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Top Ten Commercial General Liability Considerations for the Construction Lawyer

By Carrie L. Berger and Terry J. Galganski



Whether you are advising a construction client regarding the type of coverage that is needed before commencing a project or representing a client who is seeking coverage after experiencing a loss, you will undoubtedly encounter issues involving the nature and scope of coverage afforded by its commercial general liability (CGL) policy. Although there will likely be some minor differences from insurer to insurer, most insurers use one of the editions of the CGL policy forms of the Insurance Service Offices¹ (ISO) as their starting point in developing their standard CGL policy. Therefore, this article uses ISO's current, occurrence CGL policy form as the backdrop for its discussion: CG 00 01 12 07 (ISO CGL Policy). Presented herein are the top

ten CGL considerations of which a construction attorney should have a fundamental understanding when either advising a client as to the type of coverage to purchase or evaluating coverage for a client who has experienced a loss. *Read more...*

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Top Ten Commercial General Liability Considerations for the Construction Lawyer

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ten CGL considerations of which a construction attorney should have a fundamental understanding when either advising a client as to the type of coverage to purchase or evaluating coverage for a client who has experienced a loss.

No. 1 – Exclusions

Although there are different types of coverage afforded under the ISO CGL Policy (including Coverage B, Advertising Injury and Coverage C, Medical Payments), the type of coverage that is most relevant for the business of construction clients is Coverage A, Bodily Injury and Property Damage Liability. Coverage A applies to "bodily injury" or "property damage" caused by an "occurrence" that takes place in the "coverage territory."²

When determining the type of coverage that is necessary for the construction client, it is important to understand that the ISO CGL Policy does not apply to, or cover, every type of loss. In fact, ISO CGL Policy, Section I, Coverage A, Paragraph 2(a) through 2(q), which is entitled "Exclusions", identifies the various types of losses that are excluded from coverage.³ Moreover, it is these very exclusions that really define

what coverage is afforded under this coverage part. The following are some of the exclusions from coverage for “bodily injury” and “property damage” that construction clients frequently encounter:

- Contractual Liability
- Damage to Your Product
- Damage to Your Work
- Damage to Property
- Pollution⁴

Some of these exclusions will be discussed in more detail, below. Thorough understanding of these exclusions is critical to determining whether the client’s insurance program is adequate. Furthermore, many of the exclusions set forth in the ISO CGL Policy contain specific exceptions, which provide that there *is* coverage *if the exception to the exclusion applies*. For instance, Section I, Coverage A, Paragraph 2(l) provides, in relevant part, that “property damage” to “your work” is excluded. However, Paragraph 2(l) further provides that:

This exclusion *does not apply* if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor (emphasis supplied).⁵

Therefore, it is important that not only the exclusions be analyzed but also any of their exceptions in determining whether the ISO CGL Policy affords coverage for a particular loss.

No. 2 – Occurrence

The ISO CGL Policy can either be a claims made or an occurrence form policy. The latter is generally preferable to an insured since it is triggered by an “occurrence” that takes place in the “coverage territory” during the policy period.⁶ It is not triggered by a claim being made. The ISO CGL Policy defines an occurrence as:

[A]n accident, including continuous or repeated exposure to substantially the same general harmful conditions.⁷

The “occurrence” can be either a single accident, or a continuous or repeated exposure to substantially the same harmful conditions. In the absence of an “occurrence,” there is no coverage under the ISO CGL policy. In other words, a claim for defective work that is not considered an “occurrence” is usually deemed insufficient to trigger coverage.⁸ However, where there is a determination by a court that an “occurrence” has taken place following completion of the work, courts are more likely to find coverage for defective work provided there is also “property damage.”⁹ Therefore, in determining whether the construction client’s insurance program is sufficient or in analyzing a loss to assist the client in seeking coverage, it is important to understand that the CGL coverage will only apply to an “occurrence” during the period of coverage.

No. 3 – Additional Insured

Prior to July 2004, ISO promulgated revision after revision of its several forms of endorsements identifying who is an “additional insured” in an attempt to narrow coverage.¹⁰ Moreover, many insurers manuscript their own additional insured endorsements, mostly to narrow the coverage afforded to each additional insured even further. The “additional insured” endorsements contain schedules wherein the

“additional insured(s)” are named and identified. It is important that these schedules be reviewed to determine whether the construction client (owner, contractor, subcontractor, consultant, etc.) qualifies as an “additional insured” under the ISO CGL Policy.

Whether you are reviewing an “additional insured” endorsement for a construction client who is purchasing this coverage for others or determining whether a client is covered as an “additional insured,” the most important point to keep in mind is the nature and scope of coverage that the “additional insured” endorsement affords. Therefore, when evaluating the various form or manuscript endorsements, they must be analyzed from a standpoint of coverage. For instance, some of the form “additional insured” endorsements make clear that the “additional insured” is covered for certain damages “caused, in whole or in part, by [the named insured’s] acts or omissions or the acts or omissions of those acting on [the named insured’s] behalf in the performance of ongoing operations for the additional insured(s) . . .”¹¹ There are also additional exclusions that may apply to the “additional insured,” which can be found in the endorsements. These exclusions further limit the scope of coverage.

When evaluating the “additional insured” endorsements, it is also important to keep in mind the intersection between additional insured coverage and the anti-indemnity statute of the particular state whose law applies to the policy. Certain states, including Colorado, have mandated that certain “additional insured” coverage violates their anti-indemnity statute.¹²

No. 4 – Contractual Liability

Of particular importance in the construction context is the contractual liability exclusion; more specifically, the salient feature is one of its exceptions. The contractual liability exclusion excludes from coverage “bodily injury” or “property damage” for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement.¹³ But, the exclusion contains two exceptions: it does not apply to liability for damages that the insured would have in the absence of a contract or agreement or if the indemnity is an “insured contract.”¹⁴

Therefore, the construction contract or subcontract indemnity should be reviewed in connection with the latter exception and subparagraph f of the definition of “insured contract”, which, together, establish the contractual liability coverage of the ISO CGL Policy. In addition, an insurer may seek by endorsement to eliminate this coverage completely or exclude any coverage for a broad indemnity.¹⁵ The construction client and insurance broker need to be vigilant so neither endorsement is added to its CGL policy.

No. 5 – Products Completed Operations Hazard

In the ISO CGL Policy, the term “products completed operations hazard” appears several times. The term, which relates to whether the construction client is covered for a particular loss after the job is complete, is defined, in relevant part, as:

- a. Includes all ‘bodily injury’ and ‘property damage’ occurring away from the premises you own or rent and arising out of ‘your product’ or ‘your work’ except:

1. Products that are still in your physical possession; or
2. Work that has not yet been completed or abandoned. However “your work” will be deemed completed at the earliest of the following times:
 - a. When all of the work called for in your contract has been completed.
 - b. When all of the work to be done at the job site has been completed if your contract calls for work at more than one job site.
 - c. When that part of the work done at a job site has been put to its intended use by any person or organization other than another contractor or subcontractor working on the same project. . . ¹⁶

If the work has been completed at the job site and an “occurrence” arises during the policy period, there may be a question as to whether there is coverage for any loss that occurs subsequent to completed operations.

