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Audit Provisions in Private Construction Contracts: Which Costs Are Subject to Audit, Who Bears the Expense of the Audit, and Who Has the Burden of Proof on Audit Claims?

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I. Introduction

Audit provisions are often included in private construction contracts where all or some portion of the work is performed on a cost reimbursable plus a fee basis. In those situations, the Owner wants the right to audit the books and records of the Contractor to ensure that it reimburses only those costs that are properly compensable under the terms of the contract. The Contractor, however, is typically unwilling to grant the Owner audit rights with respect to any portion of the work that is compensable on a basis other than cost, such as unit prices, lump sum prices, agreed general conditions, supervisory labor and equipment rates, and fixed contractor's fee. While an agreement allowing a forensic audit of certain elements of costs but excluding "agreed prices or rates" from the ambit of the audit has a certain logical appeal, it presents difficult and challenging issues when the parties become involved in arbitration or litigation.

This article focuses on some of the legal and practical issues raised by forensic audits of private construction contracts. First, this article addresses the scope of the audit, provides a general overview of the construction audit and discusses the elements of cost that may present issues in the context of a construction audit. Second, the article explores the difficult and related issue of discoverability of documents and records that were expressly excluded from audit under the terms of the construction contract, and whether such contractual limitations on disclosure will be enforced by courts and arbitrators. Third, this article discusses the costs associated with conducting a forensic audit, and the

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ways in which the recovery of those costs can be addressed in litigation or arbitration. Fourth, the article focuses on the burden of proof in arbitration or litigation over the legitimacy of charges an Owner has previously reviewed, approved, and paid, but wishes later to challenge as not due under the contract. The article concludes by offering practical considerations concerning audit provisions in private construction contracts.

II. General Overview of Contracting Methods Utilizing Audit Provisions and Review of Audit Provisions

Audit provisions are commonly contained in construction contracts with cost reimbursable elements, whether or not subject to a Guaranteed Maximum Price (“GMP”).¹ Typically, the Owner has a broad right to audit the Contractor’s reimbursable costs, but not the documents and records reflecting or supporting its “Fixed” charges.² The Owner generally has a right to “reconcile,” or verify, the number of units installed, the number of hours worked, and the other quantities or units attendant to the “Fixed” components, but not the underlying documents and records supporting the Contractor’s actual costs incurred for the performance of that work. The cost reimbursable contract with agreed price or rate components presents significant challenges in terms of defining the bounds of a forensic “audit.” In such cases, it is incumbent upon the parties to accurately define and clearly set forth expectations of the “audit” from the outset.

A. Defining the Audit and its Scope

The term “audit” as used in construction contracts is often loosely defined and can be subject to broad variations in interpretation. As the accountants say, a construction audit is

¹*See, e.g.*, AIA Document A102-2007, Standard Form of Agreement Between Owner and Contractor where the basis of payment is the Cost of the Work Plus a Fee with a Guaranteed Maximum Price, Article 11, §§ 12.2.2 – 12.2.3.

²For purposes of this article, the term “Fixed” will be used to mean to any prices or rates that are agreed to between the Owner and the Contractor in the contract, including but not limited to general conditions rates; field, home office, or other overhead contribution based upon a fixed sum over a time duration; lump sum prices; agreed labor, equipment, material, or other rates; established unit prices, and Contractor’s fee or margin. “Reimbursable Costs,” as used in this article, means those costs that the Owner has agreed to reimburse based upon the prices actually paid by the Contractor rather than an agreed price or rate basis.

not a “capital A audit.”³ The contract will typically define the costs, in general terms, which are subject to audit, and limitations (if any), but it is rare to see a contract that goes so far as to set forth the parties’ definition of the term “audit.” Without a mutual understanding of the term, the parties are certain to disagree at the completion of the project as to the scope and breadth of any post-completion audit. For example, the Contractor is likely to view a post-completion audit as merely a reconciliation of its billings to the Owner throughout the project, but not a new opportunity for the Owner to question whether certain costs already billed and paid under the contract were properly categorized and permissible in the first place. On the contrary, an Owner which has incurred large losses on the project may attempt to use the audit as a chance to make a detailed review of the Contractor’s accounting records, including an opportunity to question whether the contract permitted certain costs, and at minimum, seek out overbillings and errors that can be exploited in the Owner’s favor. Where audit provisions in cost reimbursable contracts contain Fixed components that are excluded from a forensic audit, the parties often struggle with the audit and its scope when they wind up in litigation or arbitration.

To provide context for this discussion, below are two examples of audit provisions that contain restrictions on the types of costs available for forensic audit:

Example 1—Audit Provision for Cost Reimbursable Contract Containing Unit Rates:

In the event of a claim under this Contract based upon actual cost, Contractor shall grant audit rights to Owner and its designees with respect to all relevant documentation pertaining to such claim, with the exception of any costs, percentages or unit rates mutually agreed upon in advance.

Example 2—Audit Provision for Cost Reimbursable Contract Containing Lump Sum Component:

Contractor shall keep and maintain full, complete and detailed records of all of its costs. Contractor authorizes Owner and independent third parties designated by Owner to inspect and audit, during business hours and after 24-hour notice, of all such records relating to Reimbursable Costs, Scope Changes and Excusable

³Accountants typically use the term “capital A audit” to refer to the audit of the financial statements of public, private, or not-for-profit companies. Because construction audits are creatures of contract and are not conducted for the protection of the public, investors, or similar stakeholders, forensic audits of construction projects are generally not strictly subject to rules and guidelines of organizations such as the American Institute of Certified Public Accountants or Financial Accounting Standards Board.

Events and any other matter. Such records, books and accounts shall be preserved by Contractor for a period of three (3) years after the Final Completion Date. The internal composition of any lump sum, fixed rate or percentage mark-up on Contractor's approved rate sheet is not subject to audit.

Notably, both examples simply refer to the term "audit" without any attempt to define the parties' understanding of what an audit entails. Moreover, records subject to and excluded from audit are described in general categories, without much explanation. As discussed below, lines can easily blur between categories of costs subject to audit.

A well-drafted audit provision also defines the accounting and project-related records that the Contractor is required to generate, retain, and provide to the Owner. On a positive note, a study of U.S. construction companies found that many owners insist that the audit clause provision define the contractor's record keeping and reporting requirements; the same interviewees pointed out that without such a contractual requirement, it is incredibly difficult to obtain the proper records from the Contractor in order to conduct a proper audit.⁴ A detailed list or examples of types of project related records that the Owner expects the Contractor to maintain should be set forth in detail within the audit provision of the contract. Additionally, "Owners should require the contractor to have adequate internal controls as a contract stipulation to provide assurance that financial management is effective and that change orders and claimed costs are reliable and supported."⁵

Of course, the detail of an audit and record-keeping provision must be agreed in advance and its requirements must be integrated into the Contractor's accounting and project management systems. If the parties undertake the effort to adequately draft a detailed provision, they must establish and maintain a document protocol that conforms with the contractual provision as a basis for monthly or periodic submittals in order to minimize disputes over the nature and extent of records that the Contractor must generate, retain, and provide to the Owner during the project.

⁴James D. Cashall, George R. Aldhizer, III, & Rick Eichman, *Construction Contract Auditing*, Internal Auditor at 1 (February 1, 1999).

⁵Allen L. Overcash & Jack W. Harris, *Measuring the Contractor's Damages by "Actual Costs" — Can It Be Done?*, 25:1 *The Constr. Law* 31, 37 (Winter 2005).

B. Categories of Costs and Some Typical Issues Presented in the Context of a Post-Project Forensic Audit

In general, audit provisions should set out the specific costs that are subject to audit, and the specific limitations, if any, on auditable costs. In the end, general limitations, such as that “the internal composition of any fixed rate” or “agreed percentages or unit rates” are not subject to audit, may lead to disputes that could be alleviated through more precise contract drafting. Setting forth specific categories of costs subject to audit and not subject to audit in the contract may limit the scope of challenges that may arise in arbitration or litigation.

As an example, consider an audit provision as it relates to labor costs. In a cost reimbursable setting, actual labor costs (wages, fringes, and insurance) incurred by the Contractor for craft labor are typically subject to a fairly straight-forward labor cost audit with certified payroll and/or other appropriate documents.⁶ However, the parties often agree to rates for straight time and premium time for supervisory personnel, and agreed rates are typically not subject to audit. Working foremen or other working supervisory personnel who perform some labor tasks may also complicate the audit issues, as can personnel who split time between the home office and site office. Similarly, the parties may agree to time and materials rates for changed work. The audit provision should be drafted as specifically as possible.

