ASSOCIATION FOR PROJECT MANAGERS

The Project Manager

Volume 17 Issue 1

SPRING 2010

WHAT OWNERS & LENDERS SHOULD KNOW ABOUT THE CONSTRUCTION PROCESS

C. Bradley Cronk, RA, LEED AP

Although national construction spending has declined during the Great Recession, sophisticated planning must still inform the complex decisions that owners and their lenders must make before green-lighting construction. Or, so one would think. In reality, owners are still taking risky planning shortcuts in order to commence construction as quickly as possible, while their lenders are not aware of, or ignore the potential consequences. Early planning mistakes can cost owners and their lenders dearly after construction is underway.

These mistakes can be traced to fallacies that have become imbued in the design and construction process during the past decades. These common practices, which are dependent on the role of the construction manager, Fast-Track project delivery, and "Guaranteed Maximum Price" (a misnomer if ever there was one) contracts, have obliterated any sense of assurance that an owner will achieve project completion upon its contract-mandated schedule and price.
For several decades now, Guaranteed Maximum Price contracts and Fast-Track project delivery has been the norm for most large scale, complex projects. Construction Managers answered owners' and developers' calls to provide them with a building process that, at first look, allowed construction to proceed on an accelerated basis, potentially saving the owner millions of dollars in financing costs and ostensibly allowing it to capture "early" revenue from the completed project. However, owners and developers were slow to recognize a major flaw in the model: GMP contracts and the Fast-Track process were based on incomplete design documents, which invariably led to significant cost overruns.

Despite its name suggesting otherwise, a GMP is misleading. It still allows for myriad exclusions, allowances, and pricing assumptions made on the incomplete design which do not necessarily bear out once construction starts, the design is completed and actual costs determined. Construction Managers routinely urge architects and engineers to issue 85% complete, or less, drawing and specifications as the basis of the "final" GMP.

And despite Fast-Track jobs starting construction "early" while the design documents are still being finalized, these projects rarely finish earlier than if construction had commenced after the design had been given the time to be fully developed on the bid documents. In effect, Fast-Track often extends the construction schedule, increases construction costs and the likelihood of costly completion delays.

In the past, those unexpected cost overruns might have been paid to the builders by owners accessing additional lines of credit or by reducing the project's anticipated profits. In the current economic climate, however, unlimited project financing is no longer available. Lending requirements have tightened, typically requiring a 40% to 50% owner equity stake in order to obtain a construction loan. Moreover, mezzanine loans, which often served to finance project overruns, are a thing of the past. Such costs also now have to be paid by the owner. As a consequence, public and private owners will increasingly demand certainty for their capital project costs in order to protect their equity. Unanticipated project cost overruns can no longer remain an afterthought or be assumed to be covered by additional financing.

Yet, standard design and construction agreements, including those generated by or based upon the AIA and AGC models, fail to provide any sense of certainty in these critical areas. In fact, the AIA and AGC agreements are silent on the critical issue of contractor bids based upon incomplete designs and fail to offer any mechanism to anticipate and price "unexpected" conditions. These are precisely the circumstances in which cost overruns and change order claims run rampant through the construction industry.

Owners and construction lenders based the loan amounts upon estimates established by the Construction Manager (does the idea of a conflict of interest ever enter their minds?) because they do not have access to the pricing information that a contractor has -an asymmetry of information favoring the contractor exists. Yet as projects routinely exceed their GMP and finish behind schedule despite being Fast-Tracked, owners and lenders have been slow to make the connection between cost overruns and the construction industry's established, and preferred, way of doing business.

The following issues that are often either overlooked or rarely considered should be addressed by owners and their lenders before a project gets underway. As important, they should ponder the additional risks (which become costly change orders and delays) when the construction process is rushed ahead without consideration of the factors set out below.

AT THE OUTSET OF A PROJECT

Strategic project planning and risk avoidance analysis at the outset of the project is critical to minimize unexpected and unwarranted cost overruns. The owner and lender, together with counsel, should determine the risk appetite of the project and attempt to develop methods for quantifying project risks by using data from recently completed similar projects.

Risk mitigation continues with proper due diligence of prospective A/E/C team members. Team members should be pre-qualified and have a history of success on similar projects completed on budget and on schedule. Team members should also be investigated to ensure they are free of ongoing or pending claims and litigation, and they should be in relatively healthy financial condition. The recession has put many A/E/C firms on the edge, especially medium and small ones, and cash flow is critical to their survival. Several late or non-paying clients could significantly impact your project, even if your payments are made on schedule. It's critical to know that your A/E/C team can weather the storm and won't default halfway through the project and cause significant delays and resulting cost overruns.

In this economy, the owner can insist that it be assigned an 'A-team'. While each firm has a different reputation, it is often because of a handful of its star employees know how to deliver. In the pre-recession market, owner's, especially those who sought out high profile "starchitects," often had little or no say in the quality of the personnel assigned to their project. In today's economy, the owner shouldn't overlook the importance of assembling an A-team.

The site and/or property itself needs to be carefully evaluated to ensure that no special variances or approvals are required, without which, construction could not start. Presumably, an owner who has just purchased property will have performed this due diligence on the site as well as on the existing condition of the building before closing, but an owner with an existing building would be wise to confirm whether any new zoning regulations have been enacted since the original property purchase.

Owners and their lenders should consider convening a risk allocation meeting with legal counsel specializing in construction and/or project management expertise in order to identify commonly overlooked risks of the design / construction process. To the extent possible, these risks should be quantified and set aside in a risk contingency fund that the owner controls. This contingency becomes part of the overall project budget from the outset, so that in case there is a situation that requires additional cost, it can be drawn down from the lender without additional approvals (which would likely be denied in today's constrained credit market).