For that reason, the concept of “products completed operations hazard” is incorporated into some of the exclusions. For instance, the ISO CGL Policy contains an exclusion for “damage to ‘your work’ arising out of it or any part of it and included in the ‘products completions operations hazard.’”¹⁷ But, it has an important exception that brings back significant coverage for “damaged work or the work out of which the damage arises was performed on [the named insured’s] behalf by a subcontractor.”¹⁸ In other words, this exception provides coverage for “property damage” to the named insured’s work following project completion in at least the following circumstances:

- “Property damage” to the named insured’s work caused by one of its subcontractors.
- “Property damage” to its subcontractor’s work caused by another subcontractor.

Therefore, in those states that hold that defective work is an “occurrence”, the above exception to the ISO CGL Policy’s damage to your work exclusion may very well provide coverage if the damage is “property damage”.

No. 6 – Professional Liability Exclusion

The ISO CGL Policy does *not* exclude professional services from coverage. In fact, the only “built-in” elimination of professional liability coverage is found in the definition of an “insured contract.”¹⁹ It provides that an insured’s intermediate or broad indemnities do not protect an architect, engineer or surveyor as indemnitees from injuries or damages arising from each plying their trade or apply when the insured is an architect, engineer or surveyor.²⁰ But, insurers will generally include an absolute professional liability exclusion for its insureds that are involved in the construction industry to eliminate this coverage. Besides this exclusion, ISO provides the following three options, with the latter two trying to address where coverage for construction means and methods ends:

- ISO’s Engineers, Architects or Surveyors Professional Liability endorsement (CG 22 43)²¹
- ISO’s Exclusion – Contractors – Professional Liability endorsement (CG 22 79)²²

- ISO's Limited Exclusion – Contractors – Professional Liability endorsement (CG 22 80)

The CG 22 43 endorsement will generally be added to the CGL policy of an architect, engineer or surveyor while the other two endorsements are used for construction contractors. Of these latter two endorsements, CG 22 80 provides the broadest coverage to a construction contractor since it retains protection for its professional services if those services are “in connection with construction work performed by [the contractor] or on [its] behalf.” With this said, the crucial issue becomes whether an insurer will provide this endorsement to its contractor insureds.

No. 7 – Waiver of Recovery Rights

Like many policies²³, the ISO CGL Policy includes a provision that allows an insured to waive its recovery rights against another provided it is done *prior* to a loss. This provision is found under Section IV – Commercial General Liability Conditions:

8. Transfer Of Rights Of Recovery Against Others To Us

If the insured has rights to recover all or part of any payment we have made under this Coverage Part, those rights are transferred to us. The insured must do nothing *after* loss to impair them. At our request, the insured will bring “suit” or transfer those rights to us and help us enforce them. (*Emphasis supplied.*)

Therefore, a party that seeks or agrees to any kind of waiver of recovery rights, broadly or otherwise written, in its contract may do so as long as the agreement is entered into before any insurable loss occurs.

No. 8 – Covered Damages and Defense Outside of Limits

The damages covered by the ISO CGL Policy are not as broadly defined as those damages covered under a standard professional liability policy. Coverage is limited to the following damages:

- Bodily injury²⁴ (found under Coverage A)
- Property damage²⁵ (found under Coverage A)
- Personal and advertising injury²⁶ (found under Coverage B)
- Medical Payments²⁷ (found under Coverage C)

As a result, the ISO CGL Policy does not cover delay damages, diminution in value of affected property or other economic losses.

Unlike a professional liability policy, an insurer's defense is generally outside of the policy limits of the ISO CGL Policy. Therefore, the limits are not reduced by any costs incurred by the insurer to defend a particular accident.²⁸

No. 9 – Primary Coverage

Unless one of several exceptions applies, the ISO CGL Policy will pay first on a covered claim. Hence, it is considered primary. The most significant exception is where a named insured “has been added as an additional insured by attachment of an endorsement [to another's primary CGL policy].”²⁹ In these situations and subject to the horizontal exhaustion rule,³⁰ the ISO CGL Policy becomes excess to this other CGL policy where any of the its named insureds have been listed as an additional insured.

No. 10 – Joint Ventures

Unless the policy terms are modified or the joint venture is listed in the policy's declarations, the ISO CGL Policy does not cover current or past joint ventures of any insured, including the named insured. Specifically, the last sentence of Section II—Who is an Insured has the following prohibition:

No person or organization is an insured with respect to the conduct of any current or past partnership, joint venture or limited liability company that is not shown as a Named Insured in the Declarations.

As a result, parties to a joint venture must decide how they wish to provide coverage to the joint venture, mindful of its most legally significant characteristic – joint and several liability. Subject to policy wording considerations, a party's options include:

- Purchase separate CGL coverage for the joint venture if the exposure or the joint venture assets is sufficiently large or unique;³¹
- Add the joint venture under one or more of the partner's liability insurance program in its policy declarations by naming each joint venture or employing some "omnibus" policy language for all joint ventures that the named insured is a partner;
- Include an indemnity provision in the joint venture agreement, with contractual liability coverage under the CGL policy to support it; provided, however, the above prohibition has been removed from the policy.

Conclusion

Appreciating these top ten considerations will help any construction client, its construction attorney and its insurance broker to determine the appropriate structure of the client's CGL coverage under its corporate insurance program and its standard subcontract insurance requirements, and to assess their negotiation position under any negotiable, client contract insurance requirements. Moreover, any corporate risk management philosophy can be more effectively supported with a complete understanding of these considerations in tow. They will also assist the construction client and its construction litigation attorney in obtaining coverage if losses are experienced on a project. Without understanding them, the construction client may find itself needlessly adrift.

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Notes

1. Since 1971, ISO has provided advisory services to more than 1,500 participating insurers and agents, including underwriting, actuarial and statistical information for

and about the property and casualty insurance industry. Its products and services are provided to its participating insurers on an advisory basis. Thus, these insurers can elect to modify, use or reject ISO's forms as each may wish.

2. ISO, CG 00 01 12 07, Section I, Coverage A, Par. (1)(b).
3. ISO, CG 00 01 12 07, Section I, Coverage A, Par. 2.
4. *Id.*
5. ISO CG 00 01 12 07, Section I, Par. 2(l).
6. ISO CG 00 01 12 07, Section I, Par. 1(b)(2)
7. ISO CG 00 01 12 07 Section V, Par 13.
8. As of January 2009, 8 states support this position (e.g. *Essex Ins. Co. v. Holder*, 261 S.W.3d 456 (Ark. 2007), *Kvaerner v. Commercial Union*, 908 A.2d 888 (2006)). This information is courtesy of the law firm of Boyle & Gentile, P.A., Fort Meyers, Florida.
9. As of January 2009, 24 states support this position (e.g. *Auto Owners v. Newman*, 2008 S.C. LEXIS 74 (S.C. Mar. 10, 2008), *Lamar Homes v. Mid-Continent*, 2007 WL 2459193 (Tx. 2007), *U.S. Fire Ins. Co. v. J.S.U.B., Inc.*, 2007 Fla. LEXIS 2394 (Fla. Dec. 20, 2007)). This information is also courtesy of the law firm of Boyle & Gentile, P.A., Fort Meyers, Florida.
10. ISO's current additional insured endorsements consist of ISO CG 20 37 07 04; ISO CG 20 10 07 04; ISO CG 20 07 07 98; ISO CG 20 26 07 04; ISO CG 20 32 07 98.
11. ISO CG 20 10 07 04.
12. See the following anti-indemnity statutes that also restrict the breadth of additional insured coverage: Colo. Rev. Stat. § 13-21-111.5(6), Kan. Stat. Ann. § 16-121 and M.C.A. § 28-2-2111.
13. ISO CG 00 01 12 07, Section I, Par. 2(b).
14. ISO CG 00 01 12 07, Section V, Par. 9, specifically, for this discussion, subparagraph f.
15. ISO CG 21 39 10 93 and ISO CG 24 26 07 04 respectively.
16. ISO CG 00 01 12 07, Section V, Par. 16.
17. ISO CG 00 01 12 07, Section I, Par. 2(l).
18. *Id.*
19. ISO CG 00 01 12 07, Section V, Par. 9 f.
20. ISO CG 00 01 12 07, Section V. Par. 9 f(2) and (3).
21. In 1996, ISO clarified its manual rules for this endorsement to affirm that it is to be only used for design professionals following the demands by the construction and insurance industries to make such changes after the case of *Harbor Insurance Company v. Omni Construction Co.*, 912 F.2d 1520 (DC Cir. 1990), which held that CG 22 43 eliminated CGL coverage to a construction subcontractor who had incorrectly performed shoring activities that resulted in significant damages. Furthermore, ISO also responded to these demands by drafting two, new separate professional liability endorsements for contractors: CG 22 79 and CG 22 80.
22. CG 22 79 excludes coverage for certain professional services described in the endorsement. But, it subsequently provides that “[p]rofessional services do not include services within the *construction means, methods, techniques, sequences and procedures employed by [the insured] in connection with [the insured's] operations in [its] capacity as a construction contractor.*” (Emphasis supplied.) This exception raises several significant concerns: the terms, “construction means, methods, techniques, sequences and procedures” are not defined and the exception only applies to operations performed by the insured, not any of its