Equipment is another category of costs that can become hotly contested in the audit context if the parties do not specifically spell out which equipment costs are considered “reimbursable” under the contract.⁷ Although rental equipment may be treated as a reimbursable cost subject to audit, parties often agree to rates for owned equipment. In addition, it is not uncommon for contractors to be paid for smaller items that could potentially be defined as “equipment” through a “small tools” allowance or other

⁶The audit of craft labor is typically just a reconciliation of the craft labor billings to the craft labor payments, and a reconciliation of billings to the actual craft labor hours on the certified payroll multiplied by the applicable labor rates, fringes, and insurances. It should be a relatively straight-forward verification of billings versus payments. However, an Owner may also want to go behind the certified payroll and test certified payroll against gate logs, badge tags, or other site access data. It may want to verify that fringes, union benefits, or applicable insurances were actually paid.

⁷The “audit” of rental equipment is typically just a reconciliation of the invoices received from third-party vendors against the amounts invoiced by the Contractor and paid by the Owner which should be a relatively straight forward verification of billings and payments.

agreed rate or agreed mark-up to craft labor. These minor “equipment” costs are precisely the type of costs that that owners might attempt to analyze and challenge as non-compensable under the contract in a post-completion audit. Other potential categories of costs that can become contested in the post-completion forensic audit include:

- Charges from Third-Parties, such as outside vendors, subcontractors, and material suppliers;
- Change Orders based on Contractor cost;
- Fixed components, such as General Conditions Costs, Contractor’s Fee, Unit Prices, Lump Sum Prices, Overhead recovery, or Mark-up percentages on Change Orders, Subcontractors, or other Third-Party Costs.

This latter category may seem counterintuitive given the usual limits on auditing Fixed items, but may very well be raised by an Owner determined to fight over all of a Contractor’s charges, and either expecting formal dispute resolution proceedings where it can demand broader discovery, or prepared to assert fraud claims, argue the unenforceability of any limitations, or in some other way try to enlarge its contractor’s disclosure obligations.

These examples illustrate the importance of careful definition of the parameters of the audit, and specific description of the elements of cost that are subject to audit, and those excluded from audit.⁸ The following two sections describe consequences of the failure to adequately and specifically define the audit rights in the contract, first in terms of the discovery disputes that the tribunal⁹ may face, and then in terms of the costs and implications of a post-construction forensic audit.

III. The Discoverability of Documents and Records Excluded from Audit Under the Terms of the Construction Contract

If the parameters of discovery are not agreed in the contract,

⁸A useful description of the construction audit process appears in John A. Becka, Shannon J. Briglin, & Colin A. Daigle, *Navigating a Construction Contract Audit: Standards, Rights, and Obligations*, in Patrick A. McGeehin, Edward G. Benes, Patrick J. Greene, Jr., & Wm. Cary Wright, Eds., *Construction Accounting 75* (ABA 2010). A well-crafted audit provision should provide parties and the tribunal with guidance as to the permissible scope of the audit, and define the scope of records that are subject to audit.

⁹As used in this article, “tribunal” is intended to encompass a single arbitrator, a panel of arbitrators, a discovery master, judge, or other person or entity charged with authority for resolving the discovery dispute or the entirety of the dispute.

the process of agreeing to the limits of discovery once a dispute arises can become very difficult. Courts and arbitrators normally hold case management conferences early in the proceeding to establish the schedule for the case and the scope and timing of discovery. At that point, however, neither the judge nor arbitrators may fully understand the breadth of the dispute or the type or amount of discovery that may be needed in the case. Parties often disagree on the appropriate scope of discovery and seek resolution from the tribunal, which will generally establish a discovery regime based upon the standards generally governing discovery in that tribunal, and its knowledge of the dispute at that point.

When the parties define the parameters of discovery within a contract, logic dictates that discovery should follow the prescribed protocol¹⁰ and be more cost effective and streamlined. Unfortunately, however, agreed limits on discovery are often subject to challenges disputing the enforceability of a provision limiting discovery, to arguments over construction of the contractual limitation, or to attempts to use documents for purposes not expressly prohibited by the limitation. Even without a contractual provision regarding discovery, and depending on the forum, the documents available in discovery may not be the same universe of documents routinely contemplated by the parties' audit provision. The critical inquiry presented here is how courts and arbitrators balance the need for or right to discovery — whether those rights are contractually established or granted by a tribunal's procedural rules — against the parties' pre-dispute agreement on the scope of permissible disclosures.

Discovery can become very contentious in the face of a provision that permits the audit of reimbursable costs but expressly precludes the audit of documentation of other types of costs, including Fixed costs or agreed prices. During the contract negotiation and formation stages, the contracting parties may, among themselves, have a clear understanding of the intended limitations on disclosures. However, when a dispute arises several years later, the argument will likely be made that the written guidance offered by the contract is not clear, and the extent of discovery permitted is not prescribed by the terms of the contract. Alternatively, the argument will be made that the information is being requested for a purpose other than an audit, and therefore the scope of discovery is determined by the rules of the

¹⁰See W. A. Moseley, *What Do You Mean I Can't Get That? Discovery in Arbitration Proceedings*, 26:4 *The Constr. Law.* 18, 22 (Fall 2006).

forum, without regard to any contractual limitation. While discovery is generally more formalized in court, and more discretionary and narrower in arbitration,¹¹ the production through discovery of records of costs excluded from review or audit by the contract will dramatically increase the scope and cost of discovery before any tribunal, and has potential to redefine the dispute resolution process agreed among the parties.

For the purposes of this discussion, assume that the contract at issue includes a broad arbitration clause and invokes the procedural rules of the governing arbitral organization. Further assume that the contract provides audit rights to the Owner with respect to reimbursable costs, but expressly prohibits the Owner from reviewing Fixed price elements.

In this scenario, once a case proceeds to arbitration, the Owner will often seek *all* cost records, including the records supporting all Fixed components, typically claiming that the audit provision is not enforceable or that the discovery requested is not prohibited by the terms of the contract. If the Owner is unsuccessful on that argument, it may argue a slight variation — that even if it cannot audit the records supporting the Contractor’s Fixed components, it is entitled to review those records within the normal bounds of relevant discovery in support of its other, “non-audit” claims.

This hypothetical presents a multitude of complex queries for the arbitrator, such as:

- Is a contractual provision on audit rights the equivalent of an agreement on the scope of post-dispute discovery?
- Is a contractual limitation on discovery contained in a construction contract enforceable?
- Should the choice of forum (arbitration or litigation) affect the enforceability of a contractual limitation on discovery?
- May the Owner broaden its rights under an otherwise enforceable audit limitation by recharacterizing its claims or seeking judicial intervention?

Discussion points, perspectives, and practical considerations on each of these questions are presented below.

A. Is a Contractual Audit Provision Equivalent to an Agreement on Scope of Discovery?

At first glance, the answer seems straightforward: parties are

¹¹See, e.g., Joseph L. Forstadt, *Discovery in Arbitration*, in *ADR & The Law* at 52 (20th ed., 2006) (“One of the primary ways in which arbitration is less costly, both in terms of time and money, is that it normally has less extensive discovery than traditional litigation.”).

free to limit discovery by contract or agreement, and such agreements should be honored by arbitrators and courts alike. While this is true, especially in the case of arbitration, the answer is not as clear cut when a party asserts that its “discovery rights” are separate and distinct from its “audit rights.” The critical inquiry is whether the prohibition on an Owner’s right to “audit” certain cost records also precludes the Owner from reviewing those records in the course of discovery.

It is axiomatic that if the Owner is permitted to review certain cost records in “discovery” that the contract prohibits it from auditing then the limitations set forth in the audit provision are virtually meaningless. Further, it would defeat the goal of the parties in drafting the audit provision, which was to preclude the Owner from reviewing the overhead and profit recovered on Fixed cost items, and might engender otherwise unnecessary demands for arbitration intended simply to expand the Owner’s audit rights. In addition, contractors typically argue that discovery costs will quickly multiply if the Owner is permitted to review the Contractor’s Fixed cost records that were not contemplated for audit under the contract, and that the role of the court or the arbitrators is to enforce the contract as written, including any agreed limitations on the scope of discovery.¹² On the other hand, if the Owner can establish that the Fixed cost documents are relevant to its “non-audit” claims, the judge or arbitrator may be forced to balance the need for the information sought with the parties’ intent as manifest in the written limitation on audit rights.

