

“When you’re afraid, keep your mind on what you have to do. And if you have been thoroughly prepared, you will not be afraid.”

- Dale Carnegie

LEPATNER REPORT

CONSTRUCTION COST CERTAINTY

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A QUARTERLY FOR OWNERS AND THE REAL ESTATE & CONSTRUCTION INDUSTRY FOR 31 YEARS

Happy Holidays

Best wishes for a healthy and prosperous 2012.



Can Real Estate Developers Still Profit?

By Alex D. Tuttle, Esq.

Today’s real estate landscape is a minefield. Lending is scarce and conditioned with onerous terms against borrowers. Cash is reserved on the sidelines for only the sweetest of deals. Investors who have, in the past, demanded home runs, now must be content with doubles.

Developers are questioning their tried and true development practices. With profits hinging on such slim margins, developers are now focusing on reducing/eliminating construction delays and cost overruns that invariably eat into their development profit.

Now more than ever, developers must strategically evaluate and plan, assemble a first-class project team, critically oversee the design process, secure responsible bids from contractors, and administer quality and timely construction.

Strategic Evaluation and Planning

Construction planning requires more than simply allocating a design and construction budget. It requires evaluating sustainability goals, the quality of the design and construction, operations, project delivery options, and whether to use a general contractor or construction manager to execute the construction.

Most importantly, developers must identify and price foreseeable construction risks to mitigate potential loss. This can be achieved through the design ►

Corruption Indictments Sweeping the Construction Industry

By Barry B. LePatner, Esq.

Headlines have been blaring news about corruption in the construction industry. “Four veteran construction executives arraigned on charges they systematically stole tens of millions of dollars from investment firms, insurance companies and law firms across Manhattan,” said a May 4, 2011, New York Times article. According to charges by the New York County District Attorney’s office, in a period of three years—from 2008 to 2010—a firm’s executives bilked clients of more than \$78 million by “over-invoicing.”

According to court filings, on projects for which Lehr Construction served as construction manager, its subcontractors would agree to overbill the owner, resulting in a higher construction management fee for Lehr. Then, on subsequent projects where Lehr was serving as general contractor, these same subcontractors would provide their services to Lehr at a reduced rate or at no charge. This scheme allowed Lehr to reduce its costs and artificially boost profits associated with projects for which it acted as general contractor where the owner had agreed to pay a fixed price for the work.

Assuming the allegations are correct, one is struck by the enormity of the excessive costs built into every job this construction manager oversaw. Even more amazing, no construction contract entered into by these clients—major law firms among them—had made provisions for the requisite due diligence that could have unearthed these illicit transactions during or after the project was underway. Had these clients or their counsel performed even cursory due diligence, they would have discovered a history that included multiple corruption probes that sent its executives to jail with multi-million dollar restitution payments to corporations. These red flags should have warned clients of the dangers arising from using the firm and had them looking closely at Lehr’s contracts and practices.

The Lehr situation is not a one-off. In New York alone, the past few years have seen a litany of “perp walks” by prosecutors at the federal, state and local levels that should warn every major construction project owner of the dangers of placing millions—or tens and hundreds of millions—into the hands of companies without ►

Excerpted from an article published in the New York Law Journal November 17, 2011.

▶ continued... **Can Developers Still Profit?**

and construction team collaborating to identify (i) contingencies that may impact the project; and (ii) mitigation strategies. No longer should a developer be held hostage to alleged “unforeseen conditions” and “change order” claims.

Assembling the Project Team

Developers must surround themselves with proven and qualified talent. This requires a calculated and comprehensive due diligence and pre-qualification process.

Developers’ Requests for Proposals (RFPs) to potential team members should seek not only the most experienced candidates, but also those qualified to meet the specific project goals defined in the RFP. For example, RFPs for design professionals may require that they issue bids based upon producing fully complete and coordinated design drawings in order to obtain an accurate construction price from contractors. RFPs for owner’s representatives may require that they have experience in negotiating fixed price contracts and identifying and eliminating unwarranted general conditions line items in contractors’ proposals.

Overseeing the Design Process

Developers must carefully contract with their design team to ensure that the design drawings are fully detailed and coordinated. This eliminates contractor claims for errors and omissions in the design drawings, which otherwise serve as the single greatest source of project delays and cost overruns.

But how can developers be assured that the design drawings are complete and coordinated? One key element is ensuring that the design software incorporates BIM or other sophisticated filters that identify coordination problems between the mechanical, electrical, plumbing and structural engineering designs. Another key element is having the contractor certify that what’s reflected on the design drawings can actually be built within the contractor’s bid price.

The design process should permit the developer, with the assistance of cost estimators, to understand the true cost of what’s being designed as it is being designed. Too often developers are first presented with construction pricing when the contractor

submits its bid. That’s way too late, and most likely, the contractor bid is not the true price. Only with accurate cost information in hand can developers maintain control over the construction process and make appropriate comparisons with contractor bids to ensure fair pricing and avoid “low-balling.”

