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LEPATNER REPORT

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Fixed-Price Contracts

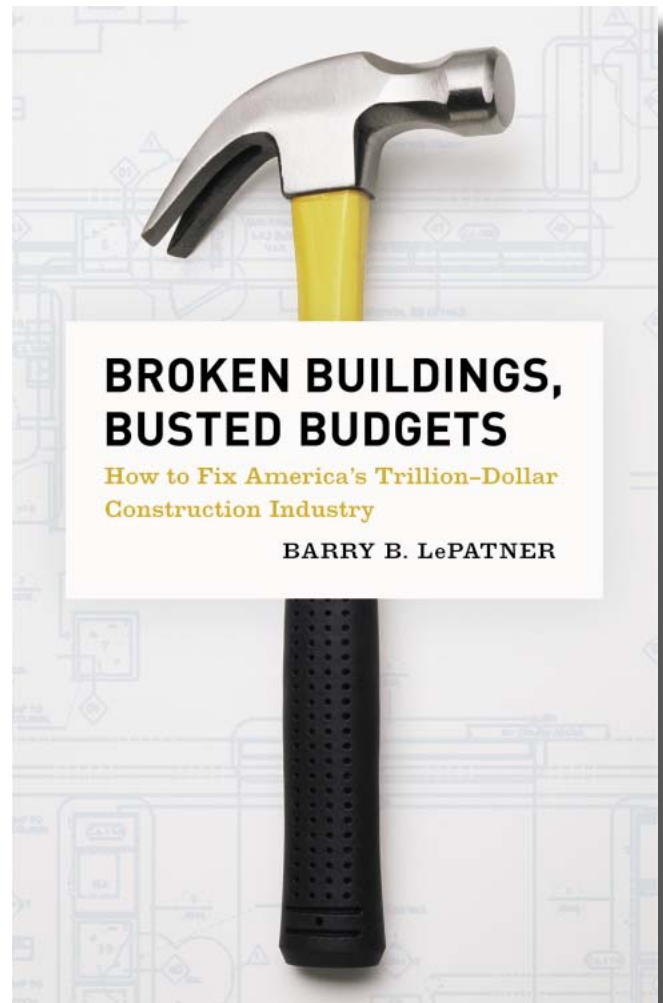
Saving the construction industry from itself

Barry B. LePatner, Esq.

The emergence of a true fixed-price contract, in contrast to today's highly mutable deals, is imperative if the construction industry's widespread inefficiencies and rampant cost overruns contained.

Most construction contracts are intended to be a fixed price for a given set of "final" construction documents, with the price set either through bidding or negotiation. Guaranteed Maximum Price (GMP) contracts, which are often based on 75%-85% complete construction documents, constitute another twenty percent. The balance is various open-ended arrangements (e.g. time and materials, cost plus fee, or unit cost plus fee) not subject to any price cap. If owners can avoid the use of the open-ended arrangements, and of vaguely worded "fixed-price" and GMP contracts, which allow unchecked cost increases after the contract is executed, the construction industry will be forced to quickly improve. ►

This article is excerpted from Barry LePatner's new book, **Broken Buildings, Busted Budgets: How to Fix America's Trillion-Dollar Construction Industry**, which will be published this September by the University of Chicago Press.



HOW TO PROTECT FEES IN A TIME OF RISING CONSTRUCTION COSTS

C. Bradley Cronk, RA, LEED AP

With solemn regularity, media headlines across the country announce that building material and labor costs are spiraling to new heights. Owners are not the only ones affected by these price increases. Designing to client budgets in a rising construction cost environment is equally challenging for architects and interior designers.

How should design firms best negotiate their way through these challenging circumstances while protecting design quality and profit

margins? Time-sensitive demands of the landlord-tenant relationship impose tight schedules on interior projects. Designers cannot afford to discover after the bids have come in that market factors beyond their control will force them back to the proverbial drawing board. With many design firms under fixed fee contracts, any value-engineering exercises that late in the process can limit or totally eliminate any profit for the design team. ►

This article was published in the May 2007 issue of **Contract** magazine.