To make this distinction, the Owner could argue that by definition, an audit would involve a formal review of the Contractor’s accounts and records that would be analyzed and scrutinized by an accounting expert and likely memorialized in an expert report.¹³ Arguably, discovery of the same documents but without the expert analysis and resulting “audit” report would not offend the letter of the agreement. From the Contractor’s perspective,

¹²This issue can become very problematic for a Contractor, particularly one whose project cost reporting is structured to provide detailed information to the Owner on reimbursable costs, but is kept more generally for Fixed components because there is no contractual obligation to track Fixed costs in any particular manner. Consequently, the level of detail accumulated in the project job costs accounting system may be significantly different for reimbursable costs (usually dictated by the requirements of the Owner as set forth in the contract documents) and Fixed components (which the contractor tracks for its own internal purposes).

¹³In the broadest of terms, an audit is a review of a contractor’s accounting records to ensure proper payments are being made under the contract. *See*

the Owner's review in discovery of records that were contractually protected from audit would be exactly the same.

B. Is a Contractual Limitation on Discovery Contained in a Construction Contract Enforceable?

The law permits parties to regulate not merely their commercial relations, but also the procedures by which disputes over those relations will be resolved.¹⁴ On this issue, the United States Supreme Court's combined holdings in *Mitsubishi Motors* and *Volt Info. Scis.* are instructive.¹⁵ The Court has explained that, "the liberal federal policy favoring arbitration agreements' . . . is at bottom a policy guaranteeing the enforcement of private contractual agreements."¹⁶ Assuming equal bargaining power between the parties, and absent any fraud, duress, and coercion in the creation of the contract, courts should enforce any contract stipulations regarding discovery in favor of the policy of enforcing arbitration agreements as written.¹⁷

While, in practice, such an approach is more commonly accepted in arbitration, several commentators have gone so far as to suggest not only that courts should give full force to the terms set forth in parties' arbitration agreements, but also that the procedural rules of court should be treated as mere default rules from which the parties can mutually negotiate deviations, as is the case in arbitration.¹⁸ "Unlike rules of civil procedure, which function largely like mandatory rules (around which parties cannot contract), most arbitral rules function like default rules (gen-

Steven Yoch, Trust but Verify "Right-to-Audit" Provisions, 2:4 FCA Contract Insight 1-2 (Nov. 2008).

¹⁴Peter B. Rutledge & Christopher R. Drahozal, *Contract and Procedure*, 94 Marq. Law Rev. 1103 (2011). The authors refer to such contracts as "procedural contracts." Rutledge and Drahozal focus on the bargaining over procedural rights even before a dispute arises, "a form of bargaining catalyzed by the judicial acceptance of arbitration over the last several decades." 94 Marq. Law Rev. at 1105-1106.

¹⁵*Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University*, 489 U.S. 468, 109 S. Ct. 1248, 103 L. Ed. 2d 488, 51 Ed. Law Rep. 725 (1989); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 105 S. Ct. 3346, 87 L. Ed. 2d 444, 1985-2 Trade Cas. (CCH) ¶ 66669 (1985).

¹⁶*Mitsubishi Motors*, 473 U.S. at 625.

¹⁷See *Volt*, 489 U.S. at 469.

¹⁸Michael L. Moffitt, *Customized Litigation: The Case for Making Civil Procedure Negotiable*, 75 Geo. Wash. L. Rev. 461 (2007)

erally subject only to the mandatory rules of the arbitral forum).”¹⁹ Others would argue that although the United States Supreme Court has validated the parties’ right to limit the issues they will arbitrate, as well as to specify by contract the rules under which an arbitration may be conducted, such agreements cannot supersede *a court’s* rules of procedure.²⁰

It is widely recognized that in arbitration, the scope of permissible discovery depends on what the parties have agreed to, which arbitration rules apply and, if necessary, the arbitrator’s discretion.²¹ It is clear that provisions in the parties’ pre-dispute agreement are expected to be applied with full force in the arbitral setting.²²

While many practitioners, and certainly clients, view it as advantageous to place meaningful limits on discovery and other aspects of any ensuing arbitration in the underlying contract, and most arbitrators are likely to honor such agreed-upon limitation, some practitioners caution against setting the bounds of discovery at the contract formation stage. Potential drawbacks exist where the party drafting such a contract clause is setting forth the timing and discovery rules for a dispute that has not yet arisen, as it is entirely possible that the dispute that ultimately emerges might better lend itself to a very different approach with respect to timing and discovery.²³ On the other hand, it makes sense to include discovery and timing limitations in the contract under circumstances where the contracting parties have

¹⁹Rutledge & Drahozal, *supra* note 14, at 1114; *see, e.g.*, AAA Commercial Arbitration Rule R-1(a): “The parties, by written agreement, may vary the procedures set forth in these rules.”

²⁰*See Volt*, 489 U.S. at 469.

²¹J.S. Christie, Jr., *Preparing for and Prevailing at an Arbitration Hearing*, 32 Am. J. Trial Advoc. 265, 292 (Fall 2008). Christie further observes that, an advantage to an agreed upon discovery protocol “is that the arbitrator’s role should be to implement whatever the parties agree upon, only ruling when there is not agreement. Some arbitrators, however, see their role as promoting arbitration by reducing the cost of arbitration. An attorney might need to be prepared to persuade a reluctant arbitrator to use the parties’ agreed upon discovery order.”

²²32 Am. J. Trial Advoc. at 265 (“In arbitration, discovery not provided for in the arbitration agreement or the applicable arbitration rules is subject to objection and must pass muster with the arbitrators, who are supposed to be sensitive to the cost and burdensomeness of discovery.”). *See also* John C. Gardner, Lea H. Kuck & Julie Bedard, *Discovery*, in James H. Carter & John Fellas, *International Commercial Arbitration in New York* at 271–72 (2010).

²³*See* Dwight Golann, *Mediating Legal Disputes: Effective Strategies for Neutrals and Advocates* (ABA Section of Dispute Resolution 2008).

a good idea as to the size and complexity of any dispute that might arise from the project at hand.²⁴

Appropriate provisions to consider including at contract formation are as follows:

- **General scope of document discovery.** It is often advisable for the parties to state what the general scope of document discovery in any ensuing arbitration is going to be. One suggested standard is that the information sought is *reasonably available and is material to an important disputed issue affecting the outcome of the case.*²⁵ Other examples of provisions designed to generally limit discovery include “documents directly relevant to one or more of the issues,” “documents needed for fair resolution of an issue of importance,” “necessary documents that can be located and produced at a cost that is reasonable in the context of all surrounding facts and circumstances,” or “documents for which there is a direct, substantial, and demonstrable need.” In contrast to the standards embedded in procedural rules of the arbitral institution, clear and concise agreed touchstones provide practical, objective guidelines to enable arbitrators effectively control discovery.²⁶
- **Scope and manner of electronic discovery.** Depending on the project, it often makes sense to address electronic discovery and production in the contract. Once litigation is underway, electronic discovery disputes can become quite contentious and expensive. The parties may consider including a general pre-dispute statement with respect to electronic discovery, such as “electronic document production shall generally be limited to those documents located in sources that are used in the ordinary course of business and will normally not include backup tapes, erased, damaged or fragmented data, archived data, or data normally deleted in

²⁴See generally Dwight Golann, *Mediating Legal Disputes: Effective Strategies for Neutrals and Advocates* (ABA Section of Dispute Resolution 2008).

²⁵See Albert Bates, Jr., *Arbitration in a Global Economy: Managing information Exchange to Expedite International Commercial Arbitration Hearings* (Yorkhill Law Publishing 2005) at 8–9 (available at <http://apps.americanbar.org>).

