Considerations in Municipal Construction Contracting

By James Walker and Christine Taylor, Miller Nash LLP

Introduction

Municipalities have long been active participants in construction markets. Many predict substantial increases in the volume of municipal construction projects over the next several decades for a variety of reasons, which include expanding populations, technological advances, and aging infrastructure. This pipeline of projects varies in scope from local roadwork projects to multi-million dollar water treatment plants.

Although all construction projects carry substantial risks for project owners, municipal projects add complexity to those risks that can be challenging to navigate. This paper summarizes some of the risks that frequently arise on municipal construction projects in today's market, and offers strategies for cities to consider when developing construction contracts to mitigate these risks.

1. Project Delivery Method

One of the most important decisions a city makes as owner on a building project is how the design and construction services will be delivered. Some states impose restrictions on the project delivery method a city may use for a given project. However, when a city has flexibility, it should consider the advantages and disadvantages presented by the different methods described below:

Design-Bid-Build – The design-bid-build delivery method is the traditional building approach under which the project owner first engages a design professional to prepare a complete design for the project. Once the design is complete, the owner facilitates a bidding phase where contractors submit bids or proposals to construct the project. In many states, the design-bid-build delivery method is the default approach and the responsible contractor submitting the lowest bid is awarded with the construction contract.[1]

The design-bid-build delivery method is familiar to most in the building industry and it equips the project owner to select the contractor offering the lowest contract price. In theory, the contractor should be constructing the project using a finalized design so planning and coordination of the construction work should be easier compared to other delivery methods. There are, however, critics of this delivery method who argue that a project owner trades price for quality when seeking out the lowest bidder to construct its projects. Additionally, since the design is complete before the contractor is hired, there is a possibility of disconnects between the two phases, resulting in challenges for the project owner. For example, if the design contains gaps in scope or specifies outdated products, the owner may not be informed of those issues until the contractor is engaged and reviews the design. If the contractor is not engaged

[1] *See*, *e.g.*, ORS 279C.335.

until the design is complete, then these issues may arise during advanced stages of the project and cause delays.

Construction Manager/General Contractor – In recent decades, the construction manager/general contractor or "CM/GC" method has grown in popularity in the construction industry. Under the CM/GC project delivery method, the contractor is engaged during the design process to offer various preconstruction services intended to aid advancement of the design and streamline construction. When the contractor initially joins the project there is no established price for construction of the project. Instead, the price is established through an amendment to the contractor's agreement that is entered after the design is complete. Since the contractor is engaged before the establishment of a contract price, project owners cannot rely on price as the sole factor for selecting the contractor. Historically some states have restricted public entities by requiring that they select the lowest bidders on their construction projects, but the introduction of the CM/GC method resulted in adjustments to many state statutes.[2]

The CM/GC method addresses some of the disconnection between the design and construction phases by engaging the contractor earlier in the process. As part of its preconstruction services, contractors will often provide estimating services during evolution of the design, which allows project owners to have a general idea of construction cost earlier during the course of the project. In exchange, the project owner may be paying more to obtain preconstruction services. Additionally, once the design is complete, the contractor engaged to perform preconstruction services will presumably have more familiarity with the project design and team than any of its potential competitors. Consequently, a project owner could choose to accept a proposed price from the contractor that may not be the lowest possible in order to preserve the makeup of the project team.

Design-Build – Under the design-build project delivery method, a city selects one entity to provide design services and to construct the project. Like the CM/GC method, the design-build method has become increasingly popular in recent decades, and several states recognize design-build as an alternative method that public bodies can employ.[3] Several studies have concluded that contracting with one entity to function as the designer and builder results in project cost and schedule advantages.[4] The design-build method also establishes a single point of contact for the owner on design and construction matters. In the event of a defect, the same party would bear liability regardless of whether the design or construction work was the cause of the defect. In exchange for obtaining a single point of contact, the project owner cannot rely on the designer or constructor to check on one another in the project owner's interest. Unlike the design-bid-build method, the designer and constructor are hired as one package and, consequently, there is an increased possibility of them acting in the interest of each other instead of the project owner.

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[2] *See*, *e.g.*, ORS 279C.337.
[3] *See*, *e.g.*, OAR 137-049-0670.
[4] *See* Quatman, *Design-Build for the Design Professional*, ch. 1 (2001) (author cites several studies reporting significant cost and schedule advantages for the design-build system over more traditional delivery approaches).

