



Negotiating Contracts in Bad Times

by Patricia Ayars

The strength of an owner's negotiating position during a construction downturn can result in a contract that ultimately lowers a builder's profit. But even in hard times, there are ways contractors can protect themselves.

Construction contracts are usually based on one of two principle types of pricing:

- The lump-sum method, which allows the contractor to receive a specific amount for completion of the construction project.
- The cost-plus method, which allows the contractor to receive actual costs for completing the project plus a specific fee.

The Lump-Sum Method

With the lump-sum method, the contractor examines the final plans and specifications for a project, estimates costs, adds profit, and submits a binding price for the entire project.

The lump-sum method provides great security for the owner by guaranteeing a price and placing the risk of any cost overruns on the contractor. If there are any unforeseen costs — for example, if material costs increase or the contractor makes an error in calculating the bid — the contractor makes up the difference. The owner is responsible for only those extra costs that he or she causes, such as changes in specifications or drawings, errors in the specifications, or increases caused by the owner's delay.

The lump-sum method is used for competitive bidding. During periods of strong construction activity, competitive bids are few, so contractors are able to build safeguards into contracts to cushion themselves against increased costs, without fear of being underbid. They can also negotiate favorable payment terms, with the payments weighted toward the earlier parts of construction.

In slower times, when competition among contractors for jobs is stronger, contractors may lose some of these safeguards or give them up voluntarily to lower the bid.

Payment schedules. One of the first contractor concessions on lump-sum contracts in slow times is on payment schedules. Payments under a lump-sum contract are typically made either periodically (every two weeks or every month), or upon completion of certain stages of construction, such as at the completion of the foundation, framing, enclosure, and so on.

During a downturn, owners will typically negotiate terms that weight the payments toward the end of the project. The contractor may end up carrying costs for longer periods.

Ordinarily, a contractor is more likely to receive payments regularly if payments are made at scheduled intervals. Regularly scheduled payments can be dangerous, however, if the contractor does not budget expenditures to correspond with payments. The contractor may find that he lacks the money to complete a project because he has already received and disbursed the majority of the scheduled payments.

When payments are based on completion of stages of construction, a third party, such as an engineer or architect, must certify the completion before payments are made. This certification process can sometimes delay payments.

Careful negotiation and attention to crucial protective clauses can help preserve both a measure of safety and a reasonable profit

Protection against cost increases.

The contractor should also try to negotiate certain favorable provisions for increases in the contract price.

These provisions include increases for change orders; extra work caused by the owner or by circumstances beyond the contractor's control; unexpected subsurface conditions if excavation is involved; work delays caused by the owner or by factors beyond the contractor's control; any owner-caused acceleration in the work schedule; and deficiencies or errors in the drawings or specifications.

Failing to maintain these safeguards may put the contractor at an unacceptable risk.

Cost-Plus Contracts

You should avoid lump-sum contracts where construction drawings and specifications have not been completed, since you will not have sufficient design information to make an accurate estimate of costs. In this circumstance, you should try to negotiate a cost-plus contract instead.

Under a cost-plus arrangement, the contractor is paid actual costs plus a fee. The fee may be a specific amount or a percentage of the cost of construction.

Traditionally, contractors have felt fairly comfortable with the cost-plus contract. The risk of price increases

and unexpected construction costs are shifted to the owner. No matter how much the project ends up costing, the contractor should recover costs and expenses, plus a protected profit.

During a downturn, however, the protections of the cost-plus contract are often whittled away in negotiations. One of the first issues negotiated concerns which "costs" the contractor is reimbursed for.

Even in good times, recoverable costs rarely include general overhead, such as salaries, telephone service, and office supplies, the contractor's own time, or work correcting defective construction. In slow times, however, other costs that might normally be recoverable, such as reusable materials, overhead attributable to the project, and accident and indemnity insurance for the project site, are often excluded as well.

In addition, if the contractor's fee is based on a percentage of the construction costs, negotiations may reduce the types of costs that are used to determine that percentage base. The costs of general conditions or temporary facilities, for instance, may be excluded, as might the cost of such items as building permit fees and performance bonds. Contractors should make sure that such exceptions don't eat too deeply into their profit.

Upper limits. Slow times also can inspire owners to include contract provisions limiting the ultimate cost of the project. This guaranteed maximum price (GMP), as it is called, may be established in a number of ways.

If the construction drawings and specifications are complete, the contractor may be asked to set a GMP which includes the contractor's fee, a maximum for general conditions and temporary facilities, subcontractor costs, and a contingency for extra costs caused by the contractor.

Even if the drawings and specifications are not complete, the contractor may be asked to set a GMP based on existing materials. When this happens, the contractor is required to make detailed qualifications and assumptions about the scope of the project, the work to be included in the final drawings and specs, and the start and finish dates. When the final drawings and specs are available, the contractor's assumptions and qualifications are compared with the final drawings and specifications, and the GMP is adjusted accordingly.

Another method for determining a GMP when drawings or specifications are incomplete requires the contractor to set maximums for general con-

ditions and facilities, the contractor's fee, and the contingency amount. These amounts can generally be determined without complete drawings or specs, based on the general nature of the construction and the construction schedule. When drawings and specs are complete, the maximum amount for subcontractor costs is determined and added in.

Owners may also try to control subcontractor costs. For instance, contracts may specify that subcontracts be awarded by competitive bidding and that the owner be involved in the bidding process. Alternatively, the contract can set a maximum amount for all subcontractor costs. These controls can force the contractor to hire a less dependable subcontractor for a lower price.

Protecting yourself. Under cost-plus arrangements with a GMP, contractors should, at the least, negotiate for a contingency amount to cover the risks assumed by the contractor. This contingency can cover increased costs related to subcontractor defaults or mistakes, correction of defective work, and other problems directly or indirectly caused by the contractor. The most important contingencies to have covered are those over which you have the least control, such as subcontractors' work or cost increases due to scheduling problems.

The contingency may be reduced as the project proceeds and the contractor's exposure to increased costs decreases. But this contingency should always be of sufficient dollar amount and duration to offer real protection to the contractor.

As with lump-sum contracts, contractors should negotiate firmly for increases to the GMP for change orders, extra work caused by the owner or by circumstances beyond the contractor's control.

Unfortunately, until better economic times return, contractors will have to live with owner-favorable contracts. However, careful negotiation and attention to crucial protective clauses can help preserve both a measure of safety and a reasonable profit. When presented with a new contract, a contractor should consider all clauses carefully, and if in doubt, should consult an attorney for help in understanding its provisions and negotiating for reasonable protections and safeguards. ■

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