²⁶See Albert Bates, Jr., *Arbitration in a Global Economy: Managing information Exchange to Expedite International Commercial Arbitration Hearings* (Yorkhill Law Publishing 2005) at 8–9 (available at <http://apps.americanbar.org>).

the ordinary course of business.”²⁷ In an arbitration, the parties may want to adopt institutional guidelines that specifically address electronic discovery. For example, the International Centre for Dispute Resolution published the “ICDR Guidelines for Arbitrators Concerning Exchanges of Information” in 2008. While these guidelines address various discovery issues, the limitation on electronic discovery is as follows:

When documents to be exchanged are maintained in electronic form, the party in possession of such documents may make them available in the form (which may be paper copies) most convenient and economical for it, unless the Tribunal determines, on application and for good cause, that there is a compelling need for access to the documents in a different form. Requests for documents maintained in electronic form should be narrowly focused and structured to make searching for them as economical as possible. The Tribunal may direct testing or other means of focusing and limiting any search.²⁸

Other organizations also have guidelines or protocols that can be expressly adopted by the parties in the disputes provision of the construction contract.²⁹ Such guidelines can be very effective in limiting discovery, while ensuring that the parties have the information that is necessary to fully and fairly present their case. The availability of cost-shifting

²⁷See, e.g., guidelines set forth by the Chartered Institute of Arbitrators’ Protocol for E-Discovery in Arbitration at 4 (available at <http://www.ciarb.org/information-and-resources/E-disclosure>). The New York State Bar Association and the Chartered Institute of Arbitrators suggest other detailed examples of early language that might be used to put meaningful limits on electronic discovery in appropriate circumstances, such as: “electronic documents shall normally be furnished on the basis of generally available technology in a searchable format that is usable by the party receiving it and convenient and economical for the producing party,” and “when the cost and burden of e-discovery are disproportionate to the likely importance of the requested materials, the arbitrator may deny the requests or require that the requesting party advance the reasonable cost of production to the other side.”

²⁸ICDR Guidelines for Arbitrators Concerning Exchanges of Information (available at http://www.adr.org/aaa/ShowPDF?doc=ADRSTG_002579)

²⁹See, e.g., Protocol for E-Disclosure in Arbitration, Chartered Institute of Arbitrators (available at <http://www.ciarb.org/information-and-resources/E-Disclosure%20in%20Arbitration.pdf>); CPR Protocol on Disclosure of Documents and Presentation of Witnesses in Commercial Arbitration, International Institute for Conflict Prevention & Resolution (available at <http://www.cpradr.org/Portals/0/Resources/ADR%20Tools/Clauses%20&%20Rules/CPR%20Protocol%20on%20Disclosure%20of%20Documents%20and%20Witnesses.pdf>).

often affects parties' approach to electronic discovery as well.³⁰

- **Economical Litigation Agreements (“ELA’s”):** Another alternative that has been developed over the past decade is an ELA, colloquially known as a “litigation pre-nup.”³¹ A means of containing civil litigation costs, ELA is a hybrid of civil litigation and arbitration, whereby parties agree to use standard, limited-scope discovery procedures in lieu of conventional discovery afforded by state or federal procedural rules. Ideally, companies would incorporate a model agreement into contracts with partners, suppliers and customers at the start of a business relationship. The growing use of ELA’s is evidence that many large and sophisticated corporations have faith that the courts will enforce pre-dispute contractual limitations on the scope of discovery.³²

C. Should the Forum Affect the Enforceability of a Contractual Limitation on Discovery?

As discussed above, there are clear differences between the procedural rules of courts and arbitrations, especially when it comes to the permissible scope of discovery. Many assume that discovery in arbitration is sure to be a less expensive and more streamlined process than would have occurred in a traditional court proceeding;³³ however, the recent trend toward arbitration of larger and larger commercial cases has led to a number of expensive elements that have traditionally been reserved for “big

³⁰See Holly E. Svetz, *Electronic Discovery: Cost-Shifting Calls for Earlier Discovery Planning*, 23:3 The Constr. Law. 9 (Summer 2003).

³¹See *Economical Litigation Agreement Unveiled by Duane Morris’ Daniel Winslow and CPR Institute*, Press Release, April 19, 2010 (available at <http://www.cpradr.org/Resources/ALLCPRArticles/tabid/265/ID/584/CPR-Pilot-Economic-Litigation-Agreement-Unveiled-April-19-Web.aspx>).

³²The “Model Litigation Pre-nup” is available on the CPR website at <http://www.cpradr.org/Resources/ALLCPRArticles/tabid/265/ArticleType/ArticleView/ArticleID/637/Default.aspx>.

³³Indeed, in *Hall Street* the Supreme Court itself called arbitration’s “essential virtue” its potential for “resolving disputes straightaway.” *Hall Street Associates, L.L.C. v. Mattel, Inc.*, 552 U.S. 576, 588, 128 S. Ct. 1396, 170 L. Ed. 2d 254, 2008 A.M.C. 1058 (2008). See also *Robbins v. Day*, 954 F.2d 679, 685, Fed. Sec. L. Rep. (CCH) P 96523 (11th Cir. 1992) (disapproved of on other grounds by, *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 115 S. Ct. 1920, 131 L. Ed. 2d 985, Fed. Sec. L. Rep. (CCH) P 98728 (1995)) (“[T]he basic policy of conducting arbitration is to offer a means of deciding disputes expeditiously and at lower costs.”); John B. McArthur, *Do Arbitrators Know Something that Judges Don’t?* 94 *Judicature* 107, 108 (Nov.-Dec. 2010) (“Speed and economy are the hallmarks of this alternative dispute-resolution system.”).

case” litigation.³⁴ Even in an arbitration with agreed upon limitations on discovery, parties should not be quick to assume that discovery will be cheap or quick. As one commentator has observed, “it is certainly not uncommon today to hear arbitration criticized as if it, too, is becoming slower, more expensive and more like litigation.”³⁵ As discussed in more detail below, once the discovery floodgates open, from a practical perspective, there is often little difference between judicial and arbitral proceedings.

The differences between the procedural rules applicable to a federal court action and arbitration are vast. First and foremost, the discovery rules applicable in court proceedings do not apply. Indeed, the International Institute for Conflict Prevention and Resolution’s (“CPR”) rules admonish that arbitration “is not for the litigator who will ‘leave no stone unturned,’ ” and state expressly that, “unlimited discovery is incompatible with the goals of efficiency and economy. The Federal Rules of Civil Procedure are not applicable.”³⁶ While the parties may agree that the Federal Rules of Civil Procedure will apply in their arbitration, doing so would be

By way of comparison, under the Federal Rules of Civil Procedure, all information “regarding any non-privileged matter that is relevant to any party’s claim or defense” is presumptively

³⁴“Arbitration proceedings are now often preceded by extensive discovery, including requests for voluminous document production and depositions . . . Although many arbitrators and some arbitration rules aim to hold the line on excessive discovery, it is not unusual for legal advocates to agree to litigation-like procedures for discovery, even to the extent of employing standard procedural rules.” Thomas J. Stipanowich, Ed., *The College of Commercial Arbitrators Protocols for Expeditious, Cost-Effective Commercial Arbitration* at 6 (2010).

³⁵McArthur, *supra* note 33, at 110 (“Judges have the power to do more.”).

³⁶CPR Rules For Non-Administered Arbitration, Rule 11 cmt. The ICDR Guidelines, *supra* note 28, at 1, state the following:

While arbitration must be a fair process, care must also be taken to prevent the importation of procedural measures and devices from different court systems, which may be considered conducive to fairness within those systems, but which are not appropriate to the conduct of arbitrations in an international context and which are inconsistent with an alternative form of dispute resolution that is simpler, less expensive and more expeditious. One of the factors contributing to complexity, expense and delay in recent years has been the migration from court systems into arbitration of procedural devices that allow one party to a court proceeding access to information in the possession of the other, without full consideration of the differences between arbitration and litigation.

The purpose of these guidelines is to make it clear to arbitrators that they have the authority, the responsibility and, in certain jurisdictions, the mandatory duty to manage arbitration proceedings so as to achieve the goal of providing a simpler, less expensive, and more expeditious process.

discoverable.³⁷ Under the Federal Rules of Evidence, which apply to all civil proceedings in the United States courts,³⁸ the critical relevance inquiry is whether the evidence in question has any tendency to make a fact more or less probable than it would be without the evidence, and whether the fact is of consequence in determining the action.³⁹ Many state rules of civil procedure still have the broader standard of discovery of any information “reasonably calculated to lead to the discovery of admissible evidence,” which language was in the federal rules until the 2000 amendments modified Rule 26 to make clear that discovery even of information which may lead to discovery of admissible evidence is limited by relevance requirements.⁴⁰ Simply put, most courts stop at the basic inquiry of whether evidence is relevant or irrelevant under the Federal Rules of Evidence.