Multi-Prime – The multi-prime method is a variation of the design-bid-build approach where the project owner functions as the general contractor on the project and contracts directly with various trade contractors. Some states require certain public projects to employ the multi-prime method.[5] Use of the multi-prime method is not, however, confined to states where it is required by statute as some public bodies have realized cost savings by not hiring a general contractor. The multi-prime method also carries significant risks as the absence of a general contractor results in the project owner being responsible for scheduling and coordination responsibilities for the project. Additionally, complex defects could result in the project owner navigating claims against multiple trade contractors as opposed to seeking remedies directly from one general contractor.

Integrated Project Delivery – Integrated Project Delivery or "IPD" is an alternative for project teams seeking to repudiate the adversarial nature of the construction contracting process. Proponents of the IPD method assert that traditional methods allocate project risk to individual parties instead of the project as a whole, resulting in a focus on self-benefit and self-preservation, as opposed to advancing the project. The IPD method attempts to offer a different approach by arranging a single agreement typically among the project owner, contractor, design professional, and select subcontractors and consultants. The content of each IPD agreement varies, but the general theme is to create a structure where parties share in the losses and gains of the project based on the achievement of objectives and milestones provided in the contract. In theory, IPD encourages greater coordination and teamwork between the parties, which should result in a successful project. But the structure is not easily applicable in many scenarios, especially where the different project contributors do not have familiarity with one another. It is tempting for parties to rely on the traditional methods of risk and blame allocation if issues arise on a project using the IPD method. IPD contracts typically carry shared benefits and losses in response to most occurrences, creating a risk that the parties may have a contract that produces inequitable outcomes in response to project shortfalls.

2. Price Escalation

Construction costs have been volatile in recent years due to a variety of factors including inflation, supply chain disruptions, and geopolitical events. These factors have applied upward pressure on the cost of materials and labor on many projects, especially those with long durations.

Most industry template contracts fail to explicitly specify which party is responsible for bearing the cost of an increase in labor or material pricing. The allocation of risk is inherent in some project delivery methods commonly used in the industry. For example, under a lump sum contract the construction contract agrees to perform the described scope of work for a fixed price. Consequently, it is generally recognized that if the work proves to be more expensive

[5] *See*, *e.g.*, Pa. Stat. Ann. Tit. 71, § 1618.

than anticipated due to increases in labor or material costs, then those additional costs are borne by the contractor.[6] Although project delivery method is a strong indicator of how cost escalation risk are allocated, the construction contract terms operate as the primary vehicle for determining which party is responsible. A few risk allocation strategies that are often included in contracts are described below:

One Party Carries Risk – The project owner and contractor can agree that one party will bear the entire cost escalation risk. When cities operating as project owners elect to bear this risk, it is important to consider alternative tools that the city can employ in response to pricing increases. One common tool is for the city to carry a separate collection of funds known as a "contingency" for use in response to contractor change orders stemming from price increases. Ideally, these funds should be carried outside of the contract and be disbursed at the city's discretion. In some jurisdictions, contingency funds are regulated by ordinance for certain projects.[7]

Requiring the contractor to carry all price escalation risk may establish greater price certainty for a construction project. However, cities should anticipate that shifting this risk to the contractor will result in higher bids for the project. For projects that use the design-bid-build project delivery method, it is often challenging to see how, or whether, a contractor has priced escalation risk into its bid. Consequently, a project owner that shifts all escalation risk to the contractor is relying on the awarded contractor to (1) produce a contract price that covers price escalation that occurs or (2) have sufficient financial capacity to cover cost overages outside of the contract.

Price Escalation Contractor Contingency – A common tool used to cover price escalation and other unknown risks arising during the course of a construction project are contractor contingency funds. In theory, a contractor contingency fund provides the contractor with monies for use in mitigating or covering certain unanticipated price escalation costs. In exchange for these funds, the contractor bears the risk of escalation costs that arise for the project after exhaustion of the contingency funds. Contingency funds are not addressed at length in most construction industry template forms, but can be introduced as an effective tool to mitigate risk. Unlike the owner contingency dollars referenced above, contractor contingency fund spending is typically controlled by the contractor. There are variations that allow project owners to have certain approval authority over the spending of contractor contingency funds, but generally the contractor is responsible for identifying, implementing, and documenting the use of these funds.

