

Building^{CFMA} Profits

THE MAGAZINE FOR CONSTRUCTION FINANCIAL PROFESSIONALS

R E P R I N T



NOVEMBER-DECEMBER 2010

CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION

The Source & Resource for Construction Financial Professionals

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Construction Contracts

FOR THE NEXT WAVE OF CONSTRUCTION PROJECTS

As we enter the next phase of economic recovery, albeit slowly, we read reports about a number of large construction projects in the early phases of planning. We also hear reports that architects, geotechnical experts, and other early-phase industry professionals are seeing an increased demand for their services. Good news for these “industry canaries” usually means that good news is coming for the rest of us.

While the prospect of better times may be encouraging, the optimism that reigned only a few years ago is not likely to immediately return. Owners will continue to approach their upcoming projects with greater scrutiny, a more critical assessment of their own risks, and a stronger bargaining position. As part of their overall construction and investment strategies, owners will expect their contractors to share in some of the enormous risks they are assuming.

On any major construction project, the contract documents determine how the owner and contractors allocate risk. Yet, for some contractors, many important contract provisions that greatly impact risk allocation often go unexamined – simply because the “contracting” phase is perceived as tedious, confusing, or less important than the actual construction work.

This article will: 1) provide context and meaning for terms that are common in construction contracts, 2) describe common issues that arise from contract provisions that may not accurately capture what the parties really wanted, and 3) offer some pointers on how to effectively avoid some of these pitfalls.

How Owners View Risk on Major Construction Projects

In order to understand construction contracting, we need to understand the risk most construction project owners assume. Why? Because this risk – *an enormous up-front investment, followed by a gradual recovery of that investment* – shapes the heart of all construction contracts.

Because owners don't have crystal balls and there are no guarantees that such massive investments will be recovered, most owners will contract to have all parties to the project share in their risks.

The exhibit to the right illustrates the risks and investments associated with an industrial project and the timeframe under which the owner attempts to recover that investment. Though

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this illustration pertains to an industrial project, commercial and even certain large public projects might be similarly portrayed.

The two time periods (Design & Construction and Commercial Operations) are closely linked from the owner's perspective, since the owner has made an enormous initial investment in the expectation that it will profit by providing some product or service after project completion.

However, there is simply no guarantee that the project output (let alone the demand for such output) will be as forecasted when the project was first presented to and approved by the owner's Board of Directors.

Moreover, each day a project is delayed, one of the most significant cost components (direct finance costs during construction) will escalate and can quickly erode other cost margins.

Thus, managing the schedule and construction costs is not simply a matter of saving a few dollars for the owner; it could mean the difference between going forward with a project and canceling it altogether.

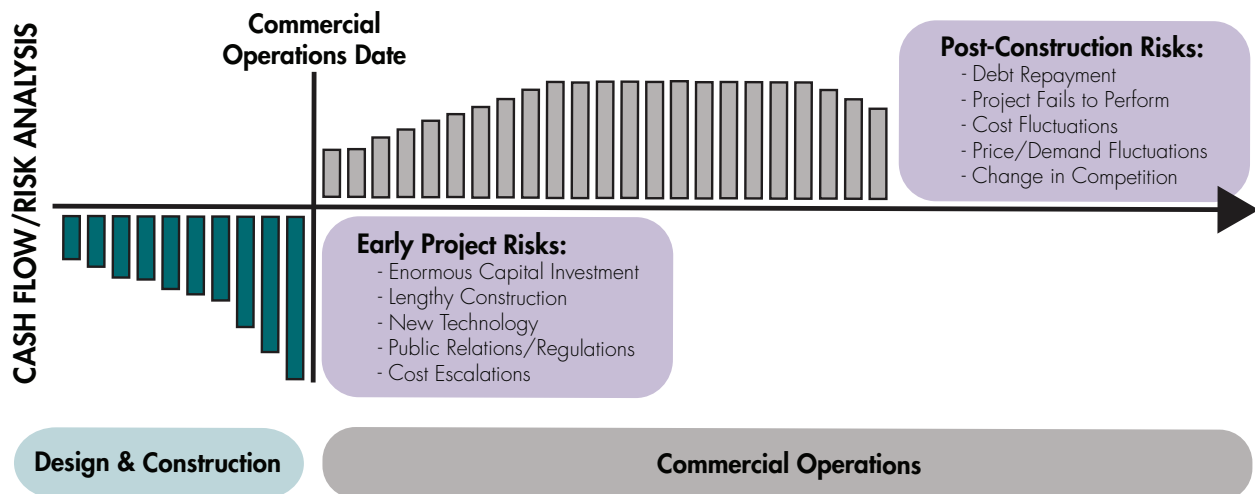
A NIGHTMARE SCENARIO

Consider the following: An owner's Board has approved a project, and the owner has incurred financing and executed key construction contracts. Then, the owner learns that all of the assumptions that went into the project forecasts have proven grossly optimistic.

