

Crafting Solid Construction Contracts

*Twenty Tips for Ensuring That
Your Interests are Well-Protected
In Your Next Rehab or Construction Project*

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Doing a Rehab?

So you've found the perfect property to rehab, or maybe you're building new. You've wisely decided to hire a general contractor to oversee the project for you, and you need to make sure that you're protecting your interests by using a sound contract. Where do you start?

Well, you need a good construction contract that addresses all the things that can go wrong on a project. You've probably heard horror stories from others about how their contractor ran off with the money before the job was done, or didn't pay their subcontractors and the subs placed liens on the property, and so on. If your contract addresses the issues we're about to discuss, your project should go much more smoothly!

I've done quite a few rehab projects over the years, some as big as office buildings and retail centers, and so I know what makes a good contract. The following is an overview of the clauses I always make sure are in my construction contracts. I encourage you to use this as a template for your own contracts to protect you and your money, no matter how big or small your project is.

Disclaimer: I am not an attorney, and I provide the following as a summary of the important terms and conditions contained in good construction contracts. This is not a contract, nor should you consider it a substitute for competent legal counsel. Seek legal assistance when necessary.

Types of Contracts

Let's begin with a discussion of the five most common types of contracts you're likely to see on rehab or construction projects. These include:

1. Cost of the Work Plus a Fee (Often called "Cost Plus" by the construction industry)
2. Cost of the Work Plus a Fee with a Guaranteed Maximum Price (Shortened to "GMP" by contractors)
3. Stipulated or Lump Sum
4. Construction Management (Known as CM/GC)

5. Design-Build

Let's examine each one:

Cost of the Work Plus a Fee:

This contract seems simple—the contract amount will be the cost of the work, plus a fee to the contractor. However, it's vital to establish upfront exactly what constitutes a cost, and what doesn't.

For example, costs directly related to the project (labor, materials, permits, etc) are actual costs, and should be reimbursed to the contractor. However, the cost of overhead at the contractor's main office is *not* a project cost. Identify the specific costs upfront, and this contract works well. We'll discuss costs to be reimbursed later.

The risk for cost overruns goes to the owner in a cost plus contract, because the project costs whatever it costs—the contractor is not guaranteeing a price in this type of contract. So the contractor has little incentive to stay within budget, especially if their fee is a percentage of total project costs, rather than a lump sum.

The keys to using this type of contract are to specify all project costs upfront, define the scope of work in detail, ask to see all subcontractor bids in writing prior to commencing work, and only use a cost plus contract on small jobs. I caution against using it instead of the GMP contract on large projects, because without a firm price guarantee like on the GMP that we'll discuss in a minute, your prices can escalate quickly if scope isn't well defined or costs aren't firm. That may not be a big deal on a small job, but on a large project, it can be a killer.

Cost of the Work Plus a Fee with a Guaranteed Maximum Price (GMP):

This is probably the most commonly used contract, especially on medium to larger projects (\$20,000 and up), because it gives the owner a guarantee that the construction costs won't exceed a specific amount. It also allows the owner to retain or share in cost savings, if there are any.

The GMP is basically a cost plus contract with a limit on cost overruns. Any cost overruns (not including changes in scope) are absorbed by the contractor. So unlike the cost plus contract, the risk for cost overruns goes to the contractor. You might pay a little more for a GMP contract vs. a cost plus contract, but the guarantee can be well worth it.

The GMP contract is particularly useful in situations where the exact costs aren't well defined. For example, you never know how much contaminated soil you'll have to haul away until you start digging, or exactly how much asbestos you'll have to abate until you start tearing the walls apart. I've done projects where both of these situations have come up, and the GMP kept my costs in check.

An important tip for using a GMP: Base the contract amount on drawings that are as complete as possible. While many GMP contracts are executed with drawings only 70-80% complete, this can cause confusion and misunderstandings. Try to have your drawings as complete as possible prior to executing a GMP.

