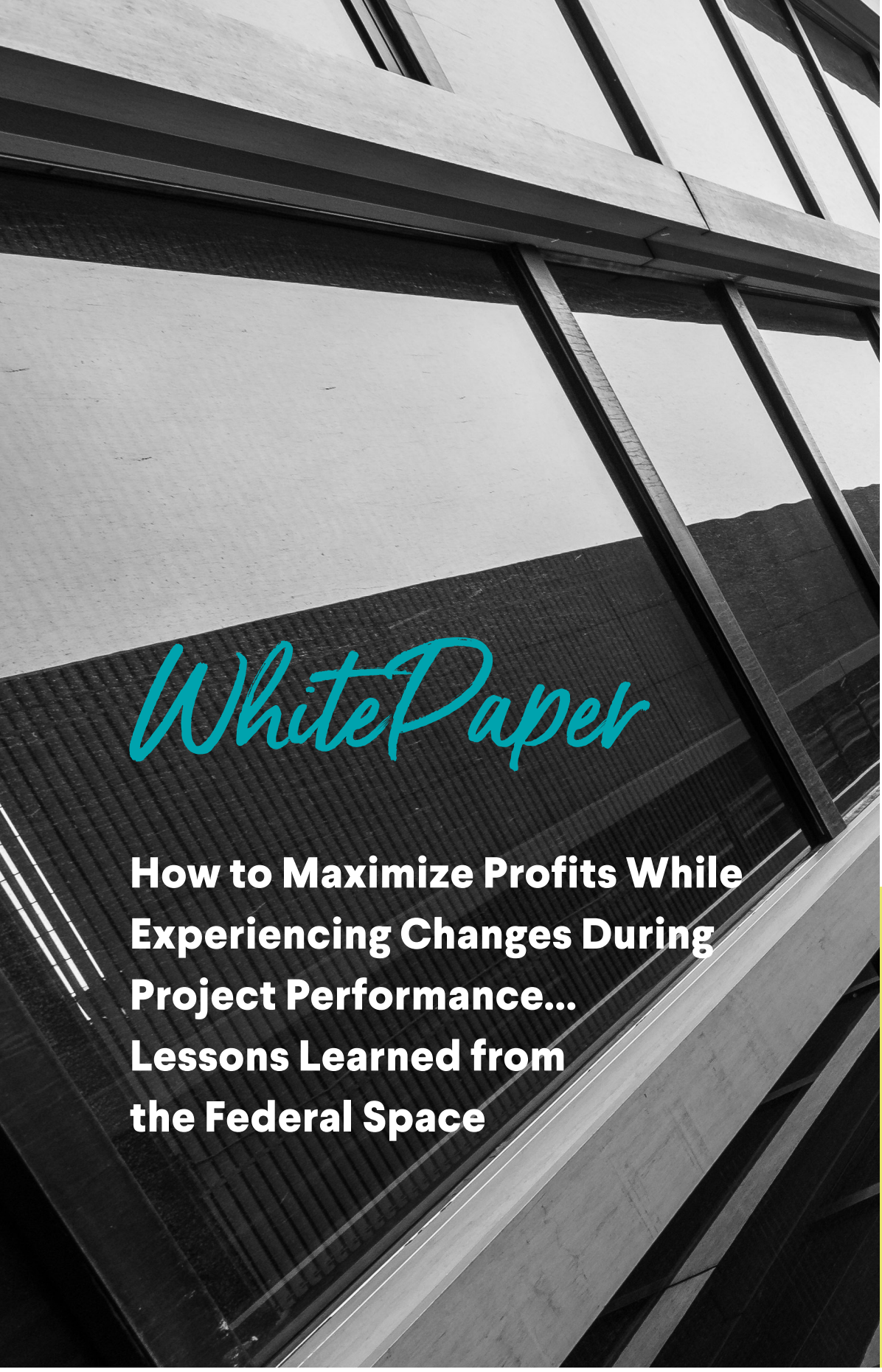

WhitePaper

How to Maximize Profits While Experiencing Changes During Project Performance... Lessons Learned from the Federal Space