Finally, take the time to establish an overall project management plan (PMP) that outlines roles, responsibilities and procedures for all to follow. The PMP will vary by project but should include:

> organizational charts, tasks and responsibilities
> contract procurement procedures
> budget and cost establishment, updating, and reporting
> project management controls, including use of PM software
> administrative, communication, and approval procedures
> quality control processes
> risk avoidance and mitigation

BEFORE COMMENCING DESIGN

Owners and lenders typically don't recognize the direct relationship between an incomplete set of construction documents and project cost overruns. Typically, the owner, with encouragement from the construction manager, mistakenly pressures its design team fast-track the project or issue incomplete drawings for bidding. The stated benefits of fast-track in order to save time never materialize. By the time owners and their lenders realize this, the project is typically overrun with scope changes, change orders and delay claims with the parties blaming each other for the errors, omissions, and incomplete drawings and bids.

Owners and their lenders should strongly consider allowing the design team the additional time (and fees) needed to produce a fully complete and coordinated set of construction documents for bidding. Owners should also strongly consider retaining an independent cost estimator who can provide cost and constructability checks throughout the design process to ensure that there are no sudden cost surprises when the final competitive contractor bids are received. The owner needs to ensure that the its program as designed won't exceed the available funds and be subject to "value-engineering" exercises, which remove scope but rarely realize significant dollar to dollar cost savings after the additional time is spent on the exercise.

This process, which is an owner and lender's best hope for attaining a "true" fixed-price contract, should be outlined in the RFP and agreements as a contractual obligation. Experienced construction counsel is necessary to provide a seamless set of agreements that obtains buy-in from all the parties and fairly allocates the project risks.

BEFORE STARTING CONSTRUCTION

The right contractual provisions are crucial to ensure that no unwarranted cost overruns are allowed. Cost control provisions that outline specific steps contractors must take to submit requisitions and required cost backup documentation, change order requests, etc. Audit provisions which allow the owner quick and full access to the contractor's records. A strict change management procedure should be instituted to address how changes are initiated, priced, authorized, and paid. The same should be done for drawing on allowances and the risk contingency.

A detailed critical path schedule should be developed and agreed to before construction starts. Updates and additional detail should be contractually required. Deviations from performance projected on the schedule needs to be identified early and a corrective action plan taken to remain on schedule. A system of "early warning" communication procedures should be established and specified in the contract.

Convene a risk allocation workshop with the owner, A/E team and prospective contractor or construction manager to define, assign, and negotiate costs for potential unforeseen conditions. These costs are added to the owner's risk contingency initially established in the project planning phase, and the contractor is contractually obligated to perform the specific contingency work at its specifically agreed price, and not a dollar more. By so doing, the owner has capped its upside exposure for those particular risks.

Going forward, lenders will require stricter oversight and verification of work in place before funds are released to the owner. Over-reporting of completed progress on requisitions will no longer be tolerated. Only earned value analysis will be acceptable. Checks and balances should be incorporated in the construction agreement. The owner should require that retention be held at 10% at least until substantial completion.

Non-performance risks should be identified and addressed during contract negotiations. While bonding is often not available to those contractors who truly need it, bonding may be required on certain types of projects or by the lenders. If bonding costs are prohibitive, consider bonding only those critical subcontractors, such as steel, HVAC, plumbing and electrical.

Partial waivers of lien should be collected with each payment requisition from all contractors and their subs during construction. This is typically mandated by the lender to ensure a lien won't encumber the property.

What owners and lenders don't often anticipate are inflated liens from contractors looking to negotiate a settlement, or liens from subcontractors because they have not been paid by the general contractor or CM. Although there is nothing to prevent such liens from being filed, the owner's recourse is tough contract language that (a) provides the form of lien to be used for all contractors and subs; (b) obligates the contractor to immediately bond liens for which the owner has paid the contractor; and (c) allows the owner to recover reasonable costs if it is forced to litigate an inflated lien.

BEFORE SIGN-OFFS

Owners and lenders should be aware of how protracted the sign-off and final completion process can be. It is critical that the owner retains enough of the A/E/C's fees /payments so that it would be more costly for them not to finish, than to fade away without performing their final contract obligations.

A good project manager will begin establishing completion checklists for each consultant and contractor well before substantial completion. Sign-off paperwork, scheduling inspections, performing re-work and re-inspection can take months even if the process is well-planned. When occupancy (and commencement of rent or closings) is dependent on achieving a temporary certificate of occupancy by a date certain, delays can suddenly cost the owner significant sums.

CONCLUSION

As the financial crisis abates in 2010 and credit availability enables construction projects to move forward, construction overruns will no longer be affordable, nor should they be tolerated by owners. Lenders will require 40% to 50% owner equity to qualify for financing, and experts predict that there will be few, if any, mezzanine lenders willing to fund cost overruns. To make matters more challenging, after several lean years of low-bidding projects just to keep their doors open, contractors will be looking to resume business as usual. As a result, it will become increasingly imperative for owners to recognize the critical importance of utilizing the above tactics and strategy to attain a true fixed-price construction contract as a means to preclude costly construction overruns.

Bradley Cronk is a consultant with the law offices of LePatner & Associates, LLP, corporate construction counsel. He may be reached at: **mail@lepatner.com**, telephone 212-935-4400, snail mail at LePatner & Associates, 600 Lexington Avenue, 21st floor, New York, NY 10022.
This article originally appeared in the Fall/Winter 2009 issue of the *LePatner Report*, reprinted with permission of the author.