Stipulated or Lump Sum:

The lump sum contract is most often used when the scope of work and the construction drawings are water-tight, the work is limited to a specific trade (installing a new roof, for example) and the bid is competitive (multiple bidders for the same job).

Since the contractor bids a lump sum contract on exactly what's in the drawings and specifications, it's usually a good idea for the contractor to supply a list of comparable alternate materials that should be considered for cost savings, and to consider these carefully. When receiving lump sum bids from contractors, be sure the bids are "apples to apples"— meaning that they contain the same quality of materials and installation methods.

Construction Management / General Contractor (Known as CM/GC):

A CM/GC contract allows the owner to engage the expertise of the contractor early in the design process. This creates efficiencies because the contractor can give the owner and architect input on issues such as constructability, costs, and value engineering (VE is the process of finding ways to build for a lower cost without sacrificing quality or design aesthetic).

The contract is executed in two phases: a consulting phase during design development, and a general contractor phase overseeing construction. Most CM/GC contracts allow for the first phase to be completed without committing to the second phase. For example, if during the design phase, the owner decides this contractor isn't the right entity to do the GC work, he or she can cancel the second phase of the contract and hire another firm.

The second phase of the contract can be executed either as a cost plus contract, or as a GMP contract. The owner and contractor usually decide together which path to take.

Design-Build:

Design-Build is a system of contracting under which one entity performs architectural and engineering services, and builds the project under one single contract.

There are DB companies that do all their projects as design-build, and they typically employ an in-house team of architects, engineers and contractors to complete each job.

Design-build also works well when you have a specific subcontractor installing something that requires some basic design work prior to installation. For example, we used a design-build contract with a subcontractor installing a new HVAC (heating, ventilation and air conditioning) system in a building. We found that because the design work of the HVAC system was fairly simple, it was more cost effective to have the subcontractor design the system than to have the architect design it (the sub threw the design work in for free just to get the contract, whereas the architect's time would've been more costly).

Design-build has grown in popularity lately, because it often saves both time and money over traditional design-bid-build contracts with separate companies doing the design and construction work.

No matter what type of contract you're using, the following are important elements to include in every contract. The following twenty sections of a contract are vital to protecting your interests on every project:

1. Parties to the Contract:

Every contract should begin with a recital of the names and addresses of the property owner, contractor, architect (if any), and the address of the property.

2. Reference to the Contract Documents:

Contract documents typically include the following:

1. The architect's construction drawings
2. Shop drawings from subcontractors or suppliers

3. The specifications book (detailing specific materials to use on the project)
4. Other instructions from the architect or other vendors to the contractor telling them how to build the project.

The contract should specifically require the contractor to build per these instructions, unless the owner or architect directs otherwise. You'll want to attach these plans and specs to the contract as addendums, so there's no confusion over which version of the plans they should use.

3. Relationship of the Parties:

This section should state that the contractor agrees to cooperate with the owner, owner's rep, and architect to build the project, using the contractor's best skills and judgment. This includes supplying enough materials and competent labor to the job site to complete the project on time and within budget. It also means that the owner must agree to supply the contractor with timely information upon request, and to make progress payments to the contractor per the terms and conditions of the progress payments section later in the document.

4. Project Timeline:

The next clause should include a start date and an end date for the project. If you're using an architect, the end date will likely be the date upon which the architect expects to issue a Certificate of Substantial Completion.

5. Contract Sum and Contractor's Fee:

This is the section where the total contract amount is stated.

It's also a good idea to specify the contractor's fee or profit here. You'll see why when we get to sharing of cost savings later on.

The contractor's fee is usually a negotiated lump sum or a percentage of the total project cost, usually anywhere from 5% to 7.5% of the total construction budget.

6. Change Orders:

A change order is a change in the construction plans from what the owner and contractor agreed to in the contract documents. Typically change orders are

made during construction when the owner changes the scope of the contractor's work for purposes that benefit the project. This can mean additions, deletions or modifications to the project scope.