In stark contrast to the broad definition provided under the Federal Rules of Evidence, the discovery rules of arbitral institutions are typically much more narrowly defined. For example, under the CPR’s Privacy Dispute Resolution Rules, document discovery is limited to items for “which a party has a substantial, demonstrable need.”⁴¹ Similarly, the American Arbitration Association’s (“AAA”) Commercial Rules provide that an arbitrator “may” require production of documents, and go on to state:

R-31. Evidence

- (a) The parties may offer such evidence as is relevant and material to the dispute and shall produce such evidence **as the arbitrator may deem necessary to an understanding and determination of the dispute. Conformity to legal rules of evidence shall not be necessary.** [. . .]
- ...
- (c) The arbitrator **shall take into account** applicable principles of legal privilege, such as those involving the confidentiality of communications between a lawyer and client.

(emphasis supplied).

Under the rules of JAMS, The Resolution Experts (“JAMS”), arbitrators are encouraged to tell parties that document discovery “should be **limited to documents** which are **directly relevant to significant issues in the case . . .**,” restricted in time frame,

³⁷Fed. R. Civ. P. 26(b)(1).

³⁸Fed. R. Evid. 101.

³⁹Fed. R. Evid. 401.

⁴⁰See, e.g., Cal. Civ. Proc. Code § 2017.010 (2005); Ala. R. Civ. P. 26(b)(1).

⁴¹International Institute for Conflict Prevention & Resolution, Protocol on Discovery of Documents and Presentation of Witnesses § 1(a) (2009).

subject matter, and person, and document requests must not include “broad phraseology such as ‘all documents directly or indirectly related.’ ”⁴²

As reflected by the text of the above rules, it is clear that arbitration rules vest the arbitrator with the authority to actively manage the case and substantially limit discovery, including the authority to strictly enforce all contractual limits on discovery agreed to by the parties. That is not to say that the Federal Rules of Civil Procedure restrict judges from imposing case management techniques and practical limits on discovery commonly used in arbitration. Techniques such as firm discovery and trial deadlines, requests for admission, and narrower expert discovery are all within the purview of state and federal judges and do not run afoul of the applicable rules.⁴³ By way of example, the Federal Rules do give judges broad powers to restrict electronic discovery based on cost, burden and similar factors.⁴⁴

Under the hypothetical posed above, arbitrator and court alike have the authority to enforce the contractual limitation protecting Fixed cost information from discovery, irrespective of whether the production of documents be electronic or paper, and irrespective of whether production is sought for audit or other purposes. Most practitioners would agree, however, that given the distinct nature of each forum, arbitrators are more likely to enforce contractual limitations on discovery than many judges would be, principally because arbitrators derive their powers from the contract, enforce rules which disfavor broad discovery, and frequently deal with limitations of one form or another on the extent of permissible discovery. Arbitration is, at its core, a creature of contract, and any procedures agreed among the parties

⁴²JAMS Recommended Arbitration Discovery Protocols (2010), “Early Attention to Discovery by the Arbitrator” (emphasis supplied). JAMS’ Comprehensive Arbitration Rules, Rule 17(a)(1) requires the parties to “complete an initial exchange of all relevant, non-privileged documents . . .” and is not limited on its face to documents that support a party’s claims or defenses.

⁴³JAMS Recommended Arbitration Discovery Protocols (2010), “Early Attention to Discovery by the Arbitrator.”

⁴⁴JAMS Recommended Arbitration Discovery Protocols (2010), “Early Attention to Discovery by the Arbitrator.” It is undeniable that electronic discovery has increased the cost, burden, and delay of document production in cases between large parties, and in many cases, turned small to medium cases into large cases with large legal fees because of the volume of electronic discovery. While arbitrators typically tend to experiment aggressively with narrowed lists of custodians whose files have to be searched, and enforce key word searches to locate documents, both arbitrators and judges need to do more to contain the costs and impact of electronic discovery on disputes.

for resolving the dispute are part and parcel of their agreement to resolve the dispute in arbitration. Most arbitrators strive to enforce the provisions of the contract, including any contractual limitations on discovery. Further, there is no right to broad discovery in arbitration, and arbitrators have vast discretion in establishing the permissible bounds of discovery on a case by case basis.

D. May the Owner Avoid a Contractual Limitation on Disclosure by Altering or Recharacterizing its Claims, or by Seeking Judicial Intervention?

An Owner whose essential claim is that the Contractor has been overpaid — or who is defending a claim by a Contractor to be paid — may anticipate that its desire for broad discovery will be frustrated by a narrow audit provision in its contract and seek to avoid that frustration by a gambit such as asserting some other kind of claim.

First, it may argue that its “discovery” rights ought to be broader than its “audit” rights. Since obtaining documents in either fashion to dispute the Contractor’s right to payment are effectively the same, such an argument probably runs afoul of the analysis in section A above. But what if the Owner decides to charge its Contractor with fraud in the payment application process, and assert that doing so should expand its discovery rights?

In such cases alleging fraud, it is difficult to ascertain which comes first: the audit or the fraud-based claims. For example, if an Owner knows that it is contractually prohibited from auditing certain Fixed Cost documents, but also knows that if it alleges fraud the tribunal may permit discovery, it would be compelling for an Owner to allege fraud, even if it later cannot support its cause of action. Once the Owner has possession of the Fixed Cost documents in an attempt to support its fraud allegations, it will seek to use the documents for various purposes, including potentially its audit claims (which are ostensibly limited to review and reconciliation of reimbursable costs). Indeed, most auditors sell themselves as forensic accountants, but also fraud hounds.⁴⁵ It is very difficult to stop the ball from rolling down the hill; if the

⁴⁵See, e.g., Kessler International, *Construction Project Audits* (available at http://www.investigation.com/construction_project_review), which advertises its construction auditing services as follows, “Fraud and negligence can now be uncovered through an in-depth construction project audit that will save money, increase accountability and reduce potential legal hassles. Fraudulent disbursements, substandard materials and labor, bribery, tax fraud, bid rigging . . . the list of potential financial hazards goes on and on. But with a thorough construc-

contractual limitation on discovery is not enforced, it is unworkable to allow Fixed Cost documents to be discovered solely for tort claims but not for audit or other contractual claims.

To complicate the hypothetical scenario even more, assume that the arbitrator upholds the audit provision as a discovery limitation and rules that the Owner is not entitled to discovery of the Contractor's Fixed Cost documents or related information. Unsatisfied with this result, the Owner seeks federal court intervention.⁴⁶ Albeit rarely, a party might find relief from a court when it is unhappy with the arbitrator's decision regarding discovery.⁴⁷ Unless "extraordinary circumstances," such as the likelihood that evidence will be lost if discovery does not occur right away, a federal court is not likely to intervene.⁴⁸ Indeed, some jurisdictions such as Florida, Michigan and Texas refuse to interfere in an arbitration at all, and require all discovery to be conducted through the arbitrator.⁴⁹ Such jurisdictions reason that a litigant in arbitration has no right to discovery, and that a

tion project audit, you can pinpoint waste and money-draining schemes, ensure fiscal accountability, and protect yourself from similar problems down the road."

⁴⁶Another manner in which this issue may arise is ancillary litigation among the parties. For example, Contractor lacks financial wherewithal and Contractor's surety or insurer denies coverage. Fixed Cost documents are requested as part of discovery in the ancillary litigation. Cynics might suggest that parties may even initiate ancillary litigation in order to conduct discovery that may otherwise be impermissible in the arbitration. This presents a very thorny issue for the arbitrators in terms of whether the tribunal will accept evidence obtained in another forum that was excluded from production in the arbitration. While resolution of this issue is highly dependent on the facts and circumstances of the case, arbitrators certainly have discretion and authority to exclude such evidence from the arbitration proceeding.

⁴⁷For a discussion of the consequences of court involvement in arbitration discovery, see Forstadt, *supra* note 11, at 4. As pointed out there, "[c]ourts generally take a hands off approach when it comes to discovery conducted in an arbitration. They do not want to interfere with the arbitration proceeding and the role of the arbitrator in controlling discovery." Indeed, in some cases, a court will interpret a party's use of the court for discovery purposes as a waiver of arbitration rights. See, e.g., *Graig Shipping Co. v. Midland Overseas Shipping Corp.*, 259 F. Supp. 929, 931, 1967 A.M.C. 716 (S.D. N.Y. 1966).

⁴⁸See *Koch Fuel Int'l. v. M/V S. Star*, 118 F.R.D. 319 (E.D.N.Y. 1987) (utilizing the "extraordinary circumstances" test to evaluate the arbitrator's discovery ruling).