First, the GC discovers inconsistencies in material quantity estimates. The major equipment contractor is located overseas and failed to convert certain material quantities from metric tonnes to U.S. tons, though all cost estimations assumed U.S. tons.

While the owner is sorting out the correct quantities and determining who pays for the cost difference, a spike in global demand for steel sends prices soaring and ensures that significant project deliveries will be delayed, pushing the entire construction schedule back several months.

Worse yet, the owner is unable to secure long-term supply contracts for the raw materials needed to manufacture its product. So, the very project that only months before had been





greeted with applause and high-fives from the owner's Board may never operate profitably.

Even though it's unlikely that any one project would be hit with each of these disasters, owners will plan for them nonetheless and try to pass as much risk as possible on to their contractors.

How Contractors View Risk on Major Construction Projects

SIMILARITIES

At least with respect to project scheduling, contractors generally view risk as owners do: Finishing on time and within budget is best for everyone. After all, it increases the likelihood that contractors will get paid, and the owner will have a successfully completed and profitable project.

A happy customer often equates to future business for contractors, and a finished project means that contractors can pursue other work. Finally, a project that is completed on time and within budget will probably not generate lengthy and costly disputes.

DIFFERENCES

In other ways, however, contractors' revenue and risk models differ significantly from owners'. For owners, project completion usually means that the profitable work is just getting started; whereas, for contractors, all of the profit is earned by the completion of construction.

Under typical payment provisions, contractors will be cash-neutral or only slightly cash-positive through much of construction. A contractor receives its profit toward the end of the project or at the very end, when the retainer is paid.

Thus, a contractor can lose all of its profit if the project is canceled, the owner goes bankrupt during construction, or the retainer is withheld. Therefore, contractors need to know exactly what the scope of work will be in order to perform the work, get paid what is due, and then move on.

ANOTHER NIGHTMARE SCENARIO

Consider the following: A subcontractor skillfully completed its work in accordance with the design documents, but the design was incorrect. Even though the subcontractor did not perform the design, but rather manufactured and installed specialty items in conformance with the design documents, the owner withheld payment to the subcontractor.

Unfortunately, the subcontractor did not carefully review its contract with the GC and agreed to a broad flow-down provision (incorporating several warranties, back charge provisions, and the owner's right to remedy defective work).

The subcontractor also agreed to a broad pay-if-paid provision (in a state where such provisions are enforceable). Thus, because the GC did not get paid, neither did the subcontractor. Worse yet, the subcontractor was hit with a back charge so that its work must be redone based on the new design.

So, for this subcontractor, the difference between a highly profitable project and a disaster was not related to the quality of its work, but rather to contract provisions that were not understood or carefully reviewed.

Apportioning Construction Risk

Ideally, contract terms will fairly and logically apportion risk to those parties in the best position to manage such risks or to those paid to absorb them. The subcontractor nightmare previously described could have been avoided during the contracting process if the subcontractor had not agreed to cover risks that it did not directly control.

But, risks are often apportioned to the party that did not carefully review or understand the interplay of complex contract provisions. The contract grid can be used as a checklist during the contracting phase to ensure that common construction risks are fairly and logically apportioned in contract documents.

Putting It All Together . . .

While an owner's needs should be met, so should those of the contractors. But, that will only happen if the contractors carefully review contract terms, understand the risks they are being asked to assume, and insist on fair and reasonable terms.

The issues described in the grid should be reviewed with any new contract. In addition to the grid, the following list of best practices can help the participants arrive at terms that are more likely to meet the needs and concerns of all parties involved:

- 1) Decide how the risks will be apportioned and then worry about the precise language of the contract. Attempting to draft a contract (or more importantly, to reject overbearing contract provisions) may be complicated if the basic terms are still being worked out.



- 2) Ensure that the contract allows all parties to successfully implement their responsibilities on the project (specifically, that your company will be able to do the job it is being hired to do).
- 3) Ensure that the intent of the parties is clear, and that the contract is written in plain English and is easy to understand.
- 4) Don't be greedy, but don't leave issues unresolved when the contract is signed. After all, there is no guarantee that the feeling of "we're all in this together" will last. (Sometimes, it disappears on a project after the first few heavy rains!)
- 5) Avoid last-minute provisions because they invite inconsistencies with other provisions and often are agreed to only under pressure to "get the deal done."