The contract should stipulate that changes in scope shall affect the contract amount. For example, if the owner eliminates any aspects of the work from the contractor's scope, the owner and contractor should reduce the contract amount by a corresponding amount. Otherwise, if the owner elects to reduce the contractor's scope of work, the contractor will still be paid for work they didn't perform.

Conversely, the contract should state that changes in scope that add to the project costs shall add a corresponding amount to the contract amount.

The contract should also address how the owner and contractor will use change orders to provide an exact cost for work that was originally budgeted using allowances.

Allowances are where the contractor makes an estimate about the cost of a certain part of the work, rather than getting an iron-clad bid from a subcontractor or supplier. Contractors use allowances when the scope of work is undefined or unknown (you never know for sure what your costs will be on a rehab until you start taking the structure apart). They also use them when the drawings are incomplete, or when construction costs are in flux and the work is scheduled to be done far enough into the future that getting an accurate bid early on will be difficult, and so on. We'll discuss allowances in more detail later on.

Typically, when allowances are used, a change order is submitted from the contractor to the owner to provide an exact unit cost of the work after the work is finished, and an adjustment is made to the contract amount. Your contract should provide for that process, and not allow the contractor to charge the owner the allowance amount for the work performed, when if the cost of such work might be less than the amount of the allowance.

Furthermore, change orders should be carried out on either a "cost plus a fee" or "time & materials" basis, with a schedule of values for the hourly costs of various trades spelled out in an exhibit to the contract.

That way, the contractor can't charge whatever they want for change orders—(contractors often charge two to three times the actual cost of the work on change orders unless there is a schedule of labor rates attached as an exhibit to the contract). The profit/fee paid to the contractor for any change orders should be spelled out in the Contract to avoid overcharging.

Further, wage rates for the general contractor (as well as the subs) should be attached as an exhibit to the contract in the event that change orders necessitate

additional labor hours for the project manager, foreman, superintendent, or other of the contractor's own forces, in addition to the subcontractor labor rates mentioned above.

In the event that the contractor engages labor not listed on that schedule of values for labor rates, the contract should stipulate that the contractor must receive written approval from the owner prior to hiring that labor. Without this language, the contractor may hire labor for prices well above industry standard for change order Work, without receiving permission from the owner.

7. Terms and Conditions of Progress Payments:

There should be a section in the contract that addresses progress payments made from the owner to the contractor. This language should address the usual and customary safeguard of allowing the owner to examine and audit records of payrolls, petty cash accounts, receipted invoices or invoices with check vouchers attached and any other evidence required by the owner to demonstrate that cash disbursements already made by the contractor on account of the cost of work *meet or exceed the progress payments received by the contractor*. In other words, the contract must allow the owner to require that the contractor prove they have paid the subcontractors after receipt of progress payments from the owner.

The contract should also *reserve the right* for the owner to, at the owner's discretion and to protect the interests of the owner from subcontractor liens, issue payment to contractor by dual-payee check or checks (naming contractor and subcontractor or supplier as joint payees) and to require the contractor to give the owner such information as is necessary to facilitate such payment. This prevents the possibility of the contractor receiving progress payments and not paying subcontractors, and the sub contractors filing a Notice of Lien on the property.

8. Savings in Construction Costs:

You should include in your contract a provision for splitting the cost savings (if any) between the owner and the contractor if the project is built for less than the contract amount.

As we discussed above, there should be detail in the contract that breaks out the contractor's profit from the rest of the project budget. Typically, construction contracts show the costs of the work, plus the amount of the contractor's fee/profit on the project.

You want a provision for a split of any cost savings, because it creates an incentive for the contractor to try to finish the project under budget. Typically, every dollar you save should be split 50/50, 60/40 or 70/30 between the owner and the contractor (with the first number going to the owner).

Without a cost savings sharing provision, it is in the contractor's interest to cut corners wherever possible, because every dollar saved will go directly into the contractor's pocket—the owner will realize no benefit from any savings in construction costs. This puts the contractor and Owner in opposing interests, because the net effect is that the GMP is not just the greatest maximum price—it's also the *lowest minimum price* the owner will pay for the work, even if the costs are lower than anticipated.

