ARTICLE

Assessing Project Costs & Schedule Issues When Considering Terminations

Supplemental Information in Response to the July 16, 2020 NACA Roundtable

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On July 16, 2020, The National Association of Construction Auditors ("NACA") hosted a roundtable discussion titled "Construction 2021 - What Do We Expect and How Do We Diversify?". One recurring topic brought up during the discussion was how organizations can better prepare to handle potential cash flow issues and related bankruptcy issues. A serious outcome of these issues that was also discussed is the potential terminations of contracting parties, which raises the question of what organizations can do to mitigate the potentially drastic impact of a termination in such uncertain times.

Introduction

This article will discuss the various considerations that should be made by a terminating party and the importance of properly reporting the financial and schedule status of a project at the time of termination. This article will also address some special considerations for COVID-19 that could affect a decision to terminate.

The potential need to terminate a contractor or subcontractor is a crucial decision that should not be taken lightly. In the current economic climate, many contractors and subcontractors will likely experience cash flow and performance issues when completing the contract and may in fact be unable to complete the project at all. When considering the termination of a contractor, owners must be aware of contractor/surety relationships, whether to terminate for convenience or cause, and if a termination for cause, are there sufficient grounds for the action? Contractors terminating a subcontractor should consider if a replacement subcontractor would have the means to complete the project, and if the decision to terminate the subcontractor may ultimately subject the contractor itself to default or delay damages under its prime contract. Further, as was mentioned during the discussion, terminating a party that has initiated bankruptcy proceedings may be more difficult than anticipated for numerous reasons, presenting additional challenges that both owners and contractors must consider.

Once an owner or contractor has decided to proceed with a termination, whether it be for cause or convenience, it is important that the terminating party be able to quickly and accurately assess the status of a project for both costs and schedule status at the time of the termination. This assessment is crucial as the project status at the time of termination is the basis for determining money owed to the terminated party and money that the terminated party or their surety will ultimately owe to the owner/contractor in a termination for cause. Discrepancies between each parties' assertion of actual project status all too often plays a large role in post-termination disputes, and more importantly can lead to a surety's refusal to complete a bonded contract. The ability to accurately assess the project status and to present the findings in a clear and effective manner is critical to a favorable result in any dispute regarding the costs and appropriateness of the termination.

The following is a list of important steps and analyses to help both owners and contractors perform project status assessments. A proper status assessment can help an owner or contractor decide if terminating a contractor/ subcontractor will be beneficial or detrimental to the project. It is also useful to bolster an organization's position in a termination dispute and help defend against an opposing party's position.

Know Your Contract!

The importance of specific contract terms for each project and advice and guidance from counsel cannot be understated. Contract interpretation, as well as legal implications, are best left to legal professionals. The terms of a contract will dictate how an organization navigates a termination and the accompanying project status assessment. Contract terms will also impact how an organization navigates any COVID-related termination issues.

For project status assessments, the contractual payment method defines the approach to the cost assessment. For example, a fixed price contract typically uses a schedule of values or milestones for billing as opposed to actual cost which often creates a disconnect between actual cost and contract payments that must be investigated. Conversely, a cost reimbursable type contract does not share the same disconnect but presents other issues that must be analyzed separately.

Beyond the contractual payment method, there are other contractual items that must be considered. The following is a non-exhaustive list of important clauses in contracts that will impact the way in which an owner or contractor will prepare its assessment:

- Termination for Convenience (and potential associated fees)
- Termination for Cause
- Payment Terms and Retainage language
- Performance Bond
- Notice Requirements
- Cost Audit Clauses

In the current climate of COVID-19, it is also important to be aware of contract language that may complicate an owner or contractor's ability to terminate another contracted party. Force majeure and change of law clauses are frequently cited in support of COVID-19 claims and may provide the terminated party with a valid defense to a termination. It is also important to be aware of notice requirements, as improper notice can be cited in defense of certain claims.

Assessing Contractual Costs of the Project Scope

The ability to quickly and accurately assess the contractual cost and schedule status of a project at any point in time is paramount in both asserting and defending against termination claims. In relation to the contractual cost assessment, if an owner decides to terminate a party without fully understanding its contractual cost impacts, it may be left overpaying the terminated party for the value of work in place and/or overpaying the replacement contractor. Conversely, a contractor may be terminated having been paid less than the fair value of work in place. At the very minimum, a party terminated for convenience will likely request, and be due, the unpaid balance of its work in place and other costs directly attributable to the termination. In the case of a termination for cause, the terminating party may withhold any amounts due for work in place in order to fund the cost of completion. On rare occasions, upon completion of the work where the replacement contractor's completion costs are less than the total remaining contract value, the terminated party may then be due some of its unpaid amounts for work in place at the time it was terminated that will be paid out of the contract savings balance.