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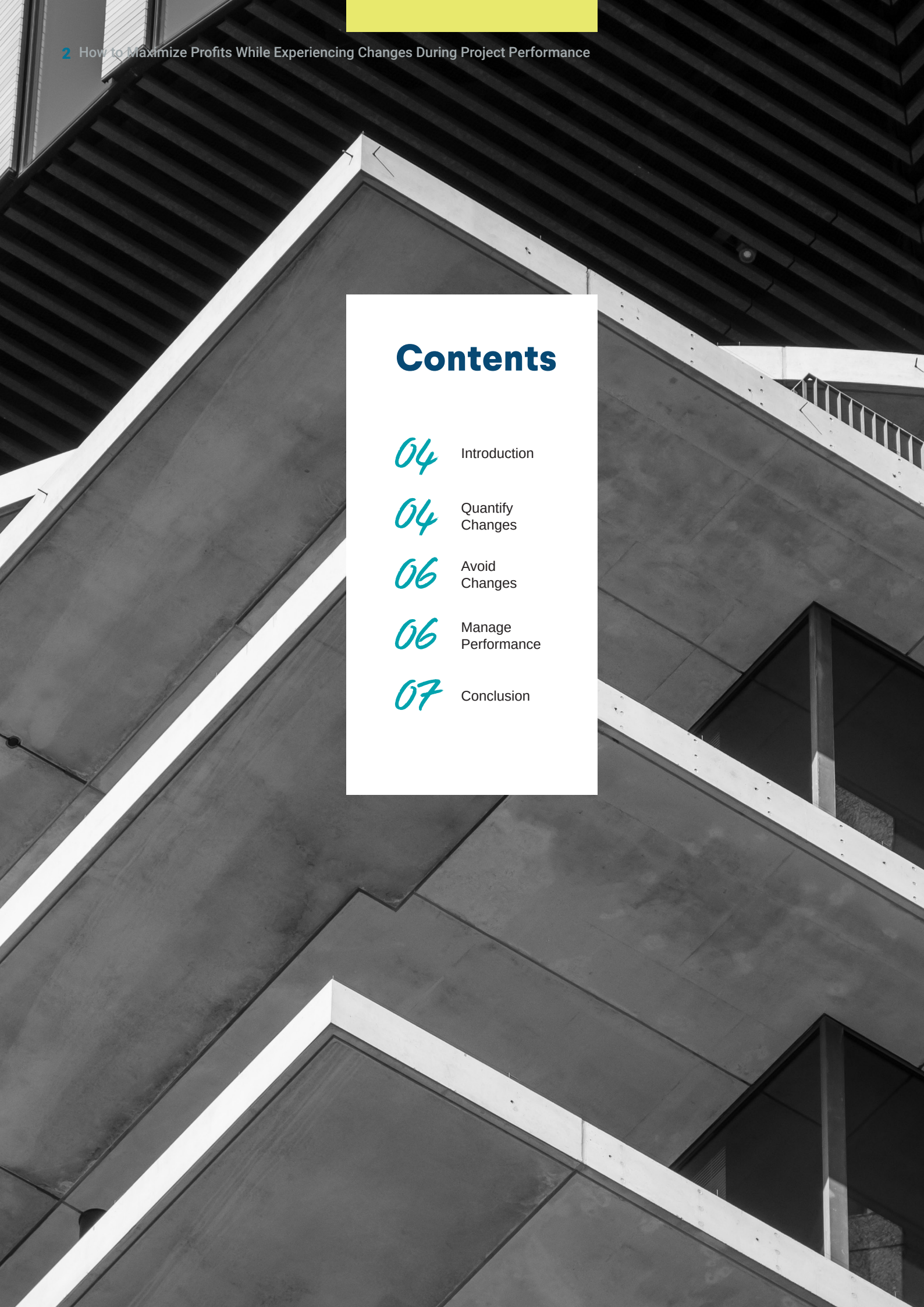

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Mr. Wolf currently serves as President of Peritia Partners. He has over 35 years of experience in the development and construction industry. He has evaluated more than 300 projects across 20 countries totaling over $110 billion in both the private and federal sectors. Mr. Wolf has provided analysis and expert testimony on complex, domestic, and international construction-related projects involving standard of care, constructive and directed changed work, delay, termination, suspension, acceleration, disruption, and productivity issues. His career, whether in the role of an executive or an expert witness, is marked with several large-scale and/or mega-projects located in the United States, South America, Europe, Eurasia, and Southeast Asia.