Selecting a Contractor

Unfortunately, the opaque nature of the construction process promotes contractor theft of services. This occurs in the form of supplier kick backs, billing phantom costs, low ball bidding projects, and charging full-time rates for workers not even on the job. How do developers protect against this?

Developers should have a systematic process of screening potential contractors. The RFP should include uniform bidding forms that identify each trade breakdown, itemized general conditions, insurance coverages, bonds, a fixed fee for the contractor, and a list of potential risks that may occur during construction.

The RFP should further contain specimen contracts that the contractor will ultimately sign. The contracts should require the contractor to: (i) certify that the design drawings are complete and coordinated to enable an accurate bid; (ii) waive all rights to make claims based on errors/omissions in the design drawings; (iii) complete the project within the agreed-upon schedule and assume all risk of delay; and (iv) identify and quantify specified risks and contingencies that may arise during the project.

Administering the Construction

Developers must implement certain controls over their project. These controls may include a (i) detailed project management plan with precise performance dates; (ii) monitoring system of critical cost items; (iii) auditing program against illegal subcontracting; (iv) system to tally manpower on the project; (v) requisition process that verifies project materials and equipment; and (vi) program to confirm all contract requirements are satisfied.

These are just a sampling of issues that should be considered before embarking on a project. A misstep with any one of these could be the difference between millions in profit and foreclosure, bankruptcy, and recourse against personal assets.



image of WTC development site courtesy NYCTheBlog@blogspot.com

► **Corruption Indictments** continued...

proper due diligence and contractual protections. As reported in *The New York Times*, for the past year, both the District Attorney of New York County and State Police investigators have called in over a hundred subcontractors in the latest round-up of indictments related to corruption on projects as prominent as the Goldman Sachs and Bank of America headquarters. Recently, another construction management firm, the Builders Group, and its corporate officers pleaded guilty to stealing millions of dollars from clients in corporations and on condominium projects.

The District Attorney in New York County says corruption adds 10 percent to construction costs in Manhattan. Those of us seeking to guide owners away from the trickery that permeates the industry also know that studies show that nearly 50 percent of all labor on a construction project is wasted due to late deliveries, workers only performing 3-4 hours of actual work during a 7-hour work day, and taking hours of time going up and down hoists in a single day.



Due Diligence

Owners of all kinds must acknowledge that their failure to perform the requisite due diligence that the construction industry's history mandates. Some owners believe that if they retain union contractors, who are bound by so-called "project labor agreements," rules are already in place with defined costs for the work to be done. In fact, while a project labor agreement may establish rates and benefits for every category of worker on a project, the widespread use of illegal mark-ups, fictitious invoices and kickbacks that are embedded in the fabric of the construction industry demands more effective means of protecting project budgets.

Owners can start to protect themselves by implementing due diligence when hiring the project team. Requests for Qualifications and Requests for Proposals should include thorough questionnaires that require bidders to answer questions about their businesses, ownership and history, including jobs worked, liens filed, criminal, civil and administrative inquiries and similar information. This provides owners with a baseline of information from which to verify qualifications and conduct background investigations of bidders and their owners, principals and employees.

Owners should verify licenses and business registration of bidders and search public records to uncover any history of litigation, criminal convictions, unpaid taxes, undisclosed conflicts of interest among the project team, and other matters casting doubt upon a bidder's integrity or business practices. Bidders doing municipal work may be listed in such public indices as Vendex and may have been deemed non-responsible or been debarred from public work.

A search of press reports can also help avoid the mistake of hiring contractors publicly known to have engaged in wrongful conduct. Lehr Construction, for example, pleaded guilty to charges related to bid rigging in the late 1990s having overcharged clients tens of millions of dollars. A Lehr principal, Howard Lazar, reportedly pleaded guilty to attempting to bribe a city inspector in the 1970s. A robust due diligence background investigation would have uncovered this information.

Owners should retain licensed private investigators with experience conducting background investigations and knowledge of construction practices to assist in the due diligence process. For larger projects, a further layer of diligence includes in-depth interviews of prior customers of a bidder, construction managers and design professionals who have previously worked with the bidder, opposing parties in litigation, former employees and other industry and confidential sources of information.

Protective Language

Transparency—largely lacking in today's construction industry—is the key to maintaining integrity in the bidding, billing and timely completion of a large project. Contractual language between the owner and project team members should give owners the right to obtain and review all financial and accounting documentation relating to subcontractors as well as access to individuals and materials. If possible, electronic access to contractor and subcontractor information should be provided. This access will help an owner detect overbilling, fraud, waste and abuse, and also set a tone with the project team that the owner is serious about preventing cost overruns and untoward behavior.