subcontractors. Therefore, the *Harbor Insurance Company* holding could occur again under similar circumstances.

23. For example, NCCI's standard workers compensation/employer's liability policy form, ISO's business automobile policy form (CA 00 01) and CNA's professional liability and pollution incident liability policy form (GSL 2200, Ed. 10/05) have similar provisions that allow an insured to waive its recovery rights so long as it is done before an insurable loss occurs.

24. ISO CG 00 01 12 07, Section V, Par. 3 defines "bodily injury" to mean "bodily injury, sickness or disease sustained by a person, including death resulting from any of these at any time".

25. ISO CG 00 01 12 07, Section V, Par. 17 defines "property damage" to consist of "a. Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of physical injury that caused it; or b. Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the 'occurrence' that caused it". It goes on to provide that electronic data, which is defined under this definition, is not tangible property.

26. ISO CG 01 12 07, Section V, Par. 14 defines "personal and advertising injury" to mean "injury, including consequential "bodily injury", arising out of one or more of the following [7] offenses: a. False arrest, detention or imprisonment; b. Malicious prosecution; c. The wrongful eviction from, wrongful entry into, or invasion of the right of private occupancy of ... premises . . . ; d. . . . slander[] or libel[] . . . ; e. oral or written publication, in any manner, of material that violates a person's right of privacy; f. The use of another's advertising idea in your "advertisement" or g. Infringing upon another's copyright, trade dress or slogan in your "advertisement".

27. ISO CG 00 01 12 07, Section I, Coverage C. Subject to certain restrictions, this coverage provides for the payment of certain medical expenses for "bodily injury" regardless of fault.

28. ISO CG 00 01 12 07, Section I, Coverage A and Coverage B and Section III.

29. ISO CG 00 01 12 07, Section IV, Par. 4. b.(1)(b).

30. A majority of the states follow this rule. It provides that all relevant primary CGL insurance policies of an insured, including those policies where its status is as an additional insured, must be exhausted before any of the relevant excess or umbrella policies must pay for an insurable loss (e.g. *Kajima Construction Services, Inc. v. St. Paul Fire & Marine Ins. Co.*, 368 Ill.App.3d 665, 669, 856 N.E.2d 452, 456 (1st Dist. 2006), citing *Illinois Emcasco Ins. Co. v. Continental Cas. Co.*, 139 Ill.App.3d 130, 487 N.E.2d 110 (1st Dist 1985)).

31. ISO CG 00 01 12 07, Section II, Par. 1.b.: The partners who make up a joint venture would also be covered under the policy.

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MESSAGE FROM THE CHAIR-ELECT

Boxcars

By [James S. Schenck, IV, Conner Gwyn Schenck PLLC](#)



What is the significance of the number 12 to us in the Forum? Of course it is the number of months in the Gregorian calendar, based on the twelve month Julian calendar. In my new role, I have been reminded that if nothing else the Forum looks far ahead on the calendar. Important, but mundane, I suppose, unless you are the one who has to find meeting dates in 2013.

The same goes for the twelve hour clock. There must have been a point to making a twelve hour clock. Was it earthly rotation? Longitude: brilliant, but not peculiarly important to the Forum. Except of course we are a national organization, so we are constantly trying to figure out which time zone is hosting a conference call.

For those who are still young, twelve is grade school, unless you count kindergarten, pre-kindergarten, and the post-graduate prep school year for athletes. Who knows why we grade school from 1-12, but it is entrenched now, and we do not dare try to change it. Well, actually, those who are still young, our Forum Young Lawyers Section, tried to introduce the number 13 into the Forum. That was bold.

Speaking of changing things, have you noticed how difficult it has been to change our adherence to old English weights and measures based on twelve? Twelve inches in a foot? A dozen eggs? Can we get a new metric here? Would it mess up the construction industry to use meters instead of feet? This initiative is not part of the Forum strategic plan, however.

If your interest is not astronomy, chronology or navigation, not education, not weights and measures, perhaps 12 channels your thoughts to religion and heritage. It is a short leap from the calendar to the Zodiac, of course; I bet you know your sign, particularly if you were young when I was. On a higher plane, you might trace your lineage to the Twelve Tribes of ancient Israel. Or perhaps you think of the twelve Apostles. If you have the imagination and patience to follow Revelations, at 21:12 you come to "a wall great and high; having twelve gates, and at the gates twelve angels; and names written thereon, which are the names of the twelve tribes of children of Israel . . ." You might recognize the walls of the New Jerusalem, a

vast cube, with walls of jasper, gold and glass, and foundations studded with twelve precious jewels. Although it is a walled city, the twelve gates are never closed. There was an architect.

Ultimately 12 is just a number, but it is a common number. It is sort of the anti-prime number. Twelve is a multiple of most single digit numbers, it seems, which means it can be loaded with false significance. Shoot, craps, too.

By now you have probably guessed where this is headed, and it is not the Apocalypse. The number 12 has special significance in the Forum. Most of us have a number from one to twelve. I am a 4.

If you don't have a number, you should get one. Twelve is the number of the Forum's "Divisions." The word "division" in this context is vaguely descriptive, but not very symbolic. Maybe we should call them the twelve gates. Or twelve angels. Maybe the twelve signs; you know, I'm a 4.