Expertise:

- Constructive & Directed Changed Work
- Cost Estimating, Monitoring & Control
- Delay & Acceleration
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- Standard of Care
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Mr. Spriggs has served as founder and CEO of his own professional services firm which, under his guidance, grew from $2 million in revenue and 15 people, to $80 million in revenue and 245 people. He has over 40 years of experience managing his own business, while at the same time, serving as a federal procurement lawyer in cases for major corporations and small to medium sized businesses. As a government contracts attorney, he has handled cases involving claims, protests, disputes, and appeals related to constructive changes, default terminations, convenience terminations, cost allowability and allocability, contract interpretation, protection of data rights, and defective pricing. His services have enabled his clients to recover nearly $1 billion in profits on government contracts, and save billions of dollars in losses.

Expertise:

- Contract Interpretation
- CPAR Reviews
- Defective Specifications
- Defense of Terminations for Default
- Government Breach of Contractual Obligations
- Monetary and Non-Monetary Claims
- Prosecution of Changes
- Termination for Convenience Claims

This article is intended to help corporate leaders maximize profits on federal contracts and subcontracts for new construction, additions, and/or renovation programs. The article is also applicable to private contracts and subcontracts. The discussion is a lesson learned review of recent programs in which contractors and subcontractors have incurred contract management and project control issues that have led to several court cases that took years to resolve.

Introduction

Federal government contracts involve a complex labyrinth of regulations, statutes, case law interpretations, sub regulations, and lengthy contract documents. These contracts can well exceed 300 pages, and are contracts of adhesion, meaning the government dictates the terms and conditions and very little, if any, can be negotiated up front. Company leadership must be familiar with the regulations, statutes, case law, contract documents, and depend on key personnel to manage the details of a specific program to assure profitability. Senior management must pay special attention to these contracts. All senior management should know the vagaries of government contracts.

The contract management control process must be able to, (1) identify any conflicts, errors, omissions, or ambiguities that could affect profitability when bidding on a contract; (2) recognize directed and constructive changes in a timely manner to assure notice of rights and avoid waiving rights during performance; and (3) be able to expand the project team capability set as needed to execute requests for an equitable adjustment (REA) submissions and claims during the performance period, and retain the necessary information to see the dispute resolution process to completion in the post construction period, if needed.

Quantify Changes to Keep the Contract Profitable

The changes clause permits pricing of the change, ***but it also provides for repricing of the original work if it is affected by the change***. Therefore, leadership needs to take a good hard look at how the change affects the original work and the means and methods of performance. The change may in fact permit the pricing of impact on the original work with the result that profitability is enhanced.

For contractors to position themselves to maintain and even enhance profits, they must apply the basics of the contract management control process during the proposal and/or contract formation step: a detailed statement of inclusions and exclusions to the scope of work, a narrative of the intended means and methods, a reasonable schedule of values with tie back to the proposal pricing, and a reasonable and achievable CPM schedule. With these pieces in place, contractors can be prepared to provide notice and forecast quantum to reserve rights, while continuing performance in the face of a dispute with the government over essential contract terms.

Prompt notice of a change is important. Failure to timely provide the contracting officer with notice of the change can lead to an assumption of the risk that can defeat any claim.

Once a directed and/or constructive change has been identified, leadership must direct a team to put together a damage claim during the performance period as part of perfecting notice. While a formal communication to the contracting officer – a letter, not an email – starts this process, few contractors have the internal resources with the necessary expertise in prospective and retrospective change analysis methods to handle this process, while simultaneously building the project in a safe and quality manner. Leadership must lead an effort that may require augmenting the project staff with outside expertise to assure, (1) the contract management control process stays intact; (2) a proper, detailed REA or claim submission to the contracting officer is prepared timely; and (3) proper and timely responses to the contracting officer during his/her review of submissions occur.

Contractors must deploy the right expertise in a timely manner on contractual entitlement and quantum. Most entitlement involves the government failing to discharge its implied by law and express duties, its mistaken interpretation of contract terms and conditions, and its failure to understand the doctrine of good faith and fair dealing. Entitlement not only involves careful analysis of all the facts, but it also requires knowledge of the various theories of recovery in government contract law.

