurance is purchased from a licensed and approved insurance carrier.

b. Purchase a policy through the assigned risk pool.

c. Secure coverage through a self-insured group fund.

d. Receive authorization from the Bureau of Workers' Disability Compensation to be self insured.

e. Rates are determined by the type of work each employee does and the number of employees in each classification.

4. Who may be excluded from the Workers' Compensation Fund?

By securing a copy of the "exclusion form" (BWC 337) that the subcontractor or employees of the businesses listed below have filed with the Bureau of Workers' Disability compensation, the contractor can protect himself from the responsibility of having to provide workers' compensation insurance.

a. Sole Proprietorships, because the owner is self-employed.

b. Family members of a sole proprietorship may be excluded.

c. Partners of a Partnership if they are the only employees.

d. Stock Corporations, if all employees are stock holders who own 10% or more of the stock.

e. Employees of a Limited Liability Company who have chosen to exclude themselves from coverage under the workers' compensation statute.

5. Who is an Independent Contractor?

If one company hires another company to come in and do some work, the second company is ordinarily an "independent contractor", and not an employee of the first company. Sometimes however, a company hires one person to come in and perform a specific job and disputes arise as to whether or not that person is an employee or an individual contractor. The law states that if the worker does not maintain a separate business, or render services to the public, does not employ other workers, then the worker will be considered an employee.

6. Questions used to determine classification.

a. Does the person work solely for your organization?

b. Can the worker set their own hours and leave when the job is done?

c. Does the worker provide his own tools, equipment and supplies?

d. Can the worker demonstrate that they are in their own business?

e. Does the person invoice the company for payment?

f. Can the person bring in additional help if required?

g. Does the person receive training from the employer?

7. Is it appropriate to require a certificate of Workers' Compensation Insurance from a subcontractor?

a. It is not only appropriate, but it is prudent to ask for certificates of insurance from subcontractors to be sent to you from their insurance carriers. If the policy is cancelled or paid by the subcontractor, the insurance carrier must notify you immediately. If the subcontractor has cancelled his insurance, the contractor will be responsible for any claims.

b. For subcontractors who have no employees, you can obtain the following in place of the policy as proof that he is an independent contractor and not required to have a policy: 1) Federal Identification Number (FIN) of the sole proprietorship, 2) a copy of the written contract between the subcontractor and the general contractor, 3) a certified copy of the sole proprietorship's DBA, and 4) an advertisement that shows the sole proprietorship is available to work for others.

Workers' Compensation Insurance provides benefits to employees who have injuries or illnesses caused or made worse by their work or workplace. **Benefits include:**

a. Partial wage replacement

b. Payment for loss of use or function

c. Medical treatment

d. Vocational rehabilitation

e. Dependent benefits

8. If I am collecting Worker's Comp and am offered a job that I am able to do, do I have to accept it?

If an employee receives a bonified offer of reasonable employment and the employee refuses that employment without good and reasonable cause, the employee shall be considered to have voluntarily removed themselves from the workforce and is no longer entitled to Workman's Compensation benefits.

9. If I am injured on the job and am no longer able to do the work and get paid the same, do I have to take a lesser job with lesser pay?

Yes, you may have to take a pay cut, however, Workman's Compensation may make up the difference to where you would be making at least 80% of your previous pay rate.

10. What is meant by reasonable employment?

The law reads: Work that is within the employee's capacity to perform that poses no clear and proximate threat to that employee's health and safety and that is within a reasonable distance from the employee's residence. The employee's capacity to perform shall not be limited to jobs in work suitable to his or her qualification and training.

Injury or Illness Classifications

TTD - Temporary Total Disability. Employee is entitled to 2/3 of gross weekly wage at the time of injury or illness. Maximum and minimums may apply.

TPD - Temporary Partial Disability. Employee is entitled to 2/3 of the difference in current gross weekly wage and pre-injury gross weekly wage.

PPD - Permanent Partial Disability. Employee is compensated for permanent loss or damage to a body part. This is paid after TTD at the same rate and intervals.

PTD - Permanent Total Disability. Employee is compensated for significant listed injury or significant impact on ability to return to work.

DEATH - Dependent receives compensation for death of an employee.

Progress Check

- Why is it important to ask for proof of workman's compensation insurance from a subcontractor?
- List five benefits included in workman's compensation.

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Glossary of Insurance Terms

Here are a few terms taken from the *Michigan State Housing Development Authority (HSHDA) Glossary of Insurance Terms* that you should be familiar with when investigating which insurance policy fits your specific business needs.

Additional Insured: An individual or entity that is not automatically included as an Insured under the policy of another,

but for whom the named insured's policy provides a certain degree of protection.

Agreed Amount Endorsement: A property insurance provision that effectively does away with the coinsurance clause, thereby eliminating a coinsurance penalty should a claim arise.

All Risk Form: Property insurance form that provides coverage for losses arising from any fortuitous cause except those that are specifically excluded. This is in contract to named perils coverage which applies only to losses arising out of causes that are specifically listed as covered.

A.M. Best's Rating: A widely accepted rating system developed and published annually by A.M. Best Company. This rating system provides indications of the financial condition of insurance companies.

Blanket Limit Policy: A single limit of insurance that applies over more than one location or more than one type of coverage of both. In the case of a Blanket Property Policy, it typically adds up all of the location limits and provides the total limit of coverage as the Blanket Limit.