Here is a common quiz in the Forum, rarely passed by anyone: What is the name of each Division, in words? I have never passed this quiz; I never get past 4. I know where to look up the names, though. They are on the Forum's web page. They are in the members directory, too. Here is a cheat sheet for you (*editorial comments by the author*):

Division 1:	Dispute Avoidance and Resolution (why would anyone want to avoid a good dispute?)
Division 2:	Contract Documents (even though clients never read them)
Division 3:	Design (bet the engineers are conflicted about this name)
Division 4:	Project Delivery Systems (yep, that's mine; we used to be "alternative")
Division 5:	Contract Negotiations, Performance & Administration (because drafting the document is only part of the fun)
Division 6:	Workforce Management & Human Resources (definitely not a bunch of Marxists; but they know who actually builds the projects)
Division 7:	Insurance, Surety & Liens (sexy, sexier and sexiest)
Division 8:	International Construction (members take the best trips)
Division 9:	Specialty Trade Contractors & Suppliers (enjoy more respect than their clients get)
Division 10:	Legislation & Environment (unfortunate marriage of toxic substances and legislatures)
Division 11:	Corporate Counsel (can't get in unless you are a client)
Division 12:	Owners & Lenders (used to have money to burn)

Incidentally, we do use Arabic numerals for the names of the Divisions, not Roman numerals, and we definitely do not spell out the numbers with words.

We know that a large number of the Forum's members have not "joined" a Division.

That simply means you have not declared your allegiance to whomever one declares allegiance. You can swear allegiance to as many Divisions as you wish (so perhaps “allegiance” is the wrong term), but you have to actually do it. Then you get to say that you belong to a Division. It is a great conversation starter, because when you tell someone you belong to Division 4, you immediately have to explain what that means. You get put on the Division’s email list, which means you will get invited to meetings and programs that you otherwise probably would not hear about. You will also meet people who share your interests, like traveling to foreign countries, or making laws. You will also begin to recognize all the inside jokes and innuendo in this column.

Beginning about two years ago, the Governing Committee of the Forum started putting additional emphasis on the constitution and activities of the Divisions. Long ago when I was an active 4, the Divisions were pretty sleepy operations compared to what they do today. Today’s Divisions meet monthly by teleconference, meet in person at most Forum live programs, and sponsor teleseminars and papers. The Divisions generate many of the ideas that go into the Forum’s programs, books and journal articles. The Divisions also provide a social community-within-a-community for the Forum’s members.

Divisions are led by Steering Committees headed by a Division Chair. The Steering Committee Chairs and Members are appointed by the Forum Governing Committee after soliciting recommendations from the Division. Most steering committees have eight or nine members. Chairs typically serve for two years; steering committee members serve an average of about five years.

In addition to their steering committees, most Divisions have subcommittees and working committees so that they can spread their work. Each Division appoints liaisons to the Forum’s standing committees on Publications, Special Programs and Education, Technology, and Membership. Each Division also has a liaison to the Forum Young Lawyers Section. There is usually room for a willing volunteer to get involved and work up through the leadership of the Division, and on into Forum leadership.

Joining a Division is easy, so long as you understand the longitude, latitude and symbolism of a web page. Click [here](#), or visit <http://new.abanet.org/Forums/Construction/MO/Pages/DivisionMembersOnly.aspx>.

On the off chance that the link works, you should be at a page with a list of Divisions remarkably similar to the one above in this column. Pick one and click on it. Before you get transfixed by what you find on the Division’s page, note the big blue button on the right side of the page that says “Join the Division.” If you click on that, you will find that you can join the Division by simply giving up your email address and checking a box. Now you have done it.

For those readers who understand that you will get more out of the Forum if you put some time into it, joining a Division is a great first step. Most of the Forum’s leaders worked there way up through service in the Divisions. (Others have worked their way up through publications like *The Construction Lawyer* and *Under Construction*.) From Division and then standing committee work, many Forum members have been asked to speak at programs, plan programs, or work on publications.

The Divisions have become so busy and important to the Forum that we give them

all sorts of creepy symbolic names, like “lifeblood” and “bedrock” and “fundament”. Only recently, however, at the urging of our Chair, George Meyer, has anyone actually written down what these groups do. The Divisions are no longer a secret. This year, we will encourage and celebrate the Divisions more than ever before. Please get on the train and join in the action. If you did not do it a minute ago, head back up the page and click on that link. Pick a number. Hop on.

If you regularly read the columns written by the Forum’s officers, you have heard how all of them sincerely value the friendships and experiences they have gained in the Forum. For most of us, it started in a Division. You have twelve doors to choose from. If you are not sure which one to pick, roll the dice. I rolled a 4.

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Identifying and Avoiding Financially Distressed Contractors

By Joseph J. Egan, P.E., Joseph E. Seder, C.F.E., and Daniel S. Brennan



In today's challenging economy, an owner starting a new project, or continuing an existing project, should give increased consideration to the contractor it hires to perform the work. Obviously, hiring a financially distressed contractor puts the owner at increased risk of not completing the project on time or on budget if the contractor goes out of business. This article discusses some of the preventive steps an owner can take to help avoid hiring a financially distressed contractor, and to minimize the impact to the project if the contractor becomes financially distressed during the project. (For the purposes of this article, we will discuss the owner-general contractor relationship from the owner's perspective. Similar considerations may be applicable to the general contractor's relationship with its subcontractors and vendors).

When to Ask and What to Get

A critical time to assess the financial strength of a contractor is before the contract is awarded. During the bidding process, the owner can require the contractor to provide its recent financial information which can come from a variety of sources depending upon the size of the contractor, whether the contractor is public or private, and whether the company is audited by an accounting firm. These sources can include the following:

- Audited Financial Statements – Private contractors typically have loans from banks that require the contractor to provide audited financial statements as part of the lending process. If these are available, the owner should request them as part of the bidding process.
- Unaudited Financial Statements – Many contractors prepare financial statements for their own use that could provide valuable information for owners.
- Tax Returns – If no financial statements are available, the last two or three years of tax returns should be provided, at a minimum.

What is Important in Financial Statements?

The financial statements will help identify whether the contractor's short term financial position puts it at risk of cash shortfalls and possibly going out of business in the future. The following financial measures, together with sound business judgment and other considerations, should drive the owner's assessment of a contractor. These measures can include:

- **Cash On Hand:** One of the leading indicators of risk of bankruptcy is the availability of cash and liquid assets, or the lack thereof. If the contractor has little to no cash on hand, this contractor has an increased risk of going out of business.
- **Current Ratio:** The current ratio is calculated by dividing current assets by current liabilities. The current ratio is an indication of a company's ability to pay its short term liabilities, such as debt and accounts payable, using its short term assets, such as cash, inventory, and accounts receivable. A current ratio of less than one indicates that the company may be unable to pay its liabilities if they became due at that point in time. A ratio of less than one does not confirm a company will go bankrupt; however, it does indicate the company may have current cash flow issues and financial difficulties in the future.
- **Debt To Asset Ratio:** This is the ratio of total liabilities to total assets. This ratio shows the portion of the company's assets that are financed through some form of debt, whether short or long term. A ratio of less than 0.5 means that the company's assets are at least twice the amount of its debt. A debt to asset ratio that approaches one is an indication that the company has debt that is approaching or exceeding its assets. In challenging economic times, higher debt can put a strain on the financial stability of a company since more debt will need to be paid back or refinanced.
- **Z-Score:** The Altman Z-Score (Z-Score) is an analytical measure that was developed in the late 1960's to help predict whether or not a company was likely to go bankrupt within the next two years. The measure is calculated using four different financial ratios, as follows¹:

$$\begin{aligned} & 6.56 * (\text{working capital}/\text{total assets}) \\ + & 3.26 * (\text{retained earnings}/\text{total assets}) \\ + & 6.72 * (\text{earnings before interest and taxes}/\text{total assets}) \\ + & 1.05 * (\text{net worth}/\text{total liabilities}) \\ = & \text{Z-Score} \end{aligned}$$

The higher the Z-Score, the less likely the firm will go bankrupt in the next two years. Similar to reviewing financial ratios, the Z-Score is not 100% accurate and should be carefully considered. Depending on the duration of the project, the Z-Score may need to be calculated periodically to determine if there has been a decline in the score. The Z-Score does not directly address the importance of positive cash flow from operations of the company. The Z-Score provides a quick check of the financial health of the company but should not be the owner's sole analytical tool.