Percentage Trigger (General or Specific Items) – The city can split the price escalation risk by agreeing that one party will cover cost increases on certain labor or materials until the amount of the increase passes a negotiated percentage amount (*e.g.*, Contractor covers cost increases of up to ten percent of the price of the labor or materials at the effective date of the contract).

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[6] *See*, *e.g.*, *ITT Arctic Services, Inc. v. U. S.*, 207 Ct. Cl. 743, 524 F.2d 680 (1975).
[7] *See*, *e.g.*, Newcastle Municipal Code Section 2.65.040 (Contingency provisions).

If the increase exceeds the percentage threshold, then the balance of the increase is borne by the other party. The percentage trigger could be applied across all labor and materials or select trades and materials.

Schedule Trigger (General or Specific Items) – The city and contractor can also use time as an instrument to allocate the risk of price escalation. On some projects, the contractor may have pricing related concerns at the outset, but is willing to absorb escalation risk at a certain point during the project (*e.g.*, six months after the contract's effective date). In those instances, the parties can share the risk by adding a contract provision that makes the city responsible for proven price increases over an initial period of time. Any price escalation occurring after that initial time period expires is then borne by the contractor.

3. Delay Risk

Public and private project owners are motivated to have their construction projects completed in a timely manner for a variety of reasons. A common tool to address delay risks are liquidated damages provisions, which require the contractor to pay a specific amount in place of the actual losses incurred by the project owner for a delay in completion of the project. The amount is usually applied as a certain dollar amount for each day of delay in completion. Many contractors prefer to negotiate a liquidated damages provision that addresses project delays because it is easier to quantify the contractor's damage exposure when the contract contains a liquidated damages provision. For some cities, including liquidated damages provisions in construction contracts can be attractive. In cities where there are large volumes of projects occurring each year, liquidated damages provide an easy reference to the city's remedy in the event of a delay in completion. But it is prudent to evaluate whether liquidated damages are an appropriate protection for the city on a given project:

- **Are Liquidated Damages Necessary for the Project? –** Liquidated damages are a popular tool intended to address delays caused by the contractor, but they carry risk. One risk is that the amount established by contract may not be sufficient to cover the actual damages incurred by the city. Courts have recognized that liquidated damages operate as a substitute for actual damages that result from a breach, even when those actual damages exceed the amount provided under the liquidated damages clause.[8]

  When creating a liquidated damages provision, a city should also caution against setting an amount that is too high. Courts have a practice of denying liquidated damages provisions that are set so high that they are deemed a penalty.[9] Given the risk, it is prudent for cities to evaluate whether the advantages of a liquidated damages clause outweigh the risk of insufficient remedies or enforceability challenges. As an alternative, a city may consider foregoing liquidated damages and seeking actual damages in the event of a contractor caused delay.

[8] *See, e.g.*, *Whittaker Corp. v. Calspan Corp.*, 810 F. Supp. 457, 463 (1992).
[9] *See, e.g.*, *Gruschus v. C.R. Davis Contracting Co., Inc.*, 409 P.2d 500, 504 (N.M. 1965).

- **Provision Structure Considerations** – Liquidated damages provisions can be structured a number of ways to provide a remedy for delay damages and incentivize completion of the project. Many liquidated damages provisions require the contractor to pay a stipulated sum at a specified cadence (*e.g.*, $1,000 per day of delay). To properly address a city's damages exposure and incentivize completion, it may be prudent to require amounts that escalate over the course of a delay. Many construction contracts include liquidated damages that increase as a delay continues (*e.g.*, $1,000 for days 1 through 10 of delay, $2,000 for days 11 through 20 of delay, etc.). Some contracts also include substantial increases in liquidated damages at specific points after the scheduled date of completion to address fines or other penalties that the project owner will incur as a consequence of the delay (*e.g.*, $1,000 for days 1 through 9, $11,000 on day 10 of delay, $2,000 for days 11 through 20 of delay, etc.).