Avoiding unnecessary and costly disputes is one way to improve the bottom line. Getting paid for a job well-done is another. A contract that is unclear, open to interpretation, or that apportions risk in a manner inconsistent with a party's ability to manage such risk invites disputes and could inhibit successful project completion.

Increase your company's prospects of success in this difficult economic environment by carefully considering the principles and concepts discussed in this article as you prepare your company's next major contracts. ■

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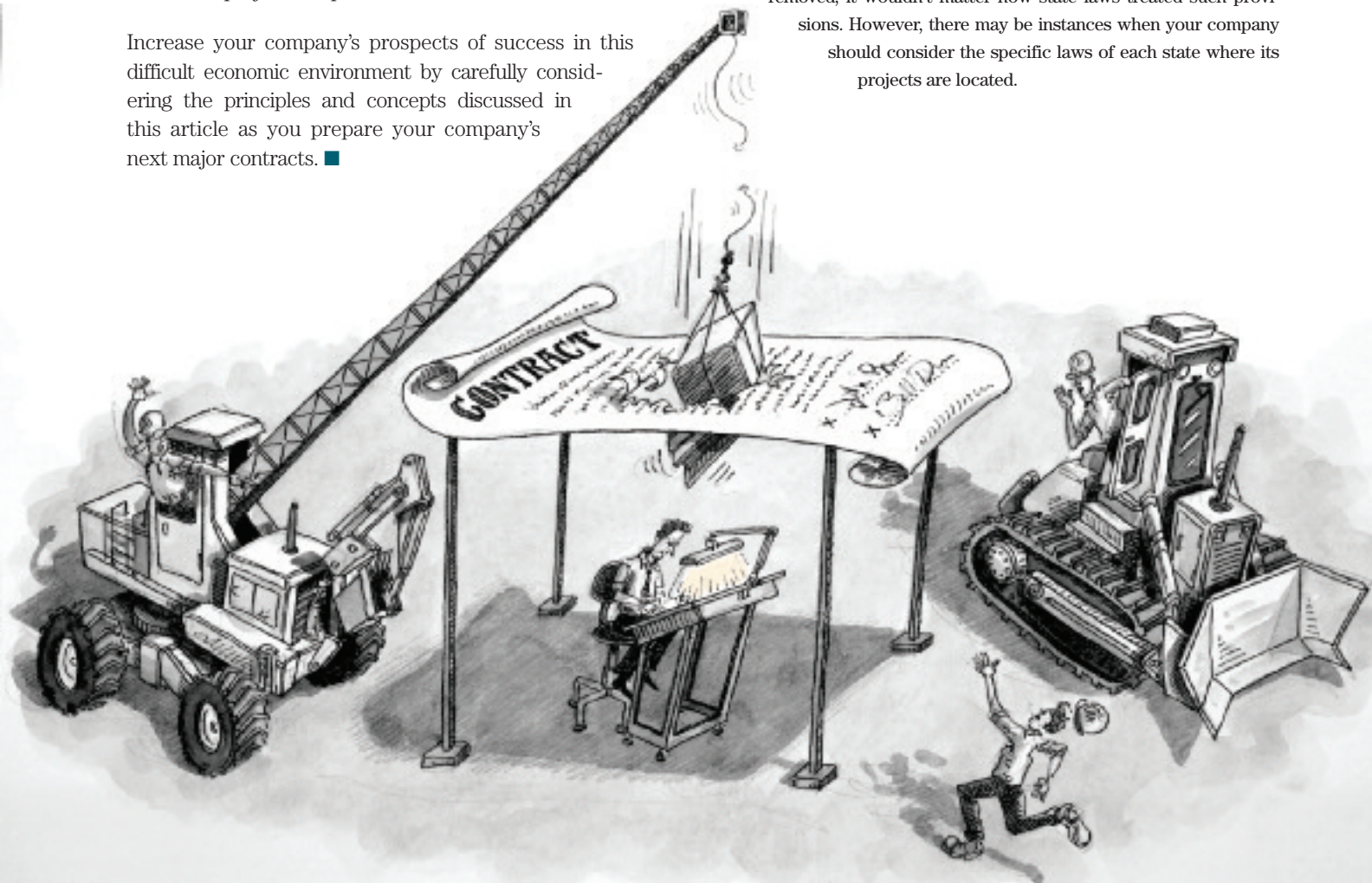
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Author's Note: This article and the construction contract grid addresses a number of risk concerns and contract provisions specific to the industry. It's important to know, however, that the laws of certain states often treat these issues and provisions differently. Of course, if contract provisions that unfairly apportion risk can be successfully removed, it wouldn't matter how state laws treated such provisions. However, there may be instances when your company should consider the specific laws of each state where its projects are located.