⁴⁹See Forstadt, *supra* note 11, at 6.

court's interference with the arbitration process would offend the FAA and state arbitration acts.⁵⁰

IV. The Costs and Logistics of the Forensic Audit

A. High Costs Associated with Post-Project Forensic Audit

Anyone who has litigated a large construction dispute involving audit rights is no stranger to the overwhelming costs associated with a post-project forensic audit. As losses on a project increase, an Owner may seek to verify project costs incurred by the Contractor, to ensure that the contractor has not been overpaid for its work. The construction audit practice can be quite profitable for accounting, consulting, and law firms. Indeed, contractors should be aware of, and inquire about the possibility that a forensic auditor is earning a percentage contingent fee based upon costs recovered.⁵¹ Indeed, the "Big Four" accounting firms have entire departments dedicated to forensic audits of large-scale construction projects. And, for every auditor hired by the Owner, there is probably an equally-expensive counterpart hired by the Contractor.

Audit firms gain customers by suggesting to Owners that *all* types of construction contracts should be audited and that a construction audit will return value at nearly every point in the project but particularly, at the end.⁵² By way of example, one firm advertises that it has audited \$3.5 billion in construction projects in the past decade, and has recovered "millions" of dollars for Owners. For an audit firm to audit millions of dollars in project costs, an Owner must spend significant money at the audit firm's hourly rates in the hopes of recouping something at the end from the Contractor. It is fair to assume that the going hourly rate for an experienced auditor is roughly comparable to that of seasoned construction attorneys,⁵³ and forensic audits are typically done under the direction of outside counsel, further increasing the

⁵⁰See Forstadt, *supra* note 11, at 6. See also *Transwestern Pipeline Co. v. Blackburn*, 831 S.W.2d 72, 74 (Tex. App. Amarillo 1992).

⁵¹John A. Becka, Shannon J. Briglin, & Colin A. Daigle, *Navigating a Construction Contract Audit: Standards, Rights, and Obligations*, in Patrick A. McGeehin, Edward G. Benes, Patrick J. Greene, Jr., & Wm. Cary Wright, Eds., *Construction Accounting* 75 (ABA 2010).

⁵²See, e.g., website of McDonald & Associates, Inc. available at <http://www.mcdassociates.com/FAQ.php>; website of Kelly Business Consultants, Inc. available at <http://www.kellybusconsultants.com>.

⁵³Obviously, auditors' billing rates are not widely publicized, but one forensic accountant/fraud investigator posted a schedule of audit charges from Ar-

costs to the Owner. In order to protect its interests, the Contractor on the same project will need to engage and pay a competing audit firm a similar amount. In the end, the audit can collectively cost the parties hundreds of thousands to millions of dollars, even if the audit ultimately establishes no material billing errors.⁵⁴

When the Owner seeks a full-scale post-project forensic audit and no limits on the auditable records are imposed by the contract, the audit costs for both parties will inevitably skyrocket. The following section explores the question of who should ultimately be responsible for the audit costs.

B. Who Should Bear the Cost of a Forensic Audit?

While each party generally bears its own costs incurred in completing a post-project forensic audit, many audit provisions contain a cost assignment or allocation provision.⁵⁵ To alleviate the Owner's cost burden, some have suggested incorporating a specific cost provision that allows the Owner to recoup the cost of the audit if the audit detects overcharges by the Contractor that reach or exceed a certain percentage of the total contract billings, for example overcharges greater than 1 percent.⁵⁶ Another similar example states:

Costs of any audits conducted under the authority of this right to audit and not addressed elsewhere will be borne by the Owner unless certain exemption criteria are met. If the audit identifies

thur Anderson's Milwaukee office dating from 1996–1997, when they ranged from \$75.00 per hour for “staff” to \$315.00 for a Partner. See *Putting auditor billing rates into perspective*, the Fraud Files Blog, online at <http://www.sequencceinc.com/fraudfiles/2007/11/putting-auditor-billing-rates-into-perspective> (last visited April 24, 2012).

⁵⁴Billing errors are inevitable on large construction projects. Despite the best efforts of the contractor, and detailed review of monthly invoices and supporting documentation by the Owner, billing and payment errors occur on large construction projects. Well-developed and designed project controls can limit the number and magnitude of billing errors, but over a three to five year construction project involving hundreds of millions to billions of dollars, some mistakes will be made in billing that are not caught during the Owner's review and payment of the invoice. However, through the use of appropriate project accounting and control procedures, the incidence of material billing or payment issues can be minimized.

⁵⁵Audit provisions are often flowed down so as to require a subcontractor to make its books and records available to the Owner for audit. Subcontractors typically bear their own costs in connection with any such audit, including legal and professional fees and expenses.

⁵⁶See Albert J. Marcella, Jr., *Outsourcing, Downsizing, and Reengineering: Internal Control Implications* (Inst. Of Internal Auditors 1995).

overpricing or overcharges (of any nature) by the Contractor to Owner in excess of one-half percent of the total contract billings, the Contractor shall reimburse Owner for the total costs of the audit.⁵⁷

An audit clause that specifically allocates the costs for the audit can be an effective way to protect the Owner from material billing errors by the Contractor. The difficulty with such a solution is that it absolves the Owner from any responsibility to carefully review and approve invoices prior to making payment to the Contractor. Further, audit provisions rarely address the apportionment of the costs incurred by the Contractor or its subcontractors in facilitating the audit, managing the audit, reviewing and responding to the audit results, and other related activities if the audit fails to demonstrate significant overbilling by the Contractor. Under many contracts, the Owner has essentially an unfettered right to audit all reimbursable costs, without any ability for the Contractor or its subcontractors or vendors to recoup any attendant costs from the Owner.

Aside from the inherently one-sided nature of most audit provisions, the cost issue can become murky where fraud or misrepresentation claims are involved. It is not unreasonable to assume that if the Owner discovers fraud or misrepresentation by way of the audit, then the Contractor should be responsible for the costs of the audit. In fact, the parties may go so far as to agree on payment of costs for an audit involving Contractor fraud.⁵⁸ As discussed below in more detail, such an audit provision clarifies which party will bear the costs of the audit, but does not shift the burden of proof for a fraud-based claim from the Owner to the Contractor.

To sum up, in the absence of a cost allocation within the audit provision, and in the absence of any fraud or misrepresentation, the Owner is almost always responsible for the costs of an audit because the audit is not mandatory, but simply an exercise of the Owner's contractual right to audit.

⁵⁷The examples provided contain language suggested by the Association of Certified Fraud Examiners (ACFE), and are available on the organization's website at <http://www.acfe.com>.

⁵⁸For example, the parties might include the following, "if the audit reveals substantive findings related to fraud, misrepresentation, or non-performance, Owner may recoup the costs of the audit work from the Contractor." *See, e.g.*, sample audit clauses available on ACFE website (<http://www.acfe.com>).

C. Practical Considerations for Transmittal and Handling of Audit Documents

1. “Audit” Documents vs. “Discovery” Documents

It is a fact that large construction cases often involve millions of documents, both in electronic form and hardcopy. Following an agreement or order on the scope of document discovery, the first step in a large document review is to assess the universe of documents, and to identify which of those documents are potentially relevant to the dispute. Next, the privileged documents are pulled and logged, and the relevant documents are made available in electronic or hard copy format to the opposing party.

An audit provision that limits the Owner’s right to audit certain documents, such as documents supporting the Fixed components of the Contractor’s price, adds a marginal layer of review (and expense) to the Contractor’s document production protocol.⁵⁹ Assuming the audit provision which excludes certain documents from the Owner’s review is fully enforced, and the Owner is denied access to the documents, the precluded documents can be segregated much like the privileged documents. The question then becomes whether the documents protected from review by the contractual limitation must nonetheless be produced in the proceeding. If the contractual limitation is fully enforced, then an ancillary question arises: must the documents excluded from production by the contract be placed on a log akin to a privilege log produced to the other party or parties? If the precluded documents are viewed as “irrelevant” in light of the contractual provision, then it generally would not be necessary to log them or otherwise account for irrelevant documents. If, on the other hand, the documents are viewed as similar to privileged documents that are protected from discovery by applicable law (rather than contract), then the documents should be withheld from production, but logged and subject to challenge by the other party or parties. The answer to that inquiry is likely dependent upon the forum, the composition of the tribunal, the specificity of the contractual limitation, and the facts and circumstances of the particular case.

