5 Crucial Contract Provisions For Mature Construction Cycles

This article discusses the current construction cycle, “mature,” and, more specifically, some of the most crucial contracting terms for this cycle. We generally recognize four construction cycles; namely, rock bottom, burgeoning, mature and declining. Different construction cycles require different contract terms because each cycle presents its own benefits and challenges. For example, during the burgeoning cycle, contractors are generally available and construction costs are very competitive. However, roughly 75 percent of all construction company failures occur during the burgeoning cycle because contractors lack working capital necessary to prosecute their work. In order to draft an appropriate construction contract, it is vitally important to understand the construction cycle and, thereafter, leverage the benefits and reduce the challenges associated with that cycle.

We are currently in a mature cycle. The benefits of a mature cycle include fantastic construction skills honed over the burgeoning and mature construction cycles. From a negative standpoint, however, contractor availability is low and construction costs are very high — indeed, the highest of the four cycles. Each mature cycle has its own unique characteristics as well. For example, the current mature cycle is plagued by a depleted workforce. The clearest manifestation of which is evidenced by the lack of subcontractors. Indeed, we are experiencing a “Perfect Storm” scenario because of three factors. First, the Great Reset of 2008 chased out roughly 600,000 people from the construction industry. Second, the baby boomers are aging out. Third, the young workforce has shown very, very little interest in replenishing the diminished ranks of the construction workforce. A combination of these factors renders the following five contract terms some of the most important for this mature cycle.

Construction is measured by three pillars; namely, quality of work, cost and delivery time. For many projects, the time pillar is most important. This is particularly true in the retail industry where, for example, “grand opening” presents drop-dead delivery deadlines. It is also true in other industries as well. For example, project delivery in tenancies can be equally important particularly in situations where the tenant needs to occupy the new space before its existing lease expires. Of all the cycles, the mature cycle presents the biggest threat to timely delivery. Therefore, most of the following five crucial contract terms focus on managing time.

Contractor’s “A Team”

The industry is experiencing profound and widespread shortages of project managers, superintendents and others. This shortage creates an environment where people are hired to fill positions for which they might not be considered during a different cycle. Stated differently, the dearth of talent has caused many contractors to “re-evaluate” their hiring criteria. Project success hinges on avoiding the lesser caliber personnel who infiltrate the field during this cycle.

When we draft construction contracts, we identify the best team of project managers and superintendents and insist they be on our project until the most critical phases are complete. This process involves frank discussions with the contractors and evaluations of the contractor’s past projects with its various teams. It is, however, often very, very difficult to get contractors to distinguish the skill levels of their various teams. Therefore, this evaluation process must also include discussions with others who have first-hand knowledge of the particular contractor’s teams (e.g., other project owners, architects, owner’s representatives, etc.). It is also important to note that the “B” or “C” team from a top-notch contractor may well be better than an “A” team from a lesser contractor.

Insisting on a particular team will likely result in an increase in the contract sum. However, this money is typically well spent. Construction should never be measured by cost. Value is the only true measurement. The additional costs, frustration, lost time and resources associated with using substandard project managers and superintendents frequently far outweigh the initial increased costs associated with using top professionals. The value proposition, therefore, rests with bringing the most competent people onboard.

Once the correct team has been identified, the contract language should include language ensuring that team is deployed to the project. The contract should, for example, identify the team members, prevent them from being replaced until key milestones have been achieved and ensure the bulk of their time is spent on the project. The contract may also include language requiring the contractor to certify that it is fulfilling this obligation on each payment application and that the owner retains the right to independently verify the same.

Acceleration Clause

The acceleration clause allows owners to expedite the contractors' production efforts if, for example, their contractors fail to achieve certain milestones. In a mature construction cycle, it is very, very common for contractors to be overextended. The shortage of competent subcontractors only exacerbates these situations. Therefore, project delays remain an ever-present and persistent threat during this cycle. Owners need to manage this threat by reserving the right to accelerate production and, thus, bring projects back into the required deadlines.

When vetting contractors, it is imperative that the owner and its team ascertain the contractor's capacities and measure the same against current and future workloads. A key question to ask is what projects is the contractor pursuing? If the answer reveals the contractor has a chance to land a project that likely will exhaust its capabilities, then the owner needs to evaluate whether the contractor's ambitions exceed its capabilities. This is particularly true if the other project is more profitable, has a tight construction deadline, etc. It is vitally important to ascertain whether the contractor has a plan to manage present and future projects.

All contracts should include an acceleration clause, particularly during a mature construction cycle. The key, however, is properly identifying the events that allows the owner to accelerate and the steps that must be taken when exercising this right. From an owner's perspective, the triggering event should be the owner's reasonable assessment that the contractor is likely to fall behind schedule. Stated differently, it is wise to include language that does not require an actual fall behind, but rather the reasonable likelihood of falling behind. This language gives the owner a chance to address the problem before it occurs.