The value of work in place is often disputed between parties, which is typically a result of discrepancies between actual cost and the invoiced/approved payment amount. Depending on contract language, the value of the work in place at the date of termination is the current outstanding payment due plus the cost of any work performed since the last payment application. Under a fixed price (or lump sum) contract using percent completes in the monthly payment application schedule of values, a contractor may have invoiced for and claim to be owed payment for 50 percent of the contract price at termination. However, a review of actual costs may indicate the contractor actually incurred significantly less than this percentage for the total cost of the work. If the contractor is terminated for convenience, the owner may pay far more to complete the second half of work. This issue is further complicated when utilizing other fixed price methods such as milestone payments and standard unit pricing, and conversely, is usually less complicated when considering cost reimbursable type contracts.

Fixed price methods (e.g., Percent Complete, Milestones, Unit Pricing, etc.), and cost reimbursable methods (e.g., Cost-Plus Fee, Time and Materials (T&M), etc.) present their own challenges when determining the contractual cost status. The challenges associated with these methods, as well as steps to quickly and accurately assess the contractual cost of the project, are defined below.

Fixed Price Methods

In a fixed price contract, contractors and subcontractors bill for work on a percent complete basis using common forms such as the American Institute of Architects' ("AIA") G-702 and G-703 which are considered an approved Schedule of Values ("SOV"). When a contractor is not terminated and completes a project under this type of contract, 100 percent of the contract balance is requisitioned by the contractor via progress payments and paid by the owner.

Under this scenario, what happens when a contractor is terminated at 30 percent, 50 percent or even 90 percent complete? Provided the SOV line item values are fairly accurate, the monthly progress payments should accurately compensate the contractor for the work performed to date. In practice, however, SOVs are not always an accurate representation of actual costs incurred, thus making the calculation of the actual value of the work in place contentious. This can be due to issues such as a "front-loaded" or "imbalanced" SOV, over/under certification of work in place, outstanding extra work issues, or even offsetting back charges/damages. This is a common cause for dispute between parties as owners often believe they have overpaid for work completed and contractors believe they were underpaid. Further, arguments over withheld retainage become a battleground for payment leverage.

One solution to avoid these disputes is to properly vet the contractor's SOV at the start of the project. In the absence of a properly vetted SOV, owners and contractors will have to independently assess the project status to determine the proper value of work in place and money earned. To do so, parties to a fixed price construction contract should ask the following questions:

Who is the party liable for completion costs and excess completion costs?

- Under a Termination for Convenience, the terminating party is responsible for the unpaid portion of the value of work in place and any associated termination costs enumerated in the contract. The terminating party is also responsible for any increased costs resulting from the termination; i.e., schedule delay and excess costs charged by the completion contractor or incurred by the terminating party itself to complete the work.
- Under a Termination for Cause, there are several scenarios:
  - The terminating party can withhold payment of all amounts due and the remaining contract balance (including change orders) from the terminated contractor until the contract scope is completed by a surety, replacement contractor or the owner/contractor itself. If the completion cost is less than the outstanding balance of the original contract (which is unlikely), the savings are used to pay the terminated contractor its unpaid amounts for work in place.
  - If the terminated party is bonded, the surety will be responsible for the completion costs up to the penal sum of the bond. The surety has several options. Oneis to complete the work using the terminated contractor (if allowed) or a replacement contractor. Another option is the surety can pay the terminating party a negotiated amount to complete the contract. Finally, a surety may refuse to complete the project. This will inevitably lead to legal action.

Are the Payment Application SOVs an accurate representation of the status of the project?

- Use physical site walkthroughs to assess progress and document with photographs.
- Identify any non-conforming work in place that may require rework. This will result in adjustments to SOV percentages invoiced and costs needed to complete the work.
- Identify front-loaded SOV items and make necessary adjustments.
- Compare the project schedule to work status reported on payment applications to check for variances.
- Interview key personnel to determine completion percentages for difficult scopes.
- For scopes that are difficult to determine, consider utilizing an independent third party.
- Remember that the last 5-10 percent of work may be the most labor- and cost-intensive.

What documentation is needed to accurately determine the financial and schedule status of the project at the time of termination?