► Most owners do not realize that after the agreement is signed and construction begins, the contractor effectively becomes a monopolist—and behaves accordingly. A recent study notes that contractors are not often motivated to control costs. The higher the construction costs, the greater the contractor's general conditions, insurance and profit, since these items are typically billed as a percentage of the construction cost. While agreements allowing mutable costs may be appropriate for complex projects entailing a high degree of uncertainty, economists have demonstrated that fixed-price contracts are superior for most projects and can benefit all parties.

Why there is no such thing as a fixed price.

When a general contractor signs a contract for a fixed price (or lump sum), he guarantees that he will provide and build every item shown on the contract bid documents within a specified time for a specified price. Accepting such a contract is seen by contractors as risky business. To construct a building the contractor must ensure that thousands of different pieces of material shown on the drawings are timely procured. He must schedule, supervise and coordinate the daily work of dozens of suppliers, subcontractors, fabricators, and general work staff, most of which may have never worked together before. If a subcontractor fails to perform as prescribed, the contractor must step into the breach, secure another subcontractor willing to complete the defaulting

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subcontractor's work and assume any cost increases charged by the completing subcontractor. Because contractors must coordinate with dozens of other "mom and pop" shops, they are extremely reluctant to assume all the risks of building. They often believe that owners who initiate the projects should bear the majority of the risks on the project. But why should this be the case when vendors typically accept such risks for every major product you buy as a consumer?

The preponderance of fragmented, small construction firms further contributes to the contractor's avoidance of risk. Small firms dominate the industry. Ninety percent of all contractors employ fewer than twenty people. There are 7.6 million individuals in the construction industry employed in over 1.1 million firms. The economic realities facing these "mom and pop" shops and the low-price mentality of most owners forces contractors to adopt a strategy to win the job with a low bid in order to win the

opportunity to then submit change orders where profits are really made.

Eliminate contractor opportunities for increasing costs after work has begun.

The owner's primary goal should be to execute agreements with all team members to ensure that construction costs are not mutable. Securing a true fixed-price contract for a project will require the architect and engineer to deliver a set of construction documents for bidding that are fully detailed, complete and coordinated in all respects. Owners often assume, incorrectly, that bid drawings are the same as 100% complete construction documents. But often, awards are made and construction starts before the construction documents are fully complete.

Information added to complete the construction documents after the contractor is awarded the job often leads to non-competitively-bid change order work and possible delays. To the extent that those post-award changes can be made pre-award, everyone will be better off. But

PROTECT YOUR DESIGN FEES continued

► Clients that do not build regularly are notoriously lacking in experience or information to establish a realistic project budget. As a result these clients often entrust construction managers or contractors, who have a clear conflict of interest, to set their project budgets from the outset. Yet the CM and owner often blame the designer when the design comes in over budget. How can a design firm protect itself and its hard-won fees against claims by the owner when construction cost overruns have become so prevalent?

First, designers need to be up front with the client about the construction climate at the outset of the project. Advising a client that costs are going up and could impact its schedule is good, cautionary advice.

Secondly, designers should be readily familiar with the products and systems they intend to specify, particularly with respect to performance, availability, first cost and life cycle cost. With this knowledge, the firm can essentially fold value-engineering into the design early on to mitigate the risk of producing an over-budget design. This is even more effective if the designer can simultaneously collaborate with a construction manager or general contractor to vet the design.

given their inevitability, it is essential that construction contracts anticipate construction document errors and omissions and provide a framework to ensure that any resulting change orders are reasonably priced and are not used to gouge owners, who are rendered virtually powerless due to the contractor's superior information and market power once construction begins. The agreement, which is currently slanted steeply in favor of contractors, has to become a level playing field.