4. Davis-Bacon Requirements

Depending on the funding sources, there are multiple cross-cutting federal requirements that need to be addressed in a given construction contract. An item that often needs to be addressed is the application of Davis-Bacon requirements. The Davis-Bacon Act and the Davis-Bacon Act Related Acts (the "Acts"), and their corresponding rules circulated by the Department of Labor ("DOL"), propose the rules for the administration and enforcement of the Acts' labor standards, which apply to federal and federally-assisted construction contracts. Specifically, the Acts require contractors and subcontractors to pay locally prevailing wages to laborers and mechanics employed under a federally funded or assisted contract in excess of $2,000.[10] The Acts require the DOL to determine prevailing wages.[11]

The DOL is currently undertaking the first comprehensive regulatory rule review of its rules issued under the Acts in nearly 40 years. According to the DOL, the review is necessary to "better reflect the needs of workers in the construction industry and planned federal construction investments." [12] The DOL issued a notice of proposed rulemaking in March of this year, with comments closing on May 17th, 2022. According to the DOL, notable changes under the proposed rules include the following:

- Creating several efficiencies in the prevailing wage update system and ensuring prevailing wage rates keep up with actual wages, which over time would mean higher wages for workers.
- Returning to the definition of "prevailing wage" used from 1935 to 1983 to ensure prevailing wages reflect actual wages paid to workers in the local community. In other words, returning to this definition would mean that if no wage rate is found prevailing among a majority of workers, wage rates may be found to be "prevailing" if

[10] https://www.dol.gov/agencies/whd/government-contracts/construction.
[11] *Id.*
[12] https://www.dol.gov/newsroom/releases/whd/whd20220311.

a wage rate is found to be paid to at least 30 percent of the local workforce in a given trade.

- Periodically updating prevailing wage rates to address out-of-date wage determinations.
- Providing broader authority to adopt state or local wage determinations when certain criteria are met.
- Issuing supplemental rates for key job classifications when no survey data exists.
- Updating the regulatory language to better reflect modern construction practices.
- Strengthening worker protections and enforcement, including debarment and anti-retaliation.
- Expanding what is considered the "site of the work" for purposes of the Acts' applicability. Specifically, the definition of the "site of the work" would no longer be confined to the construction site, and it may include some offsite manufacturing and pre-fabrication sites.
- Expanding what is considered to be covered construction and a "building or work" for purpose of the Acts' applicability. For example, the term "building or work" would include solar panels, wind turbines, broadband installation, and installation of electric car chargers in the non-exclusive list of construction activities encompassed by the definition.[13]

Should these proposed rules be adopted and implemented, they will have a significant impact on owners, contractors, and subcontractors alike with respect to construction costs, compliance, enforcement, and administrative responsibilities. The DOL is expected to issue final rules in December 2022.

5. Performance Default Risk

A growing narrative among economists is that we are headed towards global recession. Although various cities have substantial volumes of construction projects in the pipeline, if this pessimistic economic outlook proves true, multiple construction contractor businesses could fail. Many states require contractors working on public projects to carry a performance bond to protect against default.[14] Generally, a performance bond transfers the risk of contractor nonperformance to a surety, by obligating the surety to remedy the nonperformance. The methods by which a surety can remedy contractor nonperformance vary, but typical remedies include funding continued performance by the defaulting contractor, tendering a replacement contractor, or monetary payment to the municipality for completion.

[13] *Id.*
[14] *See*, *e.g.*, RCW 39.08.010.

Although statutes typically require placing performance bonds to protect against default, many statutes do not require specific terms outside of the bond amount. In a market where there is increased risk of contractor performance default, cities should evaluate whether the specific terms of bonds placed are acceptable. One detail to consider is the process established to file a claim against the bond. The AIA form performance bond (AIA Document A312), for example, requires the obligee to first provide notice to the contractor and surety that it is "considering declaring a Contractor Default."[15] Once notice is provided, the surety has an option to call a conference among the project owner, contractor, and surety to review the alleged default.[16] If the default is not resolved, then the project owner must declare a default, terminate the construction contract, and notify the surety of its intent to pay the balance of the contract price.[17] These provisions can be very burdensome to cities and could result in valuable losses of time. Additionally, the requirement to terminate the construction contract may truncate certain remedies available to a city for performance default. Consequently, cities should be cautious about the terms included in bonds placed to secure performance on its projects.

Conclusion

The risks and requirements a project owner should consider are plentiful on any construction contract. Municipalities that operate as construction project owners must consider many of those same risks and a variety of additional issues. Although not an exhaustive list, the items described above are important areas that should be considered when developing a construction contract for a municipal project.

[15] *See* AIA Document A312-2010, Section 3.1.
[16] *Id.*
[17] *See*, AIA Document A312-2010, Section 3.2 and 3.3.