- Request cost support be provided in the form of digital payroll, material, and equipment expenditure records.
- Request original estimate information used to formalize the payment schedule.
- Be sure to understand your contractual rights to audit project costs in the event there is resistance to the provision of these documents.
- Review the most current schedule update to confirm reported percent completes and the status of major construction tasks.
- An accurate assessment of the costs incurred/work completed to date should also consider remaining work to be completed. This analysis will be helpful when reviewing proposals from completion contractors for cost and time.

In a termination scenario using a fixed price contract, actual cost data must often be requested and analyzed to determine the proper value of work in place. When actual cost data is used to make an assessment, owners and contractors must be aware that actual cost data may be imbedded with costs for unproductive labor, re-work, extra work, and potential double billings. These types of costs must be removed from the data prior to any analysis to achieve the most accurate comparison. This process along with the considerations and steps identified above will help owners and contractors accurately assess the financial status of a fixed price contract.

Cost Reimbursable Methods

In a cost reimbursable contract, such as "Cost Plus," Time and Materials ("T&M"), or Guaranteed Maximum Price ("GMP"), the project assessment is similar in some ways to that of a fixed price contract, but is more straightforward. For Cost Reimbursable contracts, proof of actual costs is submitted at the time of the requisition. Additional substantiation of these costs may be required and should be requested as needed. Further, these types of contracts have fairly robust "audit" clauses that should afford an owner access to the contractor's books and records.

For cost reimbursable contracts, detailed estimates may not be available as they aren't always required. This can make the project assessment more difficult.

Assessing Schedule Delays

In a Termination for Cause, the schedule is a major basis for identifying and proving cause for termination. A schedule analysis depicting repeated delays and non-performance issues will provide support and justification for contractor termination. A schedule analysis can also support the terminated party by failing to show liability for schedule delays or impacts related to claimed non-performance issues. The analysis should also be used internally to understand the positive or negative impact a termination may have on the schedule.

To properly assess the project schedule, owners and contractors should take the following steps:

Identify potential causes of an impact and the responsible party

— Non-performance issues
— Supplier delays for materials, equipment, or components
— Force majeure events
— Extra work and/or unforeseen conditions

Verify the accuracy of the current project schedule

— Perform site inspections
— Utilize daily, weekly, and/or monthly reports to compare to the actual progress in the schedule
— Utilize photos, emails, and other contemporaneous correspondence

Identify the baseline critical path of the project or specific scope in question

— Identifying the critical path can eliminate many alleged delays and can highlight the true schedule impact and concurrent delays.

Analyze shifts from the baseline critical path to the as-built critical path in the appropriate time period

— Utilize an analysis method that makes sense for the available documents and time frame – this can include a simple "as-planned vs as-built" or a more extensive "windows" analysis.
— The total delay may not be due to a single event – multiple impacts and mitigation efforts may ultimately make up the total delay.

Address and account for any impacts that may result from a potential termination

— Gather information about what schedule changes may occur as a result of the termination.
— Will a replacement contractor be immediately available?
— Will the termination affect supplier deliveries?
— Will the termination negatively affect the project schedule in a way that the termination may not make commercial sense? ("Devil you know vs. the Devil you don't know")
— Will the termination of a subcontractor affect the completion of prime contractor work?

Synthesize findings into a graphical analysis to highlight delays

— Graphical representations, such as Gantt charts, are extremely effective in depicting the critical delays.
— A picture/graphic is worth a thousand words.

Summary

Terminations can be a difficult decision for owners and contractors. With a proper assessment of contractual costs and schedule delays, owners and contractors can decide if it is the best way to proceed in order to mitigate losses. Further, owners and contractors should remember the following steps on any project to ensure it has the proper documentation needed to decide if a termination is advantageous to the project and to support such a decision.

- Know your contract and make sure to closely follow all notice requirements
- Regularly perform status assessments on intervals that are sensible for your project
- Determine the party responsible for payment of outstanding costs
- Vet schedule of values prior to the start of a fixed price contract
- Verify accuracy of the project schedule using contemporaneous project documents and site inspections
- Determine and request the required documentation to accurately assess project costs and schedule
- Identify and document all potential impacts to the project
- Identify the critical path and impacts to the critical path duration over time
- Document project completion status using photos and all forms of correspondence
- Present findings with clear and demonstrative graphics

FTI's Construction Solutions professionals are prepared to assist your project teams in assessing the status of your project to help mitigate potential impacts and disputes that may arise. Our diverse group of professionals offer experience in all facets of the construction industry and are able to assist with project status reviews, change orders and claim preparations, claims defense, as well as expert testimony.

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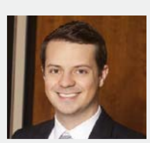

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