On a broader level, the audit review conducted by the opposing party’s outside auditing firm is quite difficult on a large-scale project. Audit reviews typically go beyond the sheer production of

⁵⁹While a limitation on discovery can add a marginal layer of review and expense to the initial production, the agreed reduction of the overall scope of production reduces the overall costs attendant to assembly, production, and review of the documents, particularly as it relates to the audit.

documents, including situations where the auditor may have questions for the employee who created or maintained certain accounting documents over the course of the project. In such cases, where the documents are being scrutinized as the auditor reviews them and selects them for production, copying and/or further inquiry with employees, it is critical that the party being audited keep detailed and accurate records of all information provided to the audit team, including document requests, documents furnished, questions answered, source of information provided, employees interviewed, and all other information.⁶⁰

It is also advisable to have a single point of contact between the Contractor and the auditors. When millions of documents are involved, the critical nature of thorough and organized record-keeping with respect to the actions taken by the Owner's auditors cannot be overstated. If and when discovery disputes such as those outlined above arise, an important inquiry will become whether the auditors had fair access to the audit documents permitted by the parties' agreement in order to conduct the audit in accordance with the terms of the contract.

2. The Importance of Properly Tracking and Documenting Reimbursable Costs

During contract negotiation, it is important that the Contractor be cognizant of its accounting and general record-keeping systems, so as not to "bite off more than it can chew" under its contractual requirements. Moreover, the Contractor's cost reporting system should be understood and approved by the Owner.⁶¹ In construction contracts for most large projects, the parties specify the Contractor's project accounting, controls, other record-keeping and planning obligations in detail. In some cases, however, the Contractor's record-keeping obligations are more generalized with respect to the Owner's audit rights. An example of each follows:

Example 1: Detailed Record-Keeping Provision

Inspection of Books, Records and Audit Rights. Contractor shall keep and maintain full, complete and detailed records of all of

⁶⁰Counsel is often involved in the planning and implementation of post-construction forensic audits for both the Owner and Contractor. It is not unusual for Contractor's counsel to be present for any meetings between the auditors and Contractor's employees, and for the audit team to rely upon contractual interpretations by Owner's counsel in formulating its audit plan.

⁶¹See Allen L. Overcash & Jack W. Harris, *Measuring the Contractor's Damages by "Actual Costs" — Can It Be Done?*, 25:1 The Constr. Law. 31, 37 (Winter 2005).

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its costs. Contractor shall upon request, make available to Owner the following documents: daily time sheets and supervisor's daily reports; insurance, welfare and benefit records; payroll registers; earnings records; payroll tax forms; material invoices; material cost distribution worksheet; equipment records; vendors', rental agencies', Subcontractors', and agents' invoices; contracts between Contractor and each of its Subcontractors; Subcontractors' and agents' payment certificates; cancelled checks; job cost reports; job payroll ledger; planned resource loading schedules; Project general ledger; cash disbursements journal; all non-privileged documents which relate to every claim together with all documents which support the amount of any Reimbursable Cost or adjustment in the Target Price sought by Contractor; work sheets or software used by Contractor to prepare its claims; and work sheets, software, and any other documents used by Contractor to calculate estimates of and actual costs and expenses.

Example 2: More Generalized Record-Keeping Provision

Company may, upon its request, inspect and audit any and all financial books, supporting records, or any other documentation of a business or technical nature (hereinafter referred to as "Documentation") of Contractor and any subcontractor relating to the performance of this Contract; provided, however, Contractor and subcontractor shall have the right to exclude any trade secrets or proprietary formulas from such inspection and audit. For purposes of this Article 23, trade secrets and proprietary formulas will not include any financial information or data. The right to inspect and audit by Company under the provisions hereof will include access to information, verbal or otherwise, from personnel of Contractor or its subcontractors.

Contractual record-keeping obligations of the Contractor will generally be strictly enforced by the tribunal. Failure to preserve information which a party knows or should know is relevant — which it can hardly deny in the case of a contractual preservation obligation — may be sanctioned as spoliation of evidence, at least by courts.⁶² While a more detailed provision, such as that provided in *Example 1*, leaves little doubt as the Contractor's obligations, it also places an extensive burden on the Contractor. On the other hand, less specific and blended record-keeping/audit provisions leave room for interpretation by a tribunal and place unnecessary risk and uncertainty on the Contractor, which could ultimately result in more exposure for any failure to comply with the tribunal's interpretation of its documentation and preservation obligations.

Under either scenario, it is critical that the Contractor

⁶²See James F. Butler III & Angus N. McFadden, *Discovery of Electronic Information in Construction: Spoliation in the Electronic Era*, 23:3 The Constr. Law. 5 (Summer 2003).

dedicates the required effort to comply with its accounting obligations under the contract.⁶³ Especially in the situation where the Owner is entitled to audit some project costs, but not others, such as Fixed components, a court or arbitrator is more likely to enforce the audit provision where the Contractor can clearly demonstrate that its accounting system complied with the contract and can easily segregate its records for Fixed elements from the documents and records supporting its reimbursable costs.⁶⁴

V. Burden of Proof

In the construction industry, practitioners try to anticipate every conceivable issue that might arise over the course of the project; however, an issue that is often not specifically addressed in the contract is the burden of proof in the context of an audit claim. Consider, for example, the situation where an Owner has reviewed, approved, and paid the Contractor's invoices during the course of the project, but later claims an overpayment because the Contractor is unable to provide to auditors appropriate supporting documentation to substantiate costs submitted, approved, and paid by the Owner during the course of the project.⁶⁵ Which party bears the burden of proof as to such a claim by the Owner? Is it the Contractor's burden to establish that the amounts received were proper, or must the Owner prove that the Contractor received monies that were not due under the contract? The following discussion attempts to shed some light on this complex, but often overlooked, legal inquiry.

⁶³As can be gleaned from these examples, record-keeping and audit obligations under the contract do not always match the information that the contractor is required to submit with its monthly progress invoices in order to get paid. In drafting the contract, care should be given to ensure consistency between project accounting records, project controls records, and other documentation requirements for progress payments or change orders and the audit provision. The "audit" records should be the additional support for summary level documents provided on a monthly basis to the Owner, and which the Owner has an obligation to review and approve before payments are made.

⁶⁴The Contractor needs to ensure that the cost control system being utilized on the project segregates and tracks costs in the manner required by the construction contract. For example, the cost reporting system must be structured to segregate reimbursable costs from Fixed components if the audit provision is structured in that manner. Otherwise, the segregation of reimbursable from fixed cost elements becomes very difficult when faced with an audit request.

⁶⁵The issue often arises when the Contractor has some documentation supporting the cost, but not the type, kind, or quality of information that the auditor seeks during the audit process. The invoice was approved and paid by the Owner during the course of the project, but the payment is now being challenged through the audit process.

A. Typically the Party Seeking Affirmative Relief Bears the Burden of Proof Regarding the Essential Elements of its Claims; does the Audit Provision Change This?

The law is clear that the party seeking affirmative relief bears the burden of proof regarding the essential elements of its claims.⁶⁶ Put another way, a claimant has the burden of proof as to the elements of his or her cause of action.⁶⁷ However, does an audit provision shift the standard burden of proof from the Owner to the Contractor when the Owner claims, on the basis of a forensic audit, that the Contractor has been overpaid?

Consider an audit clause that grants the Owner audit rights in the event of a claim under the contract, and access to all documentation relevant to that claim, except for documentation regarding Fixed Costs. For the purposes of this discussion, assume that the audit provision also requires that the Contractor maintain certain records for accounting purposes and comply with certain obligations for audit purposes. When the Owner seeks repayment of costs via the audit, may the Owner shift the burden of proof to the Contractor by alleging that the Contractor did not adequately substantiate its costs according to contract requirements? More specifically, where an Owner has periodically issued payments to the Contractor during the course of the project, and then opts to re-visit the payments at the conclusion of the project, is it proper to shift the burden to the Contractor to substantiate entitlement to retain the monies paid to it by the Owner over the course of the project?

Unless the contract contains language to the contrary, neither arbitrators nor courts are likely to shift the burden of proof for overpayment claims from the Owner to the Contractor based solely on the existence of an audit provision. Assuming that the

⁶⁶See Christopher B. Mueller & Laird C. Kirkpatrick, *Federal Evidence* § 3.3 (3d ed. 2010) (noting that “[p]erhaps the broadest and most accepted idea is that the person who seeks court action should justify the request, which means that the plaintiffs bear the burdens on the elements in their claims”); John W. Strong, et al., 12 *McCormick on Evidence* § 337 (5th ed. 2009) (“[t]he burdens of pleading and proof with regard to most facts have been and should be assigned to the plaintiff who generally seeks to change the present state of affairs and who therefore naturally should be expected to bear the risk of failure of proof or persuasion”).