The government warrants that if its drawings and specifications are followed by the contractor, suitable performance will result. The government also warrants performance is commercially practicable. The government has the implied duty in every contract to disclose to the contractor any information vital to the contractor's performance. Even if the parties are equally ignorant of the vital information, the risk may be allocated to the government if it was in a better position to know the information.

The government is obliged under every contract to cooperate with, and not interfere in, the contractor's performance. The government must do whatever is reasonably necessary to enable the contractor to perform successfully. Many constructive changes involve the government's misunderstanding or misinterpretation of contract terms and conditions. Often, where ambiguous, the contract is interpreted against the government, in other words, the contract's drafter.

Once entitlement is justified, the following quantum elements should be put in place to assure a complete submission and allow the process to move forward.

- **DIRECT COSTS.** Vendor quotations provide the most accurate pricing available but must be documented. If vendor quotations are not available, the contractor should perform a detailed take-off and cost estimate based on cost databases such as RS Means. All judgmental costs should be noted and supported with a logical written basis, such as comparison to a similar task or product, simple reasoning, proportional relations, weight basis, etc., so that the costs are fully explained for a third-party reviewer.

- **DIRECT COST MARKUPS.** In government contracting, one must follow the regulations governing allowable costs and profit percentages. A government issued risk matrix is often used to determine standard markup percentages. Such percentages may include sales tax, profit, bond, design fees, design contingency, escalation, and construction contingency. Changed work is risk intensive which often permits a higher profit factor, and other markup percentage factors, to be applied to the change and remaining work than was allowed per the original work.

- **DELAY QUANTIFICATION.** First, one must follow the contract specifications. If a time impact analysis (TIA) is required, the quality and timeliness of such analysis will be dependent upon the quality of the CPM baseline schedule or its updates. If the contract specifications are silent as to a required method, the contractor should consider a forward-looking estimate of time lost via a TIA based upon the baseline schedule or its updates, even if the quality of the baseline schedule or its updates must be improved to allow such analysis. Such analysis should include, if applicable, changes to the intended resource loading (manpower and dollars) to explain changes to crew flow, the number of crews, and/or crew size and other related matters of changing means and methods. Even if negotiations of the forward-looking time estimate fail, an adjustment of the forward-looking time impact analysis via forensic schedule analysis will be less costly and add further weight to the contractor's arguments.

- **DELAY COSTS: FIELD OFFICE OVERHEAD (FOOH).** This cost should be calculated and itemized as required by the contract and project requirements, rather than applied as a general percentage as a change may not only extend previous general condition costs but add to them as well. FOOH typically includes, but is not limited to, job supervision personnel, temporary project office, temporary storage, temporary utilities, quality control, schedules, etc. A daily rate can be developed, provided in written format for review and negotiation and thus applied to either forward estimated delay days, or delay days established through forensic analysis methods.

- **DELAY COSTS: HOME OFFICE OVERHEAD (HOOH).** This cost typically accounts for corporate office overheads, executive salaries, etc. Like FOOH, a daily rate can be developed and provided in written format for review and negotiation. The daily rate can then be applied to either forward estimated delay days, or delay days established through forensic analysis methods. For federal contracts, the Eichleay Formula is often utilized as a tool for estimating unabsorbed HOOH in cases where the government was responsible for a project's delay (i.e., not for force majeure issues). Common circumstances permitting use of the Eichleay Formula are, (1) the project's critical path schedule is extended past the contract performance period; (2) there is uncertainty of the standby period; (3) pursuit of other work that can absorb outstanding HOOH is impractical; and (4) where actual damages cannot be calculated but an increase in HOOH can be proven.

- **PRODUCTIVITY LOSS COSTS.** State in writing any productivity and/or overtime assumptions pre-award. Productivity damages are tough to quantify. A solid entitlement and delay analysis is often needed as a foundation. If such foundation is in place, methods to calculate productivity loss include use of industry established factors to estimate prospectively and analysis such as the measured mile, if needed, to true-up forensically.

- **REA PREPARATION COSTS.** Before making a final decision, contractors should also think about the potential hidden money in claims and REAs. For example, contractors can include contract administration costs as part of the damages sought in an REA. These costs can include in-house administrative costs for root cause analysis, preparation of communications with the contracting officer, and preparation of the request for equitable adjustment including related outside expert schedule analysts, attorney, and other consultant fees.