The contractor is certainly entitled to a reasonable fee for the work performed; however, any monies saved beyond a reasonable profit to the contractor should go back to the owner— not into the contractor's pocket as additional profit. It's the owner's money, and if it doesn't get spent, most of it should go back to the owner, minus any percentage of cost savings required to incentivize the contractor to stay within budget.

9. Rights of Inspection:

There should be a provision allowing for the owner or architect to reject poor workmanship performed by the contractor, or for the owner to have the right to inspect and approve the work prior to making progress payments. At minimum, the contract should state that "progress payments will be made by the owner on a monthly basis within thirty (30) days from receipt from the contractor of the Application and Certification of Payment is approved by the manager."

But I suggest adding stronger language that allows for an inspection and approval of the work that would afford the owner the ability to require the contractor to maintain a standard of quality prior to receiving progress payments. Without this language, you compromise the level of accountability on the part of the contractor to complete the work at an acceptable quality standard.

10. Use of Allowances in Budget:

Most project budgets are based on competitive bids from subcontractors. The general contractor may use *allowances* instead of *unit price bids* in a few budget line items. Typically contractors include allowances in the contract amount due to uncertainty in the scope, price or quality of the work at the time they execute the contract or because contract drawings are incomplete at the time of contract execution. If the contractor is part of the design development process the number of allowances should be very few.

If the contractor is part of the design process early on (as is becoming more common), one could reasonably expect that allowances (instead of unit price bids) would make up no more than 5-15% of the total project budget. Otherwise, if there's a high percentage of the project budget estimated with allowances, you may have a hard time getting a construction loan until those costs are more accurately detailed via the use of bids from subcontractors or suppliers.

If your contractor is calculating big parts of the project budget using allowances, it may indicate that the contractor is either trying to hide the actual unit prices to provide for more room in the overall contract price for his profit, or that they simply have not done the bid work required to get an accurate contract amount. No contractor in their right mind would enter into a contract without bidding out the project first, so be sure to insist on a contract amount that is based on unit bids from subcontractors.

If you didn't get competitive bids from multiple *general* contractors, your only form of checks and balances on the overall project cost would be to require the contractor to provide you with copies of all subcontractor bids (assuming multiple subcontractors bid for each trade's scope of work). This'll help you to verify that the lowest qualified bidders were selected.

The owner should insist on copies of all subcontractor bids.

11. Costs Not to be Reimbursed:

The contract should also address the potential for the contractor adding peripheral or indirect costs to the budget and contract amount. For example, the following items are typically expressly excluded from the project construction costs:

- Salaries and other compensation of the contractor's personnel stationed at the contractor's principal office or offices other than the onsite project office.
- Overhead, equipment costs, and general business expenses of the contractor stationed at the contractor's principal office or offices other than the onsite project office.

Without language in the contract specifically prohibiting the contractor from charging these expenses to the project, you have no way of preventing them from transferring general business expenses not directly related to the project to your project budget.

12. The Owner's Right to Accept or Reject the Bid of a Subcontractor:

Your contract should contemplate the owner's position in regard to selection of subcontractors. Otherwise, the contractor may select any subcontractor they choose, without the owner's approval.

13. The Owner's Right to Examine Contractor's Project Accounting Records:

It is customary in construction contracts to insert language that requires the contractor to keep accurate and detailed accounting of the project costs, and to allow the owner to examine, audit, and copy these records, along with any relevant books, documents, correspondence, instructions, drawings, receipts, subcontracts, purchase orders, vouchers, memoranda, and other data relating to the contract and the project.

