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## **Pitfalls of Construction Facing the Owner:**

### **Accounting Traps Found in Standard AIA Documents**

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This article explains why otherwise sophisticated owners embarking on construction projects, without the guidance of experienced construction counsel, are easy prey to construction managers and general contractors. Typically they don't take control of the manner in which contractors 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 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 the unsuspecting owner from seeing how their funds were misappropriated. 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 take control of the contract process and anticipate the issues discussed in this article by appropriate contract provisions. Generally 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 manager(2) -- 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 for the owner is that the owner, the entity funding the CM and the project, is not in control of the 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, or the pockets of its owners!

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." 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 get access to the books of the CM, it again is in for another rude awakening. Typically, the CM or general contractor uses a software program, 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 discovery(4).

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 work(5) 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 discovery.

There is a simple solution to this inappropriate 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.

(1) The AIA form contracts are not drafted from the owner perspective. These are forms generated by 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.)

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