COMMON RISKS

HOW RISK IS TYPICALLY APPORTIONED

COMMONLY IMPLICATED PROVISIONS THAT YOU SHOULD UNDERSTAND

DISPUTES

Everyone bears the risk of costly, unproductive, and time-consuming disputes. A project can go south for any number of reasons: poor weather and site conditions; quantity growth; delays or cost increases for materials and supplies; design changes and delays; the owner's decision to cancel the project; or any combination of these and other factors.

For that reason, several contract provisions are typically implicated when disputes arise. Provisions that require contractors to continue working through disputes with the owner are therefore not uncommon, but should be carefully reviewed to ensure they are reasonable and fair.

Dispute resolution procedures (good-faith negotiations, mediation, arbitration)

Work continuation clause

Venue

Indemnity

Attorney's fees

DELAYS CAUSED BY DESIGN ERRORS & CHANGES

Even if the owner is responsible for the design, the contractors will bear the risk of late or incorrect/incomplete drawings and any corresponding project impact, to some degree. For example, the contract may require the contractors to provide notice of the impact of design delays and to establish the dollar value of such impact – or be foreclosed from raising adjustment claims at a later date.

The "lateness" of design also could come in the form of owner-directed changes. In that case, the contract documents may authorize the owner to make such changes, and may even put the burden on the contractors to justify any additional compensation.

Owner-directed changes

Project schedule provisions

Time is of the essence

Liquidated damages

Limitations on liquidated damages

Notice provisions

Limitation on consequential damages

CONSTRUCTION DELAYS

The contract between the owner and GC may include liquidated damages provisions (per-day amounts) to compensate the owner if a project is delayed. But even if delays are overcome and the GC can avoid the imposition of liquidated damages, delays still are costly.

Common delay costs include: additional field and home office overhead; decreased productivity while trying to make up lost time; and inefficiencies due to performing work out of sequence, to name just a few. Claims for delay costs can be difficult to prove and recover, so the risk of construction delays is typically borne by all parties involved.

Project substantial completion date

Milestone payment schedule/lien waiver requirements

Time is of the essence

Liquidated damages

Owner suspension/ no damages for delay provision

Schedules for owner-provided materials

Protection of work



COMMON RISKS	HOW RISK IS TYPICALLY APPORTIONED	COMMONLY IMPLICATED PROVISIONS THAT YOU SHOULD UNDERSTAND
<p>COST OVERRUNS DUE TO MATERIAL COST INCREASES</p>	<p>In this economic environment, owners may prefer the predictability and incentives associated with a fixed-price (lump-sum) contract over a cost-reimbursable arrangement, even when contractors can offer a better price on a cost-reimbursable basis. In a fixed-price contract between the owner and GC, the GC typically bears the risk of increased material costs. (The GC may, in turn, try to pass this risk on to its subcontractors.)</p>	<p>Pricing provisions (fixed-price or cost-reimbursable)</p> <p>Unit rate items</p> <p>Owner-directed changes</p> <p>Change order/notice provisions</p>
<p>COST OVERRUNS DUE TO INACCURATE QUANTITY TAKE-OFFS</p>	<p>In the current economic environment, owners may prefer to pass any risk of quantity growth on to the GC, even when an owner provides design criteria for the project. If a GC provides the design based on the owner's design criteria, then it may be responsible for quantity growth, even if the contract documents incorporate quantity estimates as part of the project scope. (Different courts treat this issue differently.)</p> <p>Pricing provisions should fairly limit the risk of quantity growth to that which the contractors can reasonably assess and control.</p>	<p>Pricing provisions</p> <p>Unit rate items</p> <p>Owner-directed changes</p> <p>Change order/notice provisions</p>
<p>FAILURE OF PROJECT TO REACH REVENUE PROJECTIONS/ EQUIPMENT DOES NOT PERFORM AS EXPECTED</p>	<p>Typically, it is the responsibility of the owner, GCs, and major equipment contractors (if any), to take a properly completed project and generate revenue. However, it is up to the GCs and major equipment contractors (if any) to build a project that is capable of performing to the expectations of the owner, as defined in the contract documents. (Performance guarantees are a way to allocate the portion of this risk within the contractors' control, particularly the contractors performing the guaranteed work.)</p> <p>Difficulty arises when performance does not all fall under the same "umbrella" (e.g., a different designer, constructor, major equipment contractor) and the various contractors blame each other for a project's failure to achieve the required output.</p> <p>It is important that the contract documents clearly define which contractors are responsible for the various work items that will be necessary to reach the required performance levels, and that performance is defined with reference to each contractor's scope of work.</p>	<p>Performance guarantees</p> <p>Liquidated damages</p> <p>Limitation on damages/consequential damages</p> <p>Owner's or GC's inspection rights before equipment is delivered</p> <p>Flow-down provisions incorporating warranties (performance, fitness for purpose, conformance with specifications, laws, codes, and regulations)</p> <p>Detail design responsibility</p> <p>Back charges and owner rights to remedy defective work</p>

