

Happy Holidays

to our friends, clients and colleagues.
Best wishes for a prosperous 2007!



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An owner's construction project can have all the ingredients of success: financial backing, a talented and responsive design team, a pro-active construction manager and cooperative contractors, and even an agreed-upon budget and schedule. But if the project agreements don't properly allocate the risks of the project to the appropriate parties, even the best of intentions may not be able to prevent the project from becoming a recipe for disaster. This issue of the **LePatner Report** focuses on how an owner and its counsel can identify and protect against the multitude of risks inherent in construction projects of all sizes.

This article explains why otherwise sophisticated owners embarking on construction projects without the guidance of business and legal advice are easy prey for construction managers and general contractors. Typically owners fail to take control of the manner in which contrac-

Accounting Traps Found in Standard AIA Documents

by HENRY H. KORN, Esq.

tors and construction managers use construction funds for the project. When problems do arise, an owner's effort to see how the money on the project has been spent or to employ audit measures are often blocked by unhelpful contract provisions found in the typical form AIA contracts. Contractors and construction managers "know the game," and they take the lack of owner oversight in contract negotiations as the opportunity to bilk unsuspecting owners from seeing how their construction funds were used. To right the imbalance, the owner must take control of the contract formation process and implement an effective oversight plan before the contracts are signed. By doing so, the owner is assured of huge savings and preventing cost overruns.

The construction industry is responsible annually for a staggering \$1 trillion of expenditures. Funds for public, private and institutional projects are typically financed by sophisticated lenders or, in the case of private and many institutional projects, self-financed.

This article addresses the situation typically facing the institution (e.g., school district, university) or private owner engaged in construction. Generally where construction financing is involved, the creditors have some ►

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CONTRACT PITFALLS:

Provisions to Beware of In Owner-Contractor Form Agreements

by RONALD FEINGOLD, Esq.

Most contractors, when given the opportunity, prefer to submit to its owner/client for signature the Standard Form AIA Agreement between Owner and Contractor. After a quick review of the AIA Forms, there is little need to wonder why contractors prefer this Form Agreement. One AIA Standard Form Agreement which is regularly used by contractors calls for the contractor's work to be performed on the basis of Cost of the Work plus a Contractor Fee without an upset cost or fee or guaranteed maximum price. Thus, in this Standard Form, needless to say, there is little protection afforded the owner as far as the construction cost is concerned. Although the Agreement usually provides for the contractor to build the project in accordance with a prescribed set of drawings and specifications, and therefore should be able to provide the owner with a fixed price for the Agreement, the Agreement makes it clear that the cost is yet to be determined. There is little left to the owner's imagination about the direction the project's construction cost will go in this instance.

The remaining AIA Standard Form Agreements between an owner and contractor are not much better insofar as protecting the owner's interests. The ►

Arbitrators routinely take the position that discovery is limited by the terms of the contract and that they will not expand the scope of discovery beyond what the contract provides. For that matter, it will be a cold day in August before the owner is able to get an order from the arbitrator affording an audit of the books.

► say in the contract process and anticipate the issues discussed in this article by inserting the appropriate contract provisions. Often, institutional and private owners do not do that. As a consequence, when the contractor or construction manager typically presents the owner with a form AIA contract, stating “this is what we use; if you have any reasonable changes or additions, let us know”, the owner accepts the form contract. That is an invitation to disaster. Under the AIA scheme, the owner never will be able to determine just how the construction team spends its money or, in fact, if all the money has been spent on its project or siphoned off to pay trade contractors on other projects or for use by the construction team for its general operating purposes.

A brief review of the standard form of agreement between owner and construction manager, AIA B801 (1997 edition)¹, routinely used for private construction projects, proves this point. While this standard form contract gratuitously pronounces that the construction manager is the “agent” for the owner – a status in law that imposes certain duties and responsibilities on the construction manager² – you certainly would not believe that based on other provisions of the contract relating to the method the CM uses in disbursing owner funds.

Suppose that some months after commencement of the project and the owner’s regular payment of monthly requisitions for payment from the CM, the owner suspects that the stage of project completion does not match the payments that it has made. Under the standard contract, will the owner be able to review the checking account maintained by the CM to see how its funds have been used? Will the owner be able to review the CM’s accounting records for the project to see how the CM has spent the monies entrusted by the owner to it?