Other Information to Evaluate

The owner should consider asking the contractor for financial information that may not be readily apparent in the financial statements provided. Examples include:

- The contractor's ability to obtain further financing if needed;
- When the contractor's current loans are due;
- Whether the contractor has significant past-due obligations such as aging accounts payable, which can indicate the contractor is having trouble paying its bills as they become due; and
- Whether the contractor has aging accounts receivable.

The owner can also obtain information that is available from public records or databases such as:

- Credit bureau reports;
- History of litigation, arbitration, or claims against owners, bonding companies, subcontractors and suppliers; and
- Previous bankruptcy filings.

Another consideration for the owner is whether the project is of the kind that the contractor customarily performs. With the current economic downturn, many contractors are pursuing work in unfamiliar areas, such as office building contractors bidding on medical facilities or infrastructure work. Venturing into a new market segment is not always dangerous; however, it may present challenges for a contractor that could strain the financial management and other resources of the contractor.

Finally, owners in the private sector could borrow from the realm of public procurement. Governmental entities often require a contractor to submit a statement of financial condition. This form encompasses much of the information previously discussed in a single document. This accuracy of this document can then be referenced in the contract as a material inducement for the owner to enter into a contract and could assist in terminating a contractor if the information is misrepresented or changes for the worse without timely disclosure to the owner.

Contract Provisions to Protect the Owner

Once an owner is satisfied with the financial condition of a prospective contractor, the contract should include provisions so that the owner can monitor and manage any adverse changes in the contractor's financial condition. The most widely used form construction contracts offer limited protection for owners to monitor the financial health of a contractor during a project. Instead, those form contracts give the contractor a right to demand financial information from the owner to ensure that the owner can meet its financial obligations. In the current economic climate, an owner would be well-served to assess the contractor's wherewithal during the project. Examples of contractual protections to that allow the owner to monitor the contractor's finances include:

- Require the contractor to provide updated financial statements on a periodic basis for owner review;
- Allow the owner to institute different payment or management processes if the updated financial statements indicate an unacceptable deterioration in the contractor's financial condition including direct or joint payment to subcontractors;
- Allow the owner the right to inspect and audit contractor records during the job even on lump sum contracts; and
- Define a contractor default to include non-compliance with contractual payment procedures and a deviation from acceptable indicia of financial

health (subject to constraints imposed by law such as the bankruptcy code). This second ground for termination could include setting a Z-Score, or other measure, which will trigger the owner's right to terminate for default.

In addition to contractual rights, the owner can also avail itself of publicly available information during the project to check the contractor's financial status. These sources are basically the same as the ones that should be checked before hiring a contractor such as credit bureaus and court records.

Conclusion

Analyzing the financial health of a contractor in these difficult economic times before a contract is awarded can help prevent a potential impact to the owner and its construction project. On longer-term projects, continued due diligence and analyses can provide early warning signs of financial distress. Remember cash and other short term assets are critical to keeping a contractor solvent. Financial statement analysis can assist in evaluating the ongoing financial health of the contractor and can provide some early warning signs of potential financial difficulties or stress.

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Notes

1. The Z-Score was originally calculated for predicting bankruptcies for manufacturing companies. Over the years, the Z-Score calculation has been modified for application in other industries as well. This calculation is for general use.

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Project Neutrals to the Rescue! A New Tool for Avoiding and Resolving Disputes on Construction Projects

By Kurt Dettman, Suzanne Harness and John Carpenter



The construction industry has long been a laboratory for generating disputes and claims—and also for finding innovative ways to resolve them using a wide array of tools from the dispute resolution tool box. A recent trend in this area is the increasing use of project neutrals. Project neutrals can fill a variety of roles—they can be neutral experts who are called upon to render expert opinions to the parties; they can be facilitators of partnering processes and negotiations; they can be "on-call" neutrals who are activated only if a claim needs third-party input; and they can be "standing" neutrals who meet regularly with the parties to discuss issues and disputes throughout the life of the project. Their use is becoming more widespread as construction lawyers and their clients discover that project neutrals provide the kind of "real time" intervention that can help project participants resolve their disputes quickly and cost effectively.

The most obvious evidence of this trend is that the construction industry's standard form agreements are now offering choices that encourage the use of project neutrals early in the disputes process. For example, the 2007 edition of AIA Contract Documents® introduce a third-party neutral for deciding claims, called the Initial Decision Maker, and the 2007 ConsensusDOCS allow the use of a project neutral or dispute review board as an alternative to mediation. This article discusses the use of project neutrals under those standard form agreements. Additionally, it discusses several topics that the construction lawyer will want to consider when advising a client about how to select and work with project neutrals, such as criteria for neutral selection, how claims are presented and decided, the neutral's authority, and the effect of the neutral's decision.

I. Using Project Neutrals

A. The Architect as Decision Maker

The use of a third party to decide construction contract disputes originated in this country with the first AIA owner/contractor agreement, written in 1888. In that document, the contractor was directed to refer to the architect any questions about the accuracy and completeness of the plans and specifications and requests for additional payment. As between the owner and contractor, the Architect was considered to be neutral, and its decisions on these matters were deemed, in the words of the contract, to be “just and impartial.” If the contractor didn’t agree with any decision of the architect, it had to proceed with the work, but could appeal the architect’s decision to a three-member arbitration panel.

The process under the AIA documents of the Architect serving as the neutral for issues involving the owner and contractor remained generally unchanged until 2007. Over time it was refined into a formal claims process whereby both the contractor and the owner were required to submit claims to the Architect for an initial decision. The initial decision was binding on the parties, so it served to keep the project moving along, but was always subject to arbitration. Starting in 1997 and continuing today, the decision was subject first to mediation and then to arbitration, if the mediation failed to resolve the dispute. The initial decision took on great importance because it was required as a condition precedent to any further dispute resolution process.

In 2007, the AIA offered the parties the choice of continuing to use the architect to make initial decisions or to retain another party for that role. The Architect, or other party, serving as the initial decision maker (IDM) can be considered an on-call project neutral, because he or she is not required to meet with the parties regularly during the course of the project and is called upon to address issues and disputes only when they arise.

B. The Dispute Review Board

Since the mid-1970s many public projects have used a form of project neutral known as a Dispute Review Board or a Dispute Resolution Board (DRB). DRBs have been more commonly used in tunneling and other large complex horizontal construction projects, but the process is now being used in a much more diverse array of projects, such as hospitals and airport terminals.

A DRB is typically a panel of three neutrals, usually with an engineering and construction background related to the type of project being built. Sometimes a DRB will include only one neutral, known as a “single person DRB” or a “Dispute Resolution Advisor.”

Usually, the DRB is appointed at the beginning of the project and remains in place until the project is completed. The DRB meets regularly with the parties to hear issues and disputes, so it is considered a “standing project neutral”. In some circumstances, however, a DRB may be used in an on-call basis. For example, the FIDIC and World Bank agreements call for the use of what is variously called a Dispute Board, Dispute Advisory Board, or Dispute Adjudication Board, which does not meet regularly with the parties, but hears claims only on when called upon.