The clause should give the contractor a very short window to outline and then execute a detailed plan to avoid or cure the delay. The clause should also provide the owner with the right to declare a default and either terminate should either the plan or execution be unacceptable or, alternatively, not terminate but have the right to supplement the workforce at the contractor's expense until such delay is avoided or cured. A properly worded acceleration clause provides the owner with a great tool to mitigate perhaps the most common risks associated with a mature construction cycle.

Monetize Claims in Advance

The mature cycle presents the highest construction costs. During this cycle, material and labor costs escalate quickly. Indeed, it is very common for one or more material costs to escalate dramatically due to conditions existing somewhere in the world. For example, a large natural disaster often increases the cost of lumber. These changes can quickly wreak havoc on an owner's budget.

Given these risks, one should strongly consider including contract language that monetizes claims in advance of the claim. Many different contract clauses exist for monetizing claims. These include the nebulous "equitable adjustment" where the determination of cost often results in litigation and the battle of experts. Another more formulistic approach involves substantiating actual cost and adding to it a percentage for overhead and profit. Another approach, less frequently used, is unit costs which involves an all-in number regardless of what the actual costs are. Each of these approaches presents risks and rewards and some are better suited for particular claims than others. However, owners typically favor certainty. Therefore, in an environment of escalating costs, the method of ensuring cost certainty and litigation avoidance is typically favored over the other approaches to monetizing claims.

In light of the foregoing, one should consider utilizing the unit pricing approach for as many areas of uncertainty as possible. For example, on projects where ledge could be encountered, the parties may want to establish an allowance for a certain quantity of ledge and then establish a unit price for those quantities exceeding the allowance. The unit approach, however, is less effective for owner-initiated changes in the work that involve, for example, procuring additional materials. With regard to these types of claims, the best approach is often agreeing to labor costs in advance and then giving cost plus for the materials. Agreeing in advance on labor costs is particularly helpful for creating budget certainty on projects of long duration.

In short, during a mature cycle, it is usually best to unit price as many claims as possible and then supplement that approach with the cost plus approach for any claims that do not fall within the unit price approach.

Liquidated Damages

Liquidated damages involve agreeing in advance on the amount of damages a party must pay should an event occur. To be valid and enforceable, liquidated damage clauses must be a fair estimate of what the actual damages would be. If not, most states, if not all, will strike a liquidated damage clause as a penalty.

Few terms create as much needless anxiety as “liquidated damages.” In the context of project delays, there are essentially three measures of damages: (1) waiver of damages, (2) actual damages or (3) liquidated damages. Owners will typically never agree to waive delay damages, although they often request contractors do via “no damage for delay” clauses. In the absence of a waiver of liquidated damages, actual damages are used. The problem with actual damages is calculating the same. This process often involves hiring very expensive experts to fight over theories and assumptions.

Given the costs of proving or refuting delay claims, it usually makes sense to monetize or “liquidate” them in advance. This is particularly true in a mature construction cycle where delays are a very frequent problem. We typically create two triggers for liquidated damages. The first trigger results from missing the substantial completion deadline. The second trigger results from missing the final completion deadline (e.g., punch-list items). Again, the dollar values associated with each event are agreed in advance and, therefore, create certainty.

Contractors frequently push back on liquidated damages even though monetizing actual delay damages is far more expensive and creates far greater uncertainty. Nonetheless, we sometimes reach common ground by offering an early delivery bonus, often per diem. Alternatively. or sometimes in conjunction with the same, we will give a grace period before the liquidated damages commence. The grace period might or might not be triggered by events over which the contractor does not have exclusive control. We also sometimes provide a stepped liquidated damage amount (e.g., lower per diem liquidated damage number for the first few days followed by a high number for subsequent days). We also provide contractors with examples of situations where the liquidated damages were lower than actual damages to highlight the fact that liquidated damages might benefit the contractor. In short, liquidated damages should be strongly considered. Moreover, the availability of other contract language should enable the parties to reach common ground.

Use Payments on Project First

Although not unique to the mature cycle, projects often fail because contractors use money earned from one project to pay the obligations from another project. The problem with this “House of Cards” approach is that contractors are frequently undercapitalized to find the “last” project.

In order to protect against this situation, we often use clauses that require the contractor to use payments from our project on our project before those funds can be used for anything else. The clause constitutes a representation and warranty from the contractor. It should be noted that this clause is in addition to what others refer to as “lien waiver.” Many states do not permit “lien waivers” unless a lien already exists on a project. Accordingly, our “lien waivers” are, in actuality, “releases” containing four important protections: (1) a “release” from the contractor for funds received, (2) a release of claims unless specifically identified and reserved, (3) a representation from the contractor that those performing its work have been paid in full and (4) an agreement that the contractor shall indemnify the owner and others for making any misrepresentation in the release.

In summary, the mature construction cycle presents benefits and challenges. A properly worded contract reflecting those benefits and challenges greatly enhances the prospects of successful project completion.

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