The shocking answer to both questions is that if the owner signs the standard form contract, the owner will not be entitled to examine such records. Indeed, the owner cannot expect under the terms of such a form agreement that the CM will segregate the funds that it has entrusted to the CM in a special bank account, separate and apart from its general operating account. The reality of the form contract is that the owner and the entity funding the project, is not

in control of its money and has no control of or access to the critical books and records of the CM to see how the money is being spent, or if the money is being used by the CM to line its pockets!

This is the harsh reality facing the owner that blindly accepts the AIA form contract proposed by the CM. The owner’s only recourse to records is found in the form provision that “records of Reimbursable Expenses and expenses pertaining to Additional Services and services performed on the basis of a multiple of Direct Personnel Expense shall be available to the Owner or the Owner’s authorized representative at mutually convenient times.” On any project, however, the Reimbursable Expenses account for a small fraction of the overall project expenditures. This is the harsh reality facing the owner that blindly “takes” the AIA form contract proposed by the CM. The owner’s only recourse to records is found in the form provision that “records of Reimbursable Expenses and expenses pertaining to Additional Services and services performed on the basis of a multiple of Direct Personnel Expense shall be available to the Owner or the Owner’s authorized representative at mutually convenient times.”³ On any project, however, the Reimbursable Expenses account for a small fraction of the overall project expenditures.

Because the typical CM form contract also compels the parties to arbitrate any disputes before the American Arbitration Association under its Construction Industry rules, if the owner expects to gain access to all relevant CM financial accounting records, it is in for another rude awakening. The access contemplated by the typical AIA form is, as is apparent from the foregoing clause, restricted. Rarely, if at all, will arbitrators afford owners the access to the CM banking and internal accounting records. Rather, arbitrators routinely take the position that discovery is limited by the terms of the contract and that they will not expand the scope of discovery beyond what the contract provides. For that matter, it will be a cold day in August before the owner is able to get an order from the arbitrator affording an audit of the books.

Assuming the owner is able to access the books of the CM, it again is in for another rude awakening. Typically, the CM or general contractor uses a software program, e.g. the Building Information System (“BIS”), allowing the construction team to manipulate the data entered concerning the financial accounting management of a given project. Printouts from the BIS of the financial accounting of the project can be manipulated by the CM or general contractor by changing the criteria or fields employed by the personnel directed to pull together the “original data”. The owner cannot expect AAA arbitrators to order on-site inspection of the hard drives of the construction team, as arbitrators rarely will expand such discovery access when the contract form limits the discovery⁴.

The owner that hires a general contractor under the form AIA contract, A101-1997, with form A201-1997, General Conditions of the Contract for Construction, faces an even worse conundrum. There simply is no provision in these forms that allows the owner access to the GC’s checking accounts, its financial accounting records, let alone the hard drive and BIS software routinely used by the GC for financial accounting purposes for

the project. Arbitrators typically resist any requests by owners for such discovery, concluding that the contract is a fixed sum, the contractor has the right to buy out the trades at any price it can (if it makes a profit based on the buy out of the trade, it is of no concern to the owner), and such discovery would expand the owner's rights beyond what the parties contemplated by contract.

Even where substantial change order work⁵ is performed during the course of an owner/GC project, the owner will be surprised to learn that there is no right to discovery of how the GC used the owner funds, whether the GC spent the money for the project, paid trades for other projects, or even used the money for general operating purposes. There simply is no provision in the form contract where change order work is performed allowing the owner such information.

There is a simple solution to this imbalance in the management of the owner's money on a project: the owner must see that certain provisions are included in the contracts. Counsel with expertise in this area will rectify this imbalance by drafting contracts that include such provisions as: (a) requiring the contractor/CM to place the owner monies in a segregated account, subject to routine audit by the owner and/or its representatives; (b) affording the owner the right to review all books and records of the contractor/CM, including, where necessary, to an audit relating to financial accounting of the project, and in the latter case, where necessary, access to the hard drive and BIS system employed by the construction team and its forensic accountants; and (c) restricting claims for arbitration to only those less than a prescribed amount, with the remainder subject to resolution in court.