Tight control also is needed over who works on the project. Carefully tailored contractual terms that require owner consent to all subcontracts limit the possibility that unsavory elements will gain access to the project. Owner consent for subcontracts allows the owner to perform due diligence on subcontractors and identify those who are unqualified or who have had earlier problems. All contractors and subcontractors should use owner-approved contracts that ensure the right to audit subs. Control over team members and contractual arrangements help prevent the filing of unwarranted and surprise liens for unpaid subcontractor costs. Well-drafted contracts can prevent insurance fraud and other vulnerabilities. ►

► Forensic Procedures

Although due diligence and contract language can significantly protect owners from corruption and cost overruns, owners should also monitor projects on an ongoing basis. Periodic examinations of, among others, project accounting documentation, material and manpower on site and actual project completion can further cement an owner's control during construction. Reviews should be conducted of general conditions, charges and change orders to ensure that owners are not being charged for an item or labor cost which was to be included in the fixed-price contract. This kind of double billing is fairly common and often goes undetected by owners unfamiliar with industry practices. Owners should monitor contract compliance of fees and charges based on a percentage, such as the construction management fee, insurance or overhead costs, to detect any fee inflation.

Contractors sometimes use insurance costs as a profit center at the owner's expense. During the project, periodic reviews should be conducted of insurance policies, riders and endorsements to verify coverage, document payment (through cancelled checks) to insurance carriers, and identify fictitious charges not justified by coverage levels purchased or for insurance that was never purchased. Owners and their representatives often receive an ACORD form, an official-looking document provided by a contractor's insurance broker. The form may list all insurance coverage but it is not evidence of insurance policies and endorsements actually issued by an insurance company for the benefit of the owner. Unscrupulous contractors may collect full value of all premiums to purchase insurance without buying the policies. An audit will disclose this readily upon inquiry.

Work being performed on a time and materials basis demands additional scrutiny. Owners should perform spot verification of contractor and subcontractor payrolls to ensure that charged amounts were actually paid to laborers, tax authorities, unions or insurance carriers. A sample review of cancelled checks can provide much of this verification.

Owners can also arrange surprise on-site inspections while projects are proceeding. During inspections, owners should verify the number of workers onsite and the types of work being performed. Equipment should be spot-checked to ensure items for which the owner is paying are actually on site and being utilized. On-site inspections help identify potential issues not readily apparent from the accounting and project documentation, and also reinforce an atmosphere of transparency, owner oversight and respect for the integrity of all team members.

Most companies, publicly or privately held, hospitals, school boards or real estate developers cannot afford the public scandal when corrupt contractors were employed for a large-scale project. When this occurs, stakeholders will demand explanations for the failure to introduce proper preventive mechanisms. Where protective procedures exist, unscrupulous contractors avoid bidding. If a project construction team has marked up its general conditions or insurance costs, sufficient grounds exist to warrant increased oversight or to bring in a sophisticated forensic team to oversee the project's funding and contracts.

Owners have a choice. They can avoid challenging a construction industry whose reputation has long been tarnished by corruption, or they can practice the kind of self-help that will provide the peace of mind and cost savings worth up to tens of millions of dollars. The choice is obvious—but it is a choice few owners can afford to get wrong.

FIRM NEWS

* On November 16, Barry LePatner spoke at the Real Estate Expo New York's forum on transportation issues. The distinguished panel included former Port Authority Executive Director Chris Ward, Noah Burdick, Deputy Director of Transportation Alternatives, and Seth Pinsky, President of the New York City Economic Development Council. The topic of discussion was "New York: Who's Driving This Train?" and allowed for a wide range of discussions on the capital investment New York City has and continues to make in transportation projects, the limitations that our city, state and federal budgets are having on future capital projects and the choices that need to be made to keep the whole city moving without disruption. Link [here](#) for a summary of this excellent discussion on how critical our transportation assets are to the future commercial engine that is the City of New York.

* As a result of the publicity that his book **Too Big to Fall** has received from the business media, Barry LePatner appeared on CNBC's special "Race to Rebuild: America's Infrastructure" to describe the perils of our deteriorating infrastructure. Catch a clip of the program [here](#). LePatner also appeared on MSNBC with Dylan Ratigan and spoke about the risks of any delay in funding repairs to our 7,980 structurally deficient and fracture-critical bridges, just like the I-35W bridge that collapsed in Minneapolis in August 2007. View a clip [here](#). And in late October, LePatner appeared on a Bloomberg TV report on the impact of bridge closings to the communities affected by bridge failures. Watch the video [here](#).

* LePatner & Associates and its forensic auditing and accounting affiliate, Proactive Integrity Associates, have been assisting client Thomas Jefferson School of Law in San Diego to address a variety of issues attendant to the close-out of the recently completed \$130 million facility.

* "New York's Post-Recession Projects," a panel discussion moderated by Barry LePatner about the state of the NYC real estate development economy included industry experts Andrew Lance of Gibson Dunn and Robert Ivanhoe of Greenberg Traurig. The event was sponsored by Bisnow at the NY Bar Association in midtown.

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