14. Owner's Right to Stop the Work and/or Terminate the Contract:

The owner should have the right to stop work and/or terminate the contract if the contractor:

- Fails to provide enough skilled labor or proper materials after prior notice from owner of the specific failure in labor or materials and contractor fails to remedy that specific failure,
- Fails to make payment to subcontractor in accordance with the agreement between the contractor and subcontractor,
- Persistently disregards laws, ordinances, rules, regulations or orders of a public authority having jurisdiction,
- Otherwise is guilty of a material breach of the contract documents

15. Contractor's Right to Terminate or Suspend the Contract:

The contractor should have the right to suspend or terminate the contract in any of the following situations:

- Issuance of an order of a court or other public entity having authority which requires all work to be stopped,

- An act of government, such as a declaration of national emergency that requires all work to be stopped,
- Nonpayment by the owner for work performed under the terms and conditions of the contract.

16. Rights of the Owner in the Event of Default by Contractor:

The contract should stipulate that in the event of a default by the contractor, the owner has the right to make written request of the contractor to remedy the default within a specified amount of time. If the contractor fails to remedy the default, the owner should have the right to cancel the contract and dismiss the contractor.

In such event, the owner should have the right to take possession of the site and materials already ordered and delivered, fix the problem at the owner's expense, and deduct the costs for correcting the deficiencies (including costs of additional work by the architect and other consultants) from the payments due to the contractor. If the payments due the contractor at that time are insufficient to cover the costs of correcting the defaulted work, the contract should require the contractor to pay the difference to the owner.

17. Contractor's Warranty for Work Performed:

The contractor should warrant to the owner that the materials and equipment furnished under the terms of the contract will be of good quality and new unless the contract documents require or allow otherwise. The contractor should also warrant that the work will be free of defects, and that it will conform to the requirements of the contract documents. The owner may deem work not conforming to these requirements (including substitutions not properly authorized) defective and subject to correction by the contractor at the contractor's expense.

The owner should also have the right to require the contractor to correct work where required both *before and after* the architect issues the Certificate of Substantial Completion.

18. Indemnification:

Your contract should have language for indemnification. This means holding the owner, the architects and other associates, and their employees harmless in the event of personal or bodily injury of an employee of the contractor or subcontractor, destruction of contractor's equipment, or other risks associated

with performing the work of the contract. This is a basic clause that should be in any contract.

19. Claims & Disputes:

What happens in the event of a dispute between the owner and contractor? This section should include the definition of a claim, time limits for filing claims, the requirement that the contractor continue performance of the work while working out the dispute, the process for the contractor to request additional time or other resources to complete the work, and the process for resolving disputes. This process typically involves a written evaluation and opinion by the project architect of the conditions of the claim, with a proposed resolution. If this resolution is not acceptable by either owner or contractor, then the contract should address mediation and arbitration as next steps in claim or dispute resolution.

20. Waiver of Subrogation:

Waiver of subrogation means the relinquishment of a right to seek reimbursement for a loss from the responsible party. This is a standard contract clause that protects each party from pursuing the other in the event of loss beyond that amount covered by insurance. Be sure to have a clause in the contract that waives subrogation by both owner and contractor.

In Conclusion...

Owners can put themselves at great financial and legal risk by entering into a nonstandard construction contract with the contractor that doesn't contemplate the issues we've just discussed. In fact, these 20 points are fundamental to a good contract that protects the interests of both the owner and contractor.

I suggest using a contract from the American Institute of Architects (AIA), or from the Associated General Contractors of America (AGC). Your contractor, architect, or a competent real estate attorney should be able to provide you with these documents. You can learn more at aia.org, and agc.org.

The owner and contractor should execute the contract and memorialize it with the following exhibits to round out a complete set of Construction Documents:

1. Clarifications and exclusions
2. Construction plans & drawings

3. Project schedule
4. Project budget with detail regarding unit bid prices for each Division of Labor.
5. Contractor's Tool and Equipment Rental Rate Sheet
6. Labor rates for contractor's employees and subcontractors

Note: For more information on construction issues and contracts, I suggest checking out the book "Project Management in Construction" by Sidney M. Levy. You can find it [here](#) at Amazon.com.

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