



RHarper Consulting Update

Your Next Construction Contract: Thoughts to Consider



Most sectors of the construction industry have been in full recovery mode for two years. The market remains very competitive and margins are still razor thin, but most firms now have healthy backlogs – which weakens owners' positions as new contracts are negotiated. Owners enjoyed a real negotiating advantage during the worst of the recession, but today, a competitive balance has been restored and owners are getting more pushback as new construction agreements are prepared.

There are several steps you can take in your next negotiation to achieve maximum value, mitigate risk, and reduce claims these may also address contract requirements from lenders, sureties, equity investors and other project stakeholders who require owners to tighten up contract provisions. Contractors, on the other hand, are adding – and sometimes disguising! – new revenue sources during negotiations, in order to develop additional profit centers within their operations. Often, these are disguised or subtly identified to avoid transparency.

Below are some thoughts to consider as you approach your next construction project:

- **Qualify, Qualify, Qualify** – In addition to the usual review of the qualification statement and project portfolio, have an accountant who specializes in construction accounting review the contractor's financial package. Request statements from sureties, including claims history. Check with members of the local construction bar to see if there have been any issues regarding payment history with subcontractors or suppliers. Reference checks with other owners are still the most effective and informative sources for qualifying contractors.
- **Contract Early** – Owners have their greatest leverage before the work is awarded. Develop the contract terms that are most important to you – Fee, General Conditions, Consequential Damages, Insurance, etc. – and include them as part of the package before you select a contractor.
- **Changes in the Work** – Establishing an equitable payment structure for change orders is key to controlling costs for the owner. Contractors should be paid fairly for changes in scope. However, the traditional approach of fixed percentages for overhead and profit are rarely equitable. A reasonable approach is to apply the same fee percentage to change orders as applies to the contract amount. Limit reimbursement for overhead to demonstrable, auditable costs.
- **Establish a Subsurface Allowance** – Establishing an allowance for subsurface conditions rather than dealing with unsuitable soil or rock as change orders provides a benefit by eliminating change orders for these items until depletion of the allowance. Unused allowance is excluded from savings and returned to the owner.
- **Transparency on Insurance** – Subcontractor default insurance often becomes a profit center for contractors. While it may be difficult to identify up front, requiring the contractor to open their books on their actual insurance costs in lieu of a fixed percentage for these items is reasonable, and should be part of the contract discussions.
- **General Conditions** – Placing a cap on general conditions is a good strategy for controlling overall costs. However, contractors have started carrying more home office overhead in their general conditions chart of accounts – for example, IT, software, excessive benefit mark-ups, and other personnel-related costs. Closely examining all general condition cost categories and limiting them to costs directly related to the project is a worthwhile exercise during the negotiation process, and can result in significant cost savings.
- **Claims** – Clearly defining the claims procedure is key to controlling unbudgeted post-completion costs. Using a neutral Initial Decision Maker to quickly assess and render an opinion on claims is an effective but seldom used tool. Clearly defining what issues are subject to arbitration can eliminate lengthy and costly litigation prior to hearing a claim. Mandatory mediation is always a good idea too.
- **Integrate Pre-Construction Services** – Include provisions in both the contractor's and architect's agreements requiring at least a reconciliation of the final contract pricing or bid to the previous estimate, and allow for re-design (if practical) to achieve the previous pricing. Too often, the pre-construction budget gets jettisoned with little regard or mitigation.

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The items above are not meant to provide owner an unfair or onerous advantage – just to ensure that all parties agree on workable, clearly defined contracts which minimize opportunities for cost overruns. An equitable contractual relationship requires a fair fee for a definite scope of work – and it's in everyone's best interest to provide transparency and clear cost parameters. Take time to plan your contracting strategy early in your project - it will pay real dividends.

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RHarper Consulting Group provides development consulting, program management, and owner representation services focused on the senior living and mixed use sectors. In addition, Mr. Harper is also a listed mediator and arbitrator for providing dispute resolution services for the construction and real estate industries.