To accomplish this, your agreement with the architect—who will likely enter into separate agreements with each of the engineers—must contain language such as the following:

The Architect agrees that an essential part of its services is to provide a fully detailed set of construction documents to enable the Owner to secure a fixed-price contract from the selected contractor. To

assist the Owner in accomplishing this objective, the Architect agrees to provide for bid issue 100% complete construction documents that have been fully coordinated with each of the engineers and other designers on the project.

The owner may find it well worth the additional few extra weeks and compensation the architect requires to finalize 100% complete documents, especially when compared to the potential 20-30% hidden premium contractors include in most change orders. A constructability review by the CM or an independent consultant to the owner prior to issuing the bid drawings will detect errors and omissions *before* they impact the GMP and schedule or lead to large claims.

Once this provision is in place, the next objective is to ensure that a corollary provision is included in the construction manager or contractor agreement that provides the following:

The Construction Manager (or Contractor) has been provided full opportunity to review the Construction Documents and field conditions so as to ensure that it fully understands the design intent shown and that all elements for construction shown thereon have been included in the contract price. It is agreed that the contract price includes all necessary work, labor, and material expressly or impliedly required for the project. The Construction Manager (or Contractor), agrees to waive any claim for extra cost or delay related to any error or omission in the Construction Documents that reasonably should have been observed prior to commencing work on the project.

By including this provision, the owner protects itself against price creep. Only legitimate additions to the project, e.g. the *owner's* decision to add a new floor or additional lighting not part of the approved base scope work, will add ►

An alternative is to retain an outside estimator, although the “real world” estimates provided by a pre-construction service provider may ultimately prove more accurate in the marketplace.

The designer can also control construction costs through the quality of its drawings and specifications. On projects of nearly all types and scale, we strongly advise our design professional clients to prepare 100% complete and coordinated drawings, which encourage the contractor to provide a fixed price contract (notwithstanding exceptions for minor allowances.) The cost to the owner of the few additional weeks that it may take to prepare 100% documents should be exceeded by the cost savings from securing a fixed price construction contract, which in turn minimizes conflicts, job interruptions and change orders that result from missing or uncoordinated design information.

In the event that a re-design is required, consider adding the following provision to your agreements:

The Architect [or Designer] assumes no responsibility for rising construction costs. In the event that bids from responsible bidders exceed the Owner's proposed budget by more than 5%, then the Architect's [or Designer's] re-design services to achieve the Owner's budget shall be Additional Services.

On less complex designs, the owner and designer should consider eliminating the design development phase and instead transition directly from schematic design into construction documents to reach pricing and construction more quickly. This tactic may require additional staffing, so the designer's fee would not necessarily be lower

than it would on a traditional design schedule. In this scenario, working with a pre-construction provider may allow the design documentation to be further streamlined without decreasing design quality or bid accuracy.

Another way to protect fees is to increase them. According to the 2007 PSMJ A/E Fees & Pricing Survey, average billing rates for architectural firms increased 6% in 2006 over 2005 levels with hourly rates for principals, associates, and project managers leading the way. While this is good news for the industry as a whole, concerns remain for the 100,000+ design firms who continue to fight the commoditization of their services by clients who act as if all design firms perform the same kind and quality of services. To differentiate themselves, firms enjoying higher fees have developed non-traditional services such as programming, FF&E procurement, strategic planning, green design and LEED certification consulting, and project management services that demonstrate tangible value to the client and serve as pathways to additional fees. In addition, since many design fees are a fixed percentage of the initial budget cost of the work, when actual construction costs rise, the designer's fee can be left behind. Add provisions to your agreements that allow for reasonable fee escalation, especially over longer, phased projects.

Recognition of a fee-affecting business condition such as increasing construction costs is a prerequisite to establishing the correct fee for a project. Smart firms that identify these issues and communicate them to their clients will earn their client's respect and ultimately lead to higher fees.