II. The 2007 AIA and ConsensusDOCS Standard Forms

A. AIA’s Initial Decision Maker

The IDM’s duties are set forth in Article 15.2 of A201-2007, General Conditions of

the Contract for Construction. The identity of the IDM is to be written into any owner/contractor agreement that incorporates A201-2007, including most agreements for design-bid-build and construction manager at risk project delivery. If the owner and contractor do not identify an IDM, A201-2007 specifies that the Architect will serve in that role by default.

Except for a few types of claims that may go directly to mediation, either party must submit its claim to the IDM for an initial decision as a condition precedent to mediation. Because mediation is a condition precedent to any form of binding dispute resolution, the IDM's initial decision is the first, required step in the A201 dispute resolution process.

The AIA's 2004 Design-Build family of documents also employs the initial decision process. Those documents introduced a third-party, called the Neutral, to assume the traditional dispute resolution role the Architect held under AIA agreements for design-bid-build.

B. ConsensusDOCS' Optional Neutral/DRB

The ConsensusDOCS 200 in Article 12, "Dispute Mitigation and Resolution", allows the parties to select an optional "dispute mitigation procedure" as an alternative to mediation. Under the "check the box" format, the mitigation options include either a Project Neutral or a DRB. Generally, the ConsensusDOCS follow the traditional DRB model where the DRB makes periodic site visits and issues non-binding findings on claims. The DRB has to issue its findings within five days, or the parties can proceed directly to arbitration or litigation. Article 12 of the ConsensusDOCS provides only rudimentary details regarding how the DRB is to be established and run. For that reason, if the parties select the DRB option, some of the topics that are covered in this article should be addressed by making additions to [Article 12](#) of the ConsensusDOCS form.

III. Setting Up The Process

A. Industry Resources For IDMs and DRBs

IDMs

The AIA does not provide an IDM agreement, but The American Arbitration Association (AAA) has written IDM Procedures, available on the AAA's website (www.adr.org), that discuss the IDM's selection, impartiality, scope of authority, compensation, and limitation of liability, among other things. The AAA will also provide an IDM from its national panel of Neutrals, so the same individuals whom the AAA has prequalified to serve as arbitrators and mediators may serve in the role of IDM.

DRBs

The Dispute Resolution Board Foundation (DRBF) has a DRBF Practices and Procedures Manual on its website, www.drbb.org. The Manual thoroughly covers how to set up and implement a DRB, and provides sample specifications, operating procedures, and Three-Party Agreements among the owner, contractor and DRB members. The DRBF also provides training that covers ethical and professional duties, as well as the nuts and bolts of managing the DRB process. The FIDIC form of contract can be found at www.fidic.org and the World Bank form at www.worldbank.org. Also, the American Arbitration Association has published DRB Guide Specifications, available from its [website](#).

B. Selection Criteria

IDMs

The importance of subject matter expertise for IDMs is critical. Many disputes arise over whether the contractor has performed according to the relevant plans and specifications and, in many cases, the first thing the initial decision maker will have to do is read and analyze those documents. For building projects, architects are well qualified to make those analyses. They also understand the construction process and the appropriate roles of the owner, architect, and contractor. Other disciplines, including construction lawyers, can fill the IDM role, but whoever is selected as the IDM should have a good understanding of the design and construction process.

DRBs

Selecting the right neutrals for the DRB is the most important element—a great process on paper or in the contract can be derailed if the right people are not selected. First, subject matter expertise is important—after all, the DRB is giving an opinion on the substantive merits of claims that often involve complex engineering or construction issues. Second, DRB members should be trained on the DRB process and principles so that they understand their role and can properly manage the responsibilities that they have been given. Third, DRB members should have experience in claim resolution processes as they are acting as part of a larger process to resolve issues without resort to traditional arbitration or litigation.

C. Ethics

IDMs

Architects who are AIA members are governed by the AIA Code of Ethics, which is published online at www.aia.org. Rule 3.202 states that AIA members are required to render decisions impartially when acting under agreements to interpret contract documents and judge contract performance. The commentary to the rule specifically notes that the rule applies even though the member is being paid by the owner. A201-2007 also imposes a duty of neutrality on the architect at Section 4.2.12. It states that, when making interpretations and decisions, the Architect is not permitted to show partiality to either owner or contractor.

To maintain neutrality throughout the project, both the initial and continuing duty to disclose potential conflicts of interest should be covered in the IDM agreement. However, that duty should be tempered with an opportunity to waive conflicts in order to continue utilizing the services of a competent IDM whom both parties have previously agreed to use and continue to have confidence in. The initial decision is not the equivalent of an arbitrator's decision. For that reason, a "hair trigger" with respect to apparent conflicts, as we sometimes see in arbitrator selection, could derail the process unnecessarily.

DRBs

DRB specifications usually require that DRB members be neutral and objective. To that end, many specifications identify conflicts of interest that prohibit a DRB member from serving on a particular contract, such as having an on-going consulting relationship with one of the project participants. Other conflicts or potential conflicts must be disclosed and may be waived as, for example, a past relationship with one of the project participants. It is important to remember that for DRB members the "no conflicts" rule applies throughout the term of the contract, so serving on a DRB may prohibit certain employment opportunities for a number of

years. Likewise, during the course of the project the DRB members must retain their neutrality, including in their conduct with the parties.

IV. Operations

A. Cost of On-Call vs. Standing Neutral

IDMs

It can be costly and time consuming to educate a party about the project so that he or she can serve as the IDM. For that reason, the AIA assumes that, in most cases, the Architect will serve as IDM by default and another party will be brought in as IDM only on larger, more complex projects where the project can afford the hourly rates of the outside IDM as well as the other costs to educate the IDM. Serving as an IDM is a basic service under the AIA's owner/architect agreements, but when another party serves as the IDM the Architect may be paid additional services to assist or provide training to the IDM.

The owner/contractor agreements are silent regarding who pays the IDM, which effectively makes the IDM a cost of the project for the owner to bear. Many observers have suggested that the owner and contractor should share the IDM cost. If desired, that cost sharing can easily be made explicit in the owner/contractor agreement.

DRBs

Some parties believe that costs of having standing DRBs is too high and for that reason alone appoint only on-call DRBs that do not act unless and until a formal claim needs to be heard. Although the cost of periodic site visits by a standing DRB initially is higher than for the on-call DRB, the perceived savings may be illusory because the process of getting the on-call DRB up-to-speed on the issues may cost as much, if not more, than the cost of regular site visits. The benefit of the regular site visits is that the standing DRB becomes familiar with the disputed issues and has a chance to build up the credibility with the parties that the periodic site visits foster. Moreover, at the periodic site visits the DRB has the opportunity to head off disputes by getting the parties together to talk about project challenges and solutions—sometimes the mere presence of the DRB brings issues to the fore and allows the parties to deal with them then and there.

B. Communications

IDMs

The IDM procedures in A201-2007 do not put a restriction on direct communications with either party to a claim. In fact, Section 15.2.3 specifically states that the IDM may request information from any party as it goes about evaluating the claim and making its decision. If the Architect is performing construction contract administration, he/she may be attending project meetings on a regular basis that the owner and the contractor would also attend, and claims could be discussed at those meetings. An IDM who is not the Architect would be on-call only and not involved with project participants until asked to make an initial decision. Therefore, it would be unusual for those IDMs to communicate with the parties except regarding claims being decided.