⁶⁷In fact, CPR Privacy Dispute Resolution Rule 10.2 specifically states, “Each party bears the burden of persuasion on any claim or counterclaim raised by that party in accordance with the principles of applicable common, decisional and statutory law.”

Owner is the party asserting a right to recover or retain certain monies via claims stemming from its audit rights, the Owner — not the Contractor — bears the burden of proving that it is entitled to a financial recovery, as well as the quantum of that recovery. Because the Owner is the party pursuing an affirmative claim, it must meet its burden of entitlement to recovery (*e.g.*, Contractor breached the contract) and the amount of money the Contractor was overpaid as a result of that breach. A right-to-audit provision entitles the Owner to recoup money, but only where the Owner can prove that it is entitled to that repayment of money it paid to the Contractor. In the simplest of terms, an audit provision may facilitate proof of the right to recovery, but the Owner must still prove each element of its affirmative claims to be successful.

During contract performance, a Contractor must establish that it is entitled to be paid under the terms of the contract. The Owner typically reviews Contractor invoices, approves the portion or portions that are due and payable, and rejects or seeks further information as to the remainder. Quite commonly the Owner's architect or other design professional will have first reviewed the Contractor's payment request and "certified" it before the Owner receives it. Having reviewed and approved a Contractor's invoice for payment, the Owner which later asserts that the invoice was improperly paid must prove that overpayment.

It is not unusual for an Owner's accounting staff to be stretched thin on occasion during the course of a long and complex project; however, an Owner should not expect the Contractor to prove that it is entitled to keep money voluntarily paid to it during the course of the project by the Owner. That is not to say that progress payments by the Owner necessarily constitute a waiver of the Owner's right to question the costs after the project through an audit;⁶⁸ however, the law does not support shifting the burden to the Contractor to prove its entitlement to retain money paid to it by the Contractor during the project.⁶⁹ To do so would essentially provide an Owner with a license to pay its Contractor's

⁶⁸Indeed, Owners may enjoy a contractual privilege of reviewing decisions to pay Contractor applications. *See, e.g.*, AIA Document A201-2007, General Conditions of the Contract for Construction, § 9.5, allowing the project architect to nullify a certificate for payment previously issued, based on subsequently discovered evidence.

⁶⁹*See, e.g.*, John W. Strong, et al., 12 McCormick on Evidence § 337 (5th ed. 2009); *Hersch Bldgs., Inc. v. Steinbrecher*, 198 Neb. 486, 253 N.W.2d 310, 312 (1977), discussed at note 73, *infra*.

invoices on a periodic basis, sit on its hands until the project is complete, and then “question” each and every payment previously made to the Contractor during the Project. Should the Owner decide to do so, it does so at its own peril and must bear its own burden to recover any monies paid to the Contractor during the project.

Moreover, the voluntary payment doctrine also provides significant hurdles to an Owner’s post-completion recovery of sums paid to the Contractor over the course of the project. The voluntary payment doctrine states that money paid voluntarily without compulsion, without any promise to repay and with full knowledge of facts, cannot later be recovered.⁷⁰ In the context of proof in light of an audit provision, the voluntary payment doctrine requires that a party seeking to recover an alleged overpayment on a contract has the burden of proving not only an actual overpayment but also that overpayment was *involuntary*.⁷¹ Specifically, a payment is presumed to be voluntary unless plaintiff carries its burden of showing otherwise.⁷² Even in a case where the Owner is alleging later-discovered fraud by the Contractor with respect to payments made by the Owner, the burden is on the

⁷⁰The voluntary payment doctrine is well accepted throughout the United States. *See, e.g.*, *Genesis Ins. Co. v. Wausau Ins. Companies*, 343 F.3d 733 (5th Cir. 2003) (applying Mississippi’s voluntary payment doctrine); *Montgomery v. Gibbs*, 40 Iowa 652, 1875 WL 729 (1875) (where, in sales contract, buyer agreed to pay certain debts of seller, and afterwards voluntarily paid a sum much in excess of the originally agreed upon amount, buyer cannot recover excess payments); *Indoor Billboard/Washington, Inc. v. Integra Telecom of Washington, Inc.*, 162 Wash. 2d 59, 170 P.3d 10, 23 (2007) (“money voluntarily paid under a claim of right to the payment, and with full knowledge of the facts by the person making the payment, cannot be recovered back on the ground that the claim was illegal, or that there was no liability to pay in the first instance.”).

⁷¹*See Thomas v. Central States Elec. Co.*, 217 Iowa 899, 251 N.W. 616, 618 (1933) (plaintiff seeking repayment of overcharges made to defendant failed to meet his burden of proving that payments were made involuntarily or by mistake).

⁷²*See Hersch Bldgs., Inc. v. Steinbrecker*, *supra* note 70, at 312. In this context, an Owner may place a “reservation” of some type or another on its approval. While this may suggest that the payment was involuntary or otherwise made subject to a reservation of rights, in the absence of an agreement by the parties, a reservation does not shift the burden to the Contractor to establish entitlement to amounts received from the Owner.

one seeking to recover payments made to prove, by a preponderance of the evidence, the facts entitling it to recovery.⁷³

B. Does an Owner’s Reservation of Rights with Payments Shift the Burden?

Assume that the Owner undertakes a contemporaneous review of costs during the project, but with each payment to the Contractor, includes a reservation of rights by the Owner to seek repayment post-completion. Upon challenge by the Owner post-completion, would such a provision shift the burden of proof to the Contractor?

First, and as discussed above under the voluntary payment doctrine, there is some question as to whether a reservation of rights accompanying payment is enforceable to permit the Owner to later question payments it reviewed and approved during the course of the project. Second, even if the voluntary payment doctrine is not applied, and in the absence of an express agreement by the parties, the reservation of rights is unlikely to affect the Owner’s right to conduct an audit and recover any overpayment; however, the Owner’s unilateral reservation of rights does not shift the burden to the Contractor to establish entitlement to and quantum of amounts received from the Owner. Finally, it smacks of unfairness for the Owner to specify the documentation to be submitted in support of the progress payments and change orders, review the submitted documentation, approve payment, and make payment to the Contractor during the course of the project, but to then later require Contractor prove that its payments were adequately documented and supported, rather than requiring the proponent of the claim, the Owner, to establish breach, causation, and damages in order to recover alleged overpayments from the Contractor.

VI. Conclusion

To avoid complex and expensive disputes in arbitration or litigation, consider the following in drafting construction contracts or prosecuting claims in the future:

- Draft a detailed audit provision. Carefully and specifically define the parameters of the audit. Describe in detail the elements of cost that are subject to audit, as well as those costs that are excluded from audit.
- Define the term “audit,” and if necessary for clarification

⁷³See *Gibbs v. Farmers’ & Merchants’ State Bank*, 123 Iowa 736, 99 N.W. 703 (1904) (*reversing* trial court’s award for plaintiff where plaintiff claimed overpayment through mistake and fraud by defendants).

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purposes, provide examples of acceptable and unacceptable conduct at the time of the audit. It will also prove helpful to define and provide examples for the terms “reimbursable costs” and “fixed costs,” as well as a list of specific categories of costs that are not considered reimbursable, and thus, not subject to audit.

- Set out a discovery protocol in the contract. There is a lot of upside and only minimal downside to setting forth the parties’ boundaries for discovery, especially electronic documents and production specifications, from the outset.
- Also consider including a burden of proof provision, specifying that Owner maintains burden of proof to recoup monies paid to Contractor during course of project.
- Provide which party bears the costs for any forensic audit. If contracting on behalf of the Owner, consider including a provision that shifts the audit costs to the Contractor where audit reveals overbillings in excess of a certain percentage of the total project costs.
- Give due care to ensuring consistency between project accounting records, project control records, and other documentation required for progress payments or change orders and audit provisions.
- Advise Contractor clients to integrate the contract’s requirements into its accounting and project management systems.
- Keep organized and detailed inventories of any documents that are not subject to audit. In the same vein, it is beneficial to limit the number of people who are involved once the audit is underway. If possible, designate a single point of contact between the Contractor and the audit team.

Where formal dispute resolution proceedings are commenced, moreover, it is critical that the tribunal enforce a stringent ruling determining once and for all that audit provision will be enforced as a limitation on discovery, or that it will not. Piecemeal resolution of such an issue significantly adds to the cost and duration of discovery and of the proceedings, and may affect strategic decisions of clients and counsel in the proceeding.