► cost to the project. The CM or contractor should also be required by the contract to submit a buy-out schedule to the owner along with subsequent proof that all the project's materials and trades were bought in a timely fashion. This provision should extend to subcontractors as well. Costs need to be locked in as close to the contract award date as possible to avoid material and labor escalation affecting the project cost.

final GMP prepared by the CM far exceeds the owner's budget. Reducing scope at that point will likely have an enormous ripple effect and impact the schedule negating any advantage the fast-track process might have yielded.

A frank discussion of the project risks and how to equitably allocate them between the parties is critical for success. The contractor benefits by being allowed to put a cost on its most commonly encountered project risks. The owner benefits by locking the contractor in to a

LePatner & Associates offers two new free CLE courses for attorneys this summer and fall. **Barry LePatner** will lead the course on "Construction Cost Integrity: Protecting Your Client's Investment," and "Avoiding, Defending and Defeating Construction Claims." Much of the material will be drawn from **Broken Buildings, Busted Budgets** in addition to the firm's nearly thirty years of experience. Contact drubin@lepatner.com for more information or to schedule a course.

Get ready for the second annual **LePatner Construction Satisfaction Survey**. To expand our reach, we've separately teamed with **PSMJ Resources, Inc.**, a nationally renowned project strategy and marketing consultant for design professionals, and **The Berman Group**, a New York City based marketing consultant, to distribute an expanded online version of the survey. The survey will take the pulse of the current construction environment from the owners' and design professionals' perspective. Look for an announcement later this summer directing you to the online survey.

Brad Cronk, the firm's director of project management and registered architect, recently obtained his LEED Accreditation from the United States Green Building Congress. The Leadership in Energy and Environmental Design (LEED) Green Building Rating System is a voluntary yet measurable approach to designing and building green. LePatner aims to be a leader in this emerging field, advising its clients about the business, design and legal benefits of "going green" on their new and existing projects. Look for future articles on these critical issues, and in the meantime, contact Brad at bcronk@lepatner.com with your green design questions.

CONSTRUCTION AGREEMENT TYPES

60% are nominally fixed price for a given set of "final" construction documents;

20% are GMP contracts, which are often only based on 75%-85% complete construction documents; and

20% are various open-ended agreements, e.g. time and materials, cost plus fee, or fees based on unit costs.

A second important way to ensure a fixed-price contract is by resisting efforts to "fast-track" the project. Time is money and other arguments for commencing construction prior to completion of design are well-known, but beware that the owner's risk rises rapidly using fast-track. By agreeing to a fast-track process, the owner gives up control of the cost and schedule to the construction manager, who often bears little risk if the budget is exceeded or the project encounters serious delays. Under fast-track, no construction manager can or will provide realistic assurances that the initial proposed project budget or preliminary guaranteed maximum price (GMP) will be finalized into a GMP of the same amount, let alone less. Further, they explain that they have no control over the material marketplace or the cost of labor. Moreover, since fast-track construction commences before the project design is finalized, the owner effectively loses the opportunity to re-bid the project if the

true, fixed price at only a slight premium to what it might pay in other "fixed" arrangements.

How do we know this works?

Our clients have avoided these problems by utilizing fixed-price contracts, or what we call "Equitable Risk Allocation Agreements." Under these agreements, the contractor or CM who cannot provide accurate estimates will eat the cost overruns instead of passing them on to owners via change orders. Suddenly, to increase profits and productivity and further dilute risk, it will make sense for contractors to introduce more efficient equipment and procedures, innovative materials, and the latest training and technology to keep costs down. When this happens, as it has in many other industries, a shakeout will occur. For the first time, perhaps in the industry's history, inefficient construction firms will be forced out and won't be easily replaced by equally inefficient firms the next day. Efficient firms will find themselves operating more like a corporate business. They will profit and grow. And soon, they will find that they can acquire competitors rather than suffer them.

QUOTE OF THE QUARTER

"It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change."

— *Charles Darwin*

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