- **INTEREST COSTS.** Attorney and consultant fees are not recoverable as part of a claim. However, the Contract Disputes Act does provide for the recovery of interest on any amount that becomes due on a claim. Depending on how long the claim takes to resolve and the amount at stake, the interest collected can be considerable and should not be overlooked.

Regardless of the plan to submit a claim or REA during performance, the quantum analysis should be put forth in a manner that can be updated throughout the remaining performance period to allow for separation from other changes that may unexpectedly start at a later point during performance, or if negotiations of the change being forward priced are unsuccessful and a true-up with actual costs and time incurred needs to be performed later.

It is recommended that the contractor establishes new and separate cost accounts within its job cost accounting

system to accumulate costs related to each occurrence of changed work. Likewise, it is recommended the contractor add fragnets which describe each occurrence of changed work to the contractor's schedule updates and record in writing the effect of the change upon the scheduled base work. It is extremely important that the contractor follows the contract notice requirements and keeps all stakeholders informed of the costs related to each occurrence of changed work. The contractor may have to maintain a what-if series of schedule updates if the contracting officer does not approve of the fragnet of the change to be added to the live schedule in a timely manner – which often occurs when a disputed situation occurs.

While a claim is certainly the most direct way to proceed as it puts in place a specific timeline of events and requires a response by the government, it is not always the advisable path forward for the contractor. A contractor may have a good working relationship with the contracting officer, or the contractor may want to proceed cautiously to preserve a relationship with a particular client. In those cases, an REA offers the opportunity to reach a mutually beneficial settlement without having to file a formal claim. A contractor can also convert an REA into a certified claim at any time, if the government does not respond to the REA, or negotiations stall.

While the decision to file a claim or submit an REA should be made on a case-by-case basis, senior management must respect the submission and response process. In government contracts, all claims must go through the contracting officer before there is relief in court. This is also a wise task to complete, even in private contract situations, to avoid argument that the owner was unaware of the possible materiality of the issue. Exhaustion of administrative remedies is required in government contracts and often required with other customers. In government contracts, the contracting officer is obligated to take on a judicial role. But this duty is ignored in the ever-increasing adversarial nature of the contractual relationship. In many private contracts, there is a similar independent decision maker (IDM) role that is often fulfilled by the architect.

It is important for leadership to recognize that the constructive change should be dealt with as promptly as possible, especially when it concerns contract interpretation of the ongoing work. For government contractors, there is a little-known expedited path to judicial relief. However, it only works if the judge has the same sense of urgency as the litigating parties.

Avoiding Constructive Changes Where Possible

The best way to prevent most constructive changes is to review the solicitation with the help of experts and to make a sound decision on whether and how to bid based on a cogent risk analysis. Too often, executives turn getting the contract over to personnel who are ill-equipped to handle contracting and subcontracting and who de-emphasize the contract management control process in favor of securing a contract award; this is the first mistake on the way to achieving profitability. However, for companies that know what they are doing and are properly staffed, government contracts and subcontracts can be highly profitable. The heavy use of fixed price contracts rewards ingenuity and efficiency and payment is sure and swift.

The first step toward success involves identifying contracts on which to bid. Typically, a small team of experts vets the contract documents. They then prepare a risk analysis that identifies whether there are any conflicts, errors, omissions, or ambiguities that could affect profitability. This step should occur prior to any decision to bid on the contract and prepare a pricing proposal. This is the most important control step in the project.

The typical situation is that marketing has identified the opportunity and the operations team is making plans for execution of the work while finance is putting together the numbers. However, the contract management and project controls team members needed for the risk analysis are often the stepsister and brother brought in at the last minute, if at all, when the decision to bid already has been made.

The reality is government contracts involve an adversarial relationship with the customer. Failure to object to obvious errors, conflicts, or omissions waives the right to object later. Therefore, experienced contractors discuss the meaning of the language with the contracting officer. Seasoned contractors scrub the request for proposals and raise any questions about the request for proposals with the contracting officer. If the contractor is anxious to bid on the job, then it is perfectly permissible to protest at the Government Accountability Office, or even in court, depending on the significance of the business opportunity.