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(1) The AIA form contracts are not drafted from the owner perspective. These are forms generated from the input of architects and contractors.

(2) Under New York law where an agent engages in acts of self-dealing, conversion or fraud, the agent may be ordered to forfeit its profits, fees or benefits received. E.g., *Maniscalco v. Liro Engineering Construction Management, P.C.*, 305 A.D.2d 378, 759 N.Y.S.2d 163 (2d Dept 2003); and *Griffin v. MWF Development Corp.*, 273 A.D.2d 907, 709 N.Y.S.2d 322 (4th Dept. 2000).

(3) See section 12.6.1 of AIA form B801.

(4) Our firm has been actively engaged in substantial litigation involving the financial accounting of a CM and GC for substantial construction projects. We have hired forensic investigators, whose review of the BIS printouts provided by the CM/GC pursuant to arbitration orders confirms the data is manipulated.

(5) The standard AIA contract defines a change order as a "written instrument prepared by the Architect and signed by the Owner, Contractor and Architect, stating their agreement upon all of the following: (.1) change in the work, (.2) the amount of the adjustment, if any, in the contract sum, and (.3) the extent of the adjustment, if any, in the contract time." (See section 7.2, AIA A201, page 27.)

CONTRACT PITFALLS continued

► advice here is for owners to avoid the Standard Form Agreements. Pitfalls abound. This article will provide several examples in which key provisions of the Agreement should be modified, supplemented, replaced or added in order to provide the necessary protections for an owner. It should be noted that this is not an exhaustive discussion, but is intended to demonstrate some of the more blatant inclusions contained in, and omissions from the AIA Agreement.

While Standard AIA Agreements are drafted from the perspective of the architect, the contractor, or both, and do little to protect the owner's interests, our firm drafts the Agreement from the owner's point of view. The Standard Agreements cede the owner's authority to the architect, as the owner's representative, to direct the work, withhold payment to the contractor for defective or deficient work, and authorize change orders. Our Agreements ensure that the owner maintains the authority for these decisions.

Scheduling The Agreement should provide milestone dates for substantial completion and final completion; provide strict notice provisions in the event of any delay; provide the owner with flexibility in re-scheduling the work at no additional cost to the owner; require acceleration by the contractor to complete the work on time at no added cost to the owner; and provide for the recovery of the owner's delay damages. The Agreement may also include a provision whereby the owner may collect liquidated damages (a prescribed sum) for the contractor's delay. In this instance, the owner is able to recover a predetermined amount of money for each day the project is delayed.

Final completion is not addressed in the AIA Form Agreements. And provisions relating to contractor delay and notice requirements do not provide comparable protections for the owner.

Delay Claims It is recommended that the contractor's compensation for a delay be limited to an extension of time, i.e., the contractor waives claims for delay damages caused by its breach of the contract. It is also vital to ensure that the owner does not waive its recovery of consequential damages, in the event of a contractor delay, such as added finance and interest charges, and loss of rental and business income.

The AIA Form Agreements provide for a mutual waiver of consequential damages. Thus, the owner is prohibited from recovering damages flowing not directly from a contractor's default, but nonetheless as a consequence of the contractor's default. And the AIA Forms contains no waiver by the contractor for delay damages.

Contract Price Most significantly, it is imperative that the Agreement provide for either a lump sum fixed price cost or a guaranteed maximum price ("GMP"). The GMP or fixed price should include not only the project construction cost, but also the contractor's fee, general conditions costs (which should be capped at a certain sum) and insurance and bond costs. This will afford ample protection for the owner since the construction cost can be increased only with written change orders approved and signed by the owner. The Agreement should also include a detailed trade cost breakdown of all the included trade costs. ►

► One variation of the AIA Form provides for a fixed fee, but another provides for Cost of the Work plus a Contractor Fee, where the Cost of the Work is undefined and the Contractor's Fee is usually based on a percentage the undefined Cost of the Work. Needless to say, in this case, the owner has virtually no control over the contract price. And since the Contractor's Fee is a percentage of the Cost of the Work, it follows that the contractor is motivated to run the Cost of the Work as high as possible. This is readily achieved since the owner has little control over the project's construction cost. The construction cost is customarily increased through countless change orders. The Cost of the Work is defined in the AIA Form and usually includes the hard construction costs, as well as general conditions costs, such as insurance and bond costs, transportation, travel and subsistence expenses, storage costs, debris removal, testing, legal, mediation and arbitration costs, including attorneys fees (unless they involve a dispute between the owner and contractor), as well as costs due to emergencies. The more "general conditions" items included in the Cost of the Work, the higher the Contractor Fee.