DRBs

The DRB normally is prohibited from *ex parte* communications with the parties, except for administrative matters. Most communications go through the panel chair and all parties are copied on everything. The standing DRB members do, however,

regularly communicate with the parties on site visits. Even on site visits DRB members need to be careful in their conduct so as to maintain their neutral and objective role—this does not mean that DRB members need to be robots, but they must walk the line between familiarity that promotes confidence and familiarity that may breed suspicion.

V. Dispute Process

A. Submission of Claims

IDMs

Per A201-2007, a claim must include substantiation, a cost estimate, and an estimate of the probable effect on the schedule. The IDM has only 10 days to act on the claim, and can do one of five things: (1) ask for supporting data, or a response from the other side, also with supporting data; (2) reject the claim; (3) approve the claim; (4) suggest a compromise; or (5) advise that it is unable to make a decision, either because it lacks enough information, or, “in its sole discretion” concludes it would be inappropriate to render a decision. The process is intended to be quick, so if the IDM requests more information, the party to whom the request is made has only 10 days to provide the information, and the IDM has to make a decision upon receipt of the information. If the IDM fails to decide, then the parties are free to take the claim to mediation 30 days after sending it to the IDM.

The IDM is permitted to seek information from either party and also from experts, without restriction, and may request that the owner retain experts at the owner’s expense, if the IDM needs their opinions to decide the claim. Of course, if the owner has to retain experts not already on board, then the schedule would have to be extended.

DRBs

DRB specifications and/or DRB procedures established at the beginning of the project govern the dispute submission process, so it may vary from project to project. Usually, the contract will specify a notice of claim and a negotiation process before the claim is presented to the DRB. The claim presentation is made via position papers and supporting documents that are sent to the DRB to be read before the DRB conducts a hearing. The position papers and supporting documents usually comprise a three ring binder’s worth of paper. The parties may also send presentation materials (usually Power Points) to the DRB before the hearing.

B. Hearings

IDMs

The IDM process doesn’t mention hearings, but the AAA IDM procedures realistically account for the possibility of conference calls and meetings. Although hearings are not precluded and could be held, the A201 drafters intended an informal and expeditious process without the formality that a hearing would introduce.

DRBs

DRBs almost always hold hearings, but they are relatively informal as compared to arbitration or litigation. The operating procedures usually provide for the claimant to present first, then the respondent, followed by rebuttals until the claims have been addressed to the satisfaction of the DRB. There are no trappings of arbitration or litigation hearings, such as swearing of witnesses, recording of the proceeding,

cross-examination, motions, and the like. In essence, the hearing is simply a presentation by project participants about what happened and the reasons why the amount requested should, or should not, be paid. Another feature of a DRB hearing is that the DRB members usually ask detailed and focused questions of the parties—it is akin to a “hot bench” when arguing an appeal in court.

C. Role of Lawyers

IDMs

Both A201 and the AAA procedures are silent with respect to the representation by counsel. There’s nothing written in A201 that would prohibit them from appearing at meetings, and nothing prohibits the IDM from speaking to a party’s attorney when seeking additional information. If lawyers are involved, however, they are most often behind the scenes at this stage of the dispute.

DRBs

Generally, most DRB specifications are not “lawyer friendly.” For example, some DRB specifications require that all members of the DRB have construction subject matter expertise, which may by definition exclude lawyers. Some owners require that a lawyer serve as panel chair because these owners believe that a lawyer as chair can add to the DRB an appropriate consideration of legal and process issues, while still retaining the basic character of the DRB as a “panel of subject matter experts.”

Lawyers are usually not present at DRB hearings. Sometimes they will be present to address legal issues, if requested by one or more of the parties and approved by the DRB. Often, however, lawyers will assist in preparing parties for their presentation to the DRB and reviewing papers before they are submitted to the DRB, but it is rare for a lawyer to be present and active at a DRB hearing.

VI. Authority

IDMs

The IDM’s complete scope of services and authority are covered in Article 15 of A201. The IDM makes an initial decision on claims, and claims are defined to include disputes arising under the contract. Some claims are carved out of this process. Claims related to hazardous materials, emergencies, and the owner’s duties as a fiduciary of insurance proceeds do not require an initial decision and may proceed directly to mediation. Also, the IDM’s authority is limited to making decisions on claims arising only between the owner and contractor, unless the IDM and all parties affected by the potential decision agree.

The IDM has no power over the parties other than by its decision, and it can only decide on the basis of the information it has received. A party that does not cooperate in the process assumes some risk, because an IDM that does not have all the information that it needs to reach a decision may simply find against the non-cooperating party.

DRBs

Like the IDM, the DRB is a creature of the parties’ contract, so its scope of authority will be dictated by any limitations that the parties prescribe. Some specifications will explicitly carve out issues that the DRB cannot rule on, such as injunctive relief or punitive damages. It is advisable when setting up the DRB process to consider what issues, areas and/or relief are “off limits” to the DRB. In general, however, it is

better to give the DRB broad authority within the four corners of traditional contract-based claims—more questionable would be tort claims and equitable relief. Although most DRB decisions are non-binding, it is better to present to the DRB only those issues that it is best equipped to handle since it is more likely that the parties will accept decisions made on that basis.

The DRB has only persuasive, not sanctioning powers. Therefore, the DRB cannot “force” a party to do something, but it does have the ability to take cooperation (or lack thereof) into account in its findings and recommendations. Unless the DRB’s findings and recommendations are admissible in subsequent proceedings, the non-binding DRB decision, based on admonishing a party for non-cooperation, can simply be ignored—it is rare, however, for a party not to cooperate with a DRB.

VII. Decisions

A. Form of Decision

IDMs

As set forth in A201-2007 at Section 15.2.5, initial decisions have to be in writing. They also have to approve or reject the claim, state the reason for the decision, and advise the parties of any change in the Contract Sum or Contract Time.

DRBs

The DRB decision is usually in writing and quite detailed. It typically covers the following topics:

- The issues presented and the relief requested
- A summary of the parties’ respective positions on the issues
- The DRB’s analysis of the merits of the parties’ positions and the claim, and
- The DRB’s recommendations, which are usually short and to the point.

The DRB usually will be asked to decide entitlement only, on the assumption that if liability is agreed upon, then the parties are in the best position to negotiate a price for the claim. However, sometimes the parties will ask the DRB to decide price and time issues as well, or the DRB can remain available to hear these issues if the parties cannot come to an agreement on price and time.

It is important to note that the DRB does not act as a mediator or opine as to what it deems to be a “fair” outcome; rather, it gives its opinion on the proper outcome of the claim, on the merits.

B. Final and Binding?

IDMs

IDM initial decisions are final and binding, but that may be temporary, because initial decisions are subject to mediation. Initial decisions have always been binding because their purpose is to keep the project moving and not allow it to get bogged down in costly delays. Once a decision is made, both parties have to act on it. The Architect is required to issue change orders based on the initial decision and the contractor or owner may be paid in the next month’s pay application. Ideally, the dispute is resolved in 10 or 20 days, and everyone moves on. Also, unless appealed to mediation prior to final payment, the decision becomes final and no other steps are required to resolve the dispute.

A new provision in A201-2007 at Section 15.2.6.1 provides a process for obtaining finality of the decision prior to final payment. It works by allowing one party to demand that other party file for mediation of the decision within 60 days. If the other party does not file for mediation within 60 days, then both parties waive the right to pursue mediation, or any binding dispute resolution, of the decision in the future. This right is optional, and one that would likely be exercised only by the party that was satisfied with the decision.