COMMON RISKS

**UNEXPECTED,
SIGNIFICANT
INCREASE**
IN OPERATION &
MAINTENANCE COSTS

HOW RISK IS TYPICALLY APPORTIONED

Consider the owner nightmare described in this article. If a project's viability changes dramatically for the worse before many of the construction costs have been incurred, the owner may decide to cancel the project rather than go forward. Termination for convenience provisions move some of this risk of cancellation from the owner to all of the contractors by allowing the owner to terminate the contract irrespective of the contractors' performance.

Moreover, the owner may decide to travel under a termination for cause provision if "cause" is defined broadly. Worse yet, termination provisions can require contractors to help mitigate costs or cancel orders when a project is canceled.

COMMONLY IMPLICATED PROVISIONS THAT YOU SHOULD UNDERSTAND

Termination for cause
Termination for convenience
Termination fees (demobilization and other costs)
Flow-down
Pay-when-paid/pay-if-paid

OWNER DEFAULT/ BANKRUPTCY

If an owner becomes insolvent and a project is not completed and paid for, obviously the contractors' first concern is getting paid for the work performed and costs incurred. But, there are additional risks.

The GC may be faced with provisions that arguably compel it to continue working, store or protect work completed, or continue to pay its subcontractors without any assurance that it will be paid. However, GCs and subcontractors do have the right to request assurance of payment before continuing work, even if they are contractually required to do that work.

Security instruments
Pay-when-paid/pay-if-paid
Passage of title (title passes for materials and equipment as they are paid for, not as they are delivered, invoiced, installed, or accepted)
Default/assurance of payment

CONTRACTOR DEFAULT/ BANKRUPTCY

Often, the owner bears the risk that the GC or the major equipment contractors will be unable to complete the project, and the GC bears the risk that the subcontractors will be unable to perform.

These risks are mitigated in a number of ways, including: the requirement that GCs, major equipment contractors, and subcontractors provide some form of security; assignment provisions that enable the owner to "step into the shoes" of the GC and demand performance from subcontractors; retainage provisions that allow the owner to hold back a portion of payments until work is complete; and provisions that transfer title of equipment and materials as they are paid for (so title is not left with the bankrupt entity).

Security provisions (bonds, letters of credit, parental guarantees)
Retainage
Assignment clauses (permit the owner to "step into the shoes" of the GC)
Passage of title (title passes for materials and equipment as they are paid for)



COMMON RISKS

CHANGES IN PROJECT SCOPE

HOW RISK IS TYPICALLY APPORTIONED

Changes can make up a considerable portion of any contractor's compensation. Change orders can come in the form of owner-directed changes because the design was incorrect, incomplete, or improved through the construction process, or because the owner decides it's beneficial to add to or delete from the scope of the project.

In any of these situations, the contract documents likely will include a detailed change order process that may require any contractors seeking a change order to establish entitlement to additional time or compensation or to perform the work before the formal change order process is complete. Ensure that the change order provisions are clear, logical, and fair.

COMMONLY IMPLICATED PROVISIONS THAT YOU SHOULD UNDERSTAND

- Owner-directed changes
- Contractor-recommended changes
- Notices
- Dispute resolution procedures

SITE CONDITIONS (SOIL)

Who is responsible for all of those rocks that had to be removed from the site? In many instances, the GC will be expected to become informed of the site conditions before it bids on a project. A civil subcontractor may take on this risk for the GC, intentionally or not.

Insist on the right for price adjustments if conditions that were not reasonably expected are encountered.

- Differing site conditions
- Changed-site conditions

CLAIMS OF INTELLECTUAL PROPERTY INFRINGEMENT

This is an issue that typically affects major equipment contractors. Suppliers of component parts should be careful not to indemnify any more than the component parts they are providing.

- Indemnity





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