Builders Risk: Indemnifies for loss of or damage to a building under construction. This insurance is normally written for a specified amount on the building and applies only in the course of construction.

CGL - Commercial General Liability: A broad form of liability insurance usually covering business organizations to protect them against liability claims for bodily injury and property damage to others, arising out of the insured's operations, products and completed operations, and independent contractors, but excluding coverage for liability arising out of the use of automobiles.

Certificate of Insurance: A document providing evidence that certain general types of insurance coverage and limits have been purchased by the party required to furnish the certificate.

Co-insurance: A property insurance provision that penalizes the insured for not purchasing a limit of insurance at least equal to a specified percentage (commonly 80%) of the value of the insured property. Affects loss recovery only in the event of a partial loss.

Combined Single Limit: A liability insurance term providing one limit that is combined to cover both bodily injury and property damage. (E.g., auto insurance can provide one limit for bodily injury claims and a separate limit for property damage claims to others. A CSL is one limit that applies to both.)

Completed Value: A term used in relation to Builders Risk coverage which means you have provided the total amount of the property value upon completion of construction.

Demolition & Increased Cost of Construction (D&ICC): Coverage available by endorsement to a property policy which provides coverage for the cost to demolish a building that had an insured loss and also pays for any increased costs to rebuild as a result of now having to meet new property/building codes.

Endorsement: A form used to change the standard coverage of a policy. An endorsement to a policy can add coverage or it can reduce coverage.

Extra Expense: Coverage for expenses in excess of normal operating expenses that are incurred to continue operations after a direct damage loss.

Fidelity & Crime Coverage: Sometimes termed Employee Dishonesty Coverage, provides coverage for employee theft of money, securities, or property.

Following Form: When an umbrella policy provision follows the underlying policy as to how the coverage provisions apply.

General Aggregate Limit: The maximum limit of insurance payable during any given annual policy term by an insurer on behalf

of the insured for all losses other than those arising from the products and completed operations hazard which has its own limit.

Hard Costs: The material and labor costs of constructing a building. This does not include costs such as architect fees, legal fees, filing fees, interest and penalties, lost income if construction delayed

Hostile Fire: A fire that is not intentionally kindled or an intentionally kindled fire that does not remain within its intended confines, such as a fireplace or furnace. For the purpose of this manual, this term relates to liability coverage. Some liability policies have included smoke (from a hostile fire) as a pollutant and, therefore, smoke inhalation claims were excluded. These guidelines require that the liability policies include coverage for any claims arising from smoke from a hostile fire. The typical pollution exclusion on the liability policy must be worded in such a way as to include such claims as insured.

Insured: The individual or entity purchasing the insurance, named on the policy, is the Insured.

Loss Payee: A person or entity, other than the named insured on a property policy, having an insurable interest in the property covered is a loss payee and should be named on any property loss claims payments because they are a loss payee.

Occurrence Form: In the industry standard commercial general liability policy, the form is written to insure liability for bodily injury or property damage that is caused by an occurrence.

Ordinance or Law Coverage: Sometimes referred to as Building Ordinance Coverage (Demolition, Increased Cost of Construction, Contingent Liability from Operation of Building Laws Coverage) - This coverage is added to a property policy by way of an Endorsement. When a community has a building ordinance(s) that states when a building is damaged to a specified extent (i.e., more than 50% of building is damaged), it must be completely demolished and rebuilt in accordance with current building codes

rather than repaired. Unendorsed, standard property policies do not cover the loss of the undamaged portion of the building, the cost of demolishing that undamaged portion of the building or the increased cost of rebuilding the entire structure in accordance with the current building codes. Some insurers use three separate endorsements to add this coverage: (1) demolition, usually subject to a separate limit; (2) increased cost of construction, may be subject to a separate limit; and (3) contingent liability from operation of building laws, normally subject to the building limit. Others use one single endorsement such as the ISO Ordinance or Law Endorsement.

Property Insurance: First party insurance for Real and/or Personal Property.

Replacement Cost Coverage: A property insurance provision that changes the valuation of covered property from actual cash value (ACV) to replacement cost value: the cost to replace it today with property of like kind and quality without deduction for depreciation.

Reporting Form: Property form that allows insured to report values on a periodic schedule (e.g., monthly or quarterly reports of actual property values). The insured is penalized for late or inaccurate reports and lose coverage when filing a claim if reporting requirements have not been maintained and accurate.

Soft Costs: The costs related to a construction project that are not the material and labor costs. To obtain soft costs coverage under a builders risk policy form, you must report the soft costs values which could include costs such as architect fees, legal fees, filing fees, interest and penalties, potential loss or rents if construction delayed, etc.

Special Form: This is a property coverage term which means the policy is an All Risk policy providing coverage for losses from all causes that are not specifically excluded. The other forms are more restrictive and only provide coverage for specific named perils.

Umbrella Liability Policy: A policy designed to provide protection against catastrophic losses. It is generally written over various primary liability policies such as CGL, auto, employers' liability. The umbrella policy serves three purposes: It provides excess per occurrence limits when the per occurrence limits of the underlying liability policies are exhausted by payment of claims; it drops down and picks up where the underlying policy leaves off when the aggregate limit of underlying policy in question is exhausted by payment of claims; and it provides protection against some claims not covered by the underlying policies.

Umbrella Policy - Following Form: When an umbrella policy provision follows the underlying policy terms as to how the coverage provisions will apply.