If there are any patent problems with the contract, the contractor assumes the risk and waives any claim if it goes ahead and bids without taking care of the problem up front. Top management needs to be hands on and circumspect at this stage to assure there is a complete understanding of the risks and rewards of bidding on the contract as seen by all departments, including properly trained contract management and project control personnel. Senior leadership must lead the work by seeing, or becoming aware, of the minefields and skillfully avoiding them.

Manage Contract Performance

In government contracts, the changes clause was required due to the exigencies of war. It provides generally that the government may make changes as it deems appropriate, and the contractor must make the changes subject to the negotiation of an increase in the price and an extension

of time. A contractor can seek judicial review of differing contract interpretations, or whether under the contract's disputes clause, the contractor has the duty to proceed in situations where the government fails to provide information needed to perform the work.

It is possible for the contractor to refuse to perform the contract according to the government's interpretation in a situation called a cardinal change. A cardinal change is a requirement which changes the very nature of the work and amounts to a material breach of the contract. Regardless, the contractor is in a tight spot and judicial relief, although available, may not be timely. In fact, with the past as prologue, a judge may not be concerned about the urgency of the situation.

Many commercial contracts also include a similar continuing performance concept. For example, Article 4.3.3 of the American Institute of Architects (AIA) A201 Contract for Construction form provides for continuing contract performance pending final resolution of a claim, with certain exceptions. Some states also maintain contract law that provides that all else being equal, a contractor is generally not entitled to stop performance, or rescind the contract, when an owner commits a minor or immaterial breach such as a progress payment being untimely, for example. Conversely, with some exceptions, a contractor generally is justified in discontinuing performance when an owner has materially breached a contract. Adding new and onerous payment conditions or failing to pay at all are examples of such a material breach. The right to stop work can be tested judicially. However, once again, with the past as prologue, judicial relief may not be timely.

Thus, contractors often should, or may have to, perform through a contract dispute while simultaneously positioning themselves to recover costs/time due to changes later as issues of additional costs or delays resulting from a disputed change can be taken up as part of a claim or REA. In such situations, contractors need to be prepared to provide notice to reserve rights as failing to perform can have devastating consequences, including poor customer relationships, poor CPARs, and termination for default. However, most contractors do not do this well or wait too late to bring in expertise to assist.

The problem is that recognition of a formal change ordered by the contracting officer is easy, but there are many constructive changes that can occur during the performance of a contract where there is no formal notice, and the impact of the constructive change is not fully known until the cost is tallied up at the end. In government contracting, there is a premium on identifying, staying alert, and dealing with constructive changes during performance.

Being alert to constructive changes and doing something about them, is a key to profitability on government contracts; and most contract managers and project control personnel, let alone senior management, do not have the training or access to the necessary project information to recognize and know how to deal with such changes. It is important for a contractor to be aware of direct and constructive changes and of the available remedies to preserve the contractor's rights, and to maintain, and even enhance, profitability.

Conclusion

Doing business with the federal government either at the prime or subcontractor level requires additional attention to detail and involves some ***considerable homework on the part of senior management.*** One simply must become knowledgeable in government contracts and the particular contract. And yes, cost will be added to the indirect pools for expert assistance, which may or may not be needed in commercial contracting depending upon contract and/or project complexity.

There are plenty of examples of successful companies doing business with the federal government. They usually have many contract managers and lawyers embedded in contracts departments that are well coordinated and familiar with outside experts during performance. Senior management in those companies learned a long time ago that if one wants to do business with the government, he/she must commit to hiring knowledgeable and seasoned people as part of a contract management team.

The authors have seen many mistakes made by senior management, inclusive of bringing experts in only to clean up the mess. The purpose of this article is to help senior management deal with the problems but also turn a profit on the project. Profit is enhanced when knowledgeable people are hired by senior management to manage the contract.

Senior management needs to be aware of and use the outside expertise available in the marketplace to augment project teams when the situation arises and do so ***sooner rather than later***. Experts in the field can help senior management form a ***road map*** which will ensure the contract management control process stays intact, is responsive to the customer, and puts the company in the best position to assure profitability.

These experts also compile and share best practices for problem awareness and identification, provide helpful hints on timely non-monetary and monetary claims that preserve and avoid waiver of rights, and demonstrate how to introduce profitability into the contract dispute resolution process.

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