Change Orders Change Order approval should rest only with the owner. The contractor should be deemed to waive any right to payment for work performed without an approved change order. Additionally, the contractor should be required to continue disputed work even in the event a change order is not approved. No time extensions should be granted to the contractor because of a change order unless expressly provided. There should be an agreed upon fixed amount for the change order, including any overhead and profit.

The AIA Forms provide that the architect may approve changes in the work and payment to the contractor. There is no contractor waiver of payment provision for work performed without an approved change

order. And the AIA Agreements allow for adjustment to the Contractor's Fee and unit prices established if changes in work would cause substantial inequity to the contractor.

Indemnification The Agreement should include a comprehensive indemnity provision requiring the contractor to indemnify the owner for all claims arising out of the contractor's work. The AIA Agreements' indemnity is limited to personal injuries and property damage claims. As a consequence, economic loss damages are not covered by this indemnity. Additionally, the indemnity is limited to claims that arise out of the contractors' negligence.

Termination A broad basis for termination by the owner for cause is recommended, as well as requiring the contractor to participate in the transition/completion phase in the event of termination. It is also important to include a provision where the contractor's right to terminate is limited to non-payment only. The AIA Standard Forms severely limit and hamper the owner's ability to terminate by requiring the architect's certification for termination.

Dispute Resolution It is sensible to include a dispute resolution procedure providing for an expedited disposition of claims whose cumulative sum is less than a certain designated monetary amount, through a mutually agreed upon arbitrator. This will enable the speedy disposition of minor construction claims, where the contractor is required to continue to perform its work on the project while the parties resolve their dispute. The procedure will also require the joinder of all necessary parties to the arbitration so that all related claims are disposed of in one forum.

In the AIA Forms, there is no required joinder of necessary parties to the arbitration, which could lead to separate arbitrations against the contractor, architect and engineers, and potentially provide for inconsistent findings and awards. The Form provides a cumbersome mediation process and requires arbitration of all disputes, regardless of size.

The Owner-Contractor Agreement, if carefully drafted, can go a long way in providing adequate protection for an owner against unexpected cost overruns and potential claims by the contractor and third parties. Including the provisions discussed above and avoiding AIA Form Agreements will help reduce the likelihood of cost overruns and claims.

F I R M N E W S

Alex Ferrini, Ronald Feingold and David Esterman will present **Legal Issues for New York Professional Engineers** on January 19, 2007 in White Plains, New York. The full day seminar will explore topics including: New York State licensing and renewal requirements; the New York Board of Professional Engineering's duties, Rules and Regulations; defining unauthorized and unlicensed practice; the Board's procedures for initiating investigations and taking disciplinary action; defining professional conduct by and between engineers including out-of-state practice procedures; understanding insurance, liability and malpractice issues and identifying and avoiding potential professional liability claims; and how to act as a fact and/or expert witness in a civil litigation. Space is limited, so for additional information and to register, please visit www.halfmoonseminars.com.

Barry LePatner recently published an article in the October 17-23, 2006 **New York Real Estate Journal** on the chronic problem of construction costs far exceeding their initial estimates. "Construction Cost Increases: Owners Should Know the Difference Between the Myths and Realities," explains that the lack of a true fixed price contract and an asymmetric balance of information in favor of the contractor makes it almost impossible for an owner to truly remain in control of its construction project. Change orders, especially, invite exploitation by the contractor because of the monopoly power the contractor holds once the project has begun. The article is excerpted from Mr. LePatner's forthcoming book, **Broken Buildings, Busted Budgets**, to be published by the University of Chicago Press in 2007, and is available at www.lepatner.com.

QUOTE OF THE QUARTER

Talent is the ability to do some things, not all things.

George Will

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