CCM Consulting Group

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Vinson Chapman 972-304-0888 / vchapman@ccmcg.biz
David Butler 217-369-3280 / dbutler@ccmcg.biz
Joseph Stephens 615-804-5787 / jstephens@ccmcg.biz
Steve Roberts 817-498-7050 / sroberts@ccmcg.biz
Michael C. Byrne, *LLC* 303-884-8352 / mcbyrne@ccmcg.biz

Audit Concerns in a Shrinking Construction Market

It has been quite a few years since we have gone through a construction downturn like we are seeing currently. Over the last 10 years most of you have been more concerned with getting good people and adequately supplying the projects with materials and equipment. Some of you may recall a time when we worried about GC's parking employees on our jobs and leaving rental equipment on the job idle while continuing to bill us, the Owner. Well it seems as if some of those days are here again. We wrote recently about trying to limit GC employee bonuses and raises on GMP projects. The number of GC employees and quantity of equipment should be added to that list as well. If you have a project that also has GMP subs, these same issues apply to them.

Owners on most large projects have been given an estimate of General Conditions complete with man loading charts or schedules. We suggest dusting that document off and reviewing your current management man loading against the original estimate. Significant deviations in manpower may signal an issue to be discussed with your GC.

Equipment "parked" on your project may be harder to evaluate, especially if, as an owner, you are not present on the job site every day. On one of our projects 15 years ago, we would put small stones on the tires of some of the larger equipment and days later see if they were still there. You may have also received an equipment loading schedule or an estimate of equipment costs that could be deciphered to show what equipment was anticipated and the durations of each. Looking at this document may prove to be worthwhile.

One of our Owners on a large project in the Northeast recently recounted the GC's management openly discussing "fee enhancement" as if it was an approved concept. In this light, another possible GC response in a declining market is to be more aggressive in trying to self perform work at an additional fee. Any attempt by a GC to self perform work is potentially problematic for the Owner. Any Owner has a right to be concerned about the true competitive nature of the bid process and, after award, if self performed costs might happen to be comingled with cost plus costs.

Lastly, on new projects we have already seen some stated GC fees coming down. Regardless, expect those same GC's to be doubly aggressive in trying to get the Owner to agree to fixed labor rates, fixed burden rates, fixed GL insurance, or fixed anything that will add to fee. Of course you know better than to agree to fixed rates, right?

It is said that opportunities exist in declining markets, we just don't want one of those opportunities to be you.

Construction Contract Termination Issues

Not since late 2001 and early 2002 have we seen the amount of activity in projects being suspended or terminated prior to completion. This amount of activity is partially due to economic issues but also we have seen Owners changing direction due to opportunities to purchase already developed properties. Regardless, because these situations do not occur frequently, many Owners (and some GC's) are not sure how to handle the contractor and subcontract credits that should result from such a change in direction. Basically, in a termination, the Owner typically has two choices; 1- A credit change

order for the deleted scope of work, or 2 – A final settlement based on the Termination for Convenience language in the contract. I am sure many of you are not aware that these two methods may deliver different results. Obviously there is a danger in simplifying the termination process, and also each construction contract can be drafted differently. Here we will attempt to discuss the most commonly seen issues with the hope that something similar may apply to your situation.

The first situation would be a credit change order given to the GC, and the GC to their subs, for a deletion of the work that will not be performed. Many construction contracts require a credit for the deleted scope, but not a credit for the fee (Overhead and Profit). As you know, many GC's and subs also do not readily credit bonds and insurance as well as fee, even though the standard AIA contract only indicates that fee should not be applied.

In the situation where the credited scope is substantial, the lack of a fee credit as well can be very large. If we had a contract where the total contract value of the deleted scope was $50 mil., the lack of fee credit from subs could be 15% or $6,521,739.

Sometimes we have seen contracts that allow an Owner to get an "equitable" fee credit if the value of the deleted work is 20% or greater. In this case, the fee credit due could vary by subcontractor, given that the Owner contract language is almost always incorporated into the subcontracts.

Some of our Owners have negotiated their construction contracts such that credit change orders, of any amount, should have deductive fee. Just because this language is in your contract do not assume that the GC and subs will voluntarily price their change orders to be in compliance.

The second possibility for an Owner is a Termination for Convenience. Here too the language may vary in your construction contract. The standard AIA language, A201 Article 14.4.3, states the contractor is "entitled to receive payment for Work executed, and costs incurred by reason of such termination, along with reasonable overhead and profit on the Work *not executed*". This is the same as saying that there is no credit fee on the value of the deleted scope. However, we have seen many Owners and Contractors who have modified the Termination for Convenience clause to allow the Owner to only pay the "actual reasonable costs of the Work executed and a reasonable fee on the Work performed." The later requires the Owner to pay the reasonable actual costs of the Contractor or Subcontractor and some reasonable markup for fee, but not the total fee originally anticipated. The difference can be extremely large. If you have one subcontract of $5,000,000 where the sub has only incurred $150,000 in cost, and assuming a 15% fee, the first method would result in a credit due of $4,197,826 ($5,000,000 minus $150,000 + $652,174 total fee). The second scenario would result in a credit of $4,827,500 ($5,000,000 minus $150,000 + $22,500 fee at 15% of $150,000).

Another nuance in the whole Termination for Convenience credit due calculation is the concept of reasonable cost incurred or executed. We have had meetings with Contractors where their definition of cost incurred by a subcontractor is what the sub had billed them. A sub may have billed for mobilization, bond, insurance, and engineering based on a schedule of values, but that does not mean that the costs had been expended or that the subcontractor's costs equaled the billings. Again, on large subcontracts the difference between the billed amount and the actual incurred amount can be great and typically would be only proven during an audit of the costs. A recent audit of the costs incurred by one sub not only showed a variance between the billed amount and the cost to be $130,000 (out of a total $500,000) but also revealed that the sub stood to get a bond credit on the deleted work which would reduce the incurred cost by another $30,000. These results were discovered in the course of a four hour audit of the subs costs.

Sometimes we are asked about our interpretation of the right to audit clause in the construction contract and if that provision applies to subcontractor and suppliers as well. We always say that we believe that any provision in our GC contract that is incorporated into the subcontract should also apply, including the right to audit. In the case of a termination, you can see why we would need the right to audit cost to determine the final cost due to the sub.

We hope that not many of you are put into the situation of needing to negotiate these types of credits, but if you are, we want you to be armed.