DRBs

As noted above, DRB decisions usually are non-binding. Sometimes, however, owners and contractors will agree in advance to abide by the DRB's decision on a particular claim. Other specifications provide that all DRB decisions up to a certain dollar threshold are binding and all above that threshold are not, but a binding DRB decision is somewhat of an anomaly. The FIDIC and World Bank standard contract terms result in a decision on the merits that is "temporarily binding," meaning that the parties must follow it unless and until it is modified by agreement of the parties or it is later overturned through arbitration or litigation after project completion. In most instances this makes the decision binding as a practical matter, since very few are overturned in subsequent proceedings.

DRBs work best when they have credibility with the parties based on their subject matter expertise, project-specific knowledge, and neutrality. Some practitioners feel that DRB decisions should always be non-binding because a binding decision could drive the parties farther apart in their negotiations and make the disgruntled party hostile to the DRB process and the DRB itself, thereby making it less effective in resolving disputes on the project. The DRB is in place for the life of the project, performs some dispute avoidance functions, and renders its decisions based on a relatively informal process both as to documentation and the hearing process itself. Making the outcome binding could subvert the underpinnings and benefits of the DRB process objectives as a whole.

VIII. Effect of Decision— Admissible or Inadmissible?

IDMs

Nothing in A201 prevents the introduction of the decision as evidence. Given its role as the first step in the claims process, the party making a claim actually has to demonstrate that it received an initial decision. If not, the claim is not ripe for further dispute resolution.

DRBs

DRB specifications vary on admissibility vs. non-admissibility. The DRBF recommends that DRB decisions be admissible, the rationale being that if they are admissible the parties will take a recommendation more seriously even if it is non-binding. The ConsensusDOCS 200 also specifically states at Section 12.3 that the DRB's finding may be introduced as evidence in a subsequent binding adjudication. Some practitioners believe that making the DRB decision admissible is not a good idea since the prevailing party will become more entrenched in its position even if the decision is non-binding. Also, admissibility in a later proceeding will only transfer that fight to another forum, with the focus shifting to why the subsequent forum should adopt, or not adopt, the DRB's recommendation. The DRB process is intentionally informal without rigorous process protections, so if a DRB decision is admissible, the result would be to use the product of an informal process in a formal

subsequent proceeding without the normal protections of the adversarial process.

IX. Cost Effectiveness of Project Neutrals

IDMs

The initial decision process is very cost effective. The purpose of the initial decision is to get a prompt decision that will keep the project moving forward and avoid delay. The initial decision achieves that purpose because it is an efficient process, with specific time constraints, and it results in a binding decision.

Importantly, the initial decision is the first step in the disputes process, not the second or third. Parties on construction projects usually try to resolve their issues informally, but some contracts require parties to engage in stepped negotiations with formal time periods before they can proceed to a neutral's decision. Those formal time periods lengthen the process and some parties abuse them to further extend the time. By contrast, under A201-2007 the parties can receive an initial decision in 10-20 days, and proceed to mediation in 30 days if no decision is issued.

If the Architect serves as the IDM, the process is quite economical, because rendering decisions on claims is a basic service under AIA owner/architect agreements. If the IDM is not the Architect, then the costs will rise, but in a large complex project, those costs pale in comparison to the costs of the delay that can result when there is no initial decision.

DRBs

The DRB process should be viewed as a risk management investment in dispute avoidance and resolution. There is no doubt that it is commonly viewed as an extra project cost, and on smaller projects it can be viewed as an unacceptable percentage of overall project cost. However, the costs to a project of only one arbitrated or litigated claim on a project will far exceed the cost of a DRB, not to mention the transactional costs of tying up project personnel, loss of good will between the parties, and the expenditure of resources on non-productive activities. A properly selected and managed DRB will pay for itself in avoided claims and process costs on most projects. Also, DRBs can be scaled to the size and complexity of projects—larger projects warrant (and can support) a three-person DRB, but smaller ones can use single person DRBs with their smaller carrying costs.

Conclusion

The use of project neutrals provides a cost-effective, flexible way to implement “real time” dispute prevention and resolution of project conflicts and disputes, and thus avoid costly arbitration and litigation processes.

The initial decision provides certainty to the parties for a very low cost, in a very short time. In the best of all worlds, if neither party requests mediation of the initial decision, it becomes final upon final payment and the parties do not have to spend more time and money resolving the dispute.

The DRB process is an informal, party driven process. The DRBF has data that supports a 98% success rate in resolving claims brought to a DRB, so the DRB process has a proven track record of working effectively in its traditional format.

Kurt Dettman is a principal of Constructive Dispute Resolutions in Hingham, Massachusetts, where he concentrates on alternative dispute resolution, including serving as a mediator, arbitrator and dispute review board member on various projects. Kurt is also the New England Representative of the Dispute Resolution Board Foundation. Suzanne Harness is President of Harness Project Solutions in Arlington, Virginia, which provides procurement consulting, mediation, and arbitration services. John Carpenter is an Assistant General Counsel with Kiewit Construction, founded in 1884 and now one of largest construction companies in the country.

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The Forum Announces the 2010-2011 Chair-Elect and New Leadership

At the Annual Meeting in Austin, Texas, the Forum elected **James S. Schenck, IV**, of Conner Gwyn Schenck PLLC in Raleigh, NC, as its Chair-Elect, and four new Governing Committee Members: **Arthur D. Brannan** of DLA Piper in Atlanta, GA, **G. Edgar James** of Polsinelli Shughart PC in Kansas City, MO, **Kerry L. Kester** of Woods & Aitken LLP in Lincoln, NE, and **Susan Fisher Stevens** of Sprint Nextel Corp. in Overland Park, KS.

The Forum's Division Chairs for 2010-2011 are:

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Deborah B. Mastin, Miami-Dade County Attorney's Office (Div. 11 – Corporate Counsel)

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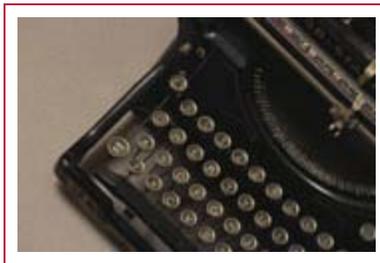
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The ABA Forum on the Construction Industry announces a writing competition for law students. The competition is open to all law students in good standing and currently attending ABA accredited law schools.

Students may submit writings on any topic related to construction law. The format of the articles should resemble the articles published in either of the Forum's two publications, *The Construction Lawyer* (law journal format) and *Under Construction* (newsletter format with articles of 1000-2000 words).

Senior ABA members will judge the submittals. Criteria for selection include creativity, clarity and precision of writing, strength of argument, novelty of subject, and quality of research.

The author of the first place submittal will receive a cash prize of \$2,000; travel expenses and registration to attend the annual meeting of the ABA Forum on the Construction Industry, where a first prize plaque will be presented; a one-year membership in the Forum and recognition in the Forum newsletter, *Under Construction*, and on the Forum's website. One or more submittals may receive honorable mention, which will be recognized with a plaque.

Submittals receiving first place and honorable mention will be considered for publication in either of the Forum's two publications, *The Construction Lawyer* and *Under Construction*.

The deadline for submission of articles for the 2010 competition is **December 30, 2010**. All articles shall be submitted to [Mark Nagasawa](#) and [Marilyn Klinger](#) in Word format.

For more information, contact Marilyn Klinger at 213/615-8308.

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