Construction and Capital Expenditures: Don't Ignore the Greatest Risk Affecting Your Project

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Like most construction lawyers, my time is divided between contract reviews, disputes, and regulatory matters. Although I primarily provide counsel on construction contracts, litigating design and construction matters is a constant reminder to me that too often owners tend to be pennywise and pound foolish. When a project gets sideways, then, and only then, do attorneys begin to examine the details of the construction contract provisions in the middle of expensive construction litigation. In fact, construction litigation may cost 10% to 20% of the project costs. If opportunity cost in the form of loss of use and lost profits are considered, construction litigation costs may exceed the project cost.

This phenomenon of foregoing contract review is so striking because the construction component is by far the single greatest risk an owner faces with a new project, and the primary means of managing construction risk is the construction contract. Yet, many owners are reluctant to hire a construction contract attorney to review and help negotiate the construction contract. This means these owners are ignoring the greatest risk affecting their capital projects, and owners are rolling the dice in the hope that any litigation cost arising from a deficient construction contract will be less than the legal cost of reviewing the contract at the beginning of the project. That is a bad bet, as further discussed below.

Capital Expenditures for a Project

For every new project, there are three primary parts that make up the total project cost: (1) the property; (2) the financing; and (3) the design & construction. Depending on the location and type of project, the real estate acquisition will account for about 5% of the total project cost. Finance will account for around 5% of the total project costs, and the design will account for another 5%. Construction costs, however, will make up 85% of the total project cost. To see how these primary parts add up to the project cost, let's consider a small office project with a total project cost of $10,000,000.

Real Estate (5%): $500,000

Financing (5%): $500,000

Design (5%): $500,000

Construction (85%): $8,500,000

These numbers speak volumes about where owners should have the most concern, but what is the actual risk of financial exposure and liability (legal and financial risks) for these different costs?

The Risks and Risk Analysis

The simplest way to analyze the legal and financial risks above is to assign a probability of occurrence to each risk and then multiply the probability by each project cost, which provides a monetary value for the risk. For example, if a business is purchasing a $100 product and there is a 2% chance the product will not function, the value of the risk is $2. Applying this basic risk analysis to our project parts, we will make some assumptions. Because there is a very small risk associated with land acquisition or financing, the risk probability for each is 1%. This risk probability makes sense because there are rarely any problems with land titles or draws on construction loans.

Although there is a higher risk for architecture and engineering problems, this risk probability is 10%. Why 10%? The design is typically provided by a single firm or two firms (i.e. an architecture firm and an engineering firm), and office design is standard and simple. The construction risk in this example, however, is 30% for the following reasons: First, the office building is essentially a new "product" that has never been built before; Second, the office will be constructed by over 100 different companies (general contractor, subcontractors, material suppliers, and service providers); Third, many of these companies and employees rarely work together; Fourth, there is a tremendous amount of work, company, payment, and schedule coordination; and Fifth, there are a multitude of external factors that may affect the cost, schedule, and scope of work for the project, such as unforeseen adverse weather, differing site conditions, design errors & omissions, owner changes, accidents & injuries, labor issues, material price escalation, permitting, inspections, licensing and on and on.

The simplified risk analysis for the office project is as follows:

Real Estate: $500,000 x 1% = $5,000 Risk Value

Financing: $500,000 x 1% = $5,000 Risk Value

Design: $500,000 x 10% = $50,000 Risk Value

Construction: $8,500,000 x 30% = $2,550,000 Risk Value

Here, the risk value for construction is 510 times greater than the risk value for real estate or financing and 51 times greater than the risk value for design. Furthermore, construction risk alone accounts for 26% of the total project cost. With legal and financial risks of this magnitude, we must ask: who is protecting the owner? Or, phrased another way, who is managing the construction risk for the owner?

Who is Managing the Construction Risks for the Owner? – Probably No One

Owners are very astute at managing risk in their line of business, but my experience shows that many owners do not closely examine the enormous risks associated with a new project – the construction contract and the accompanying legal and financial risks. Moreover, owners often assume that: (1) other project parties will be managing the owner's construction risks; or (2) owner employees on the project are capable of managing the owner's construction risk.

For example, an owner may assume the lender will manage the construction risk, but the lender is primarily concerned about the risk of a loan default – not a project failure or cost overrun. An owner may also assume the architect or engineer is managing the construction risk, but the design professionals are not in the risk management business for the owner – design firms are protecting themselves in the event there are design defects or design delays. Lastly, an owner may rely on internal operations personnel to manage the project and the construction risks; yet such employees are normally not well versed in the laws governing the construction contracts, contract risk shifting provisions, or liabilities for each project member – even though such owner personnel may be qualified to manage the technical aspects of design and construction (value engineering, cost controls, CPM schedules, etc.)

In short, the owner embarking on a capital project is, in many cases, relying on parties who are not managing construction legal and financial risks or on personnel who are not qualified to manage construction legal and financial risks. Litigation or arbitration is the natural and probable consequence in this scenario if there are any major problems on the project. Disputes are expensive propositions, whether the legal costs are 20% or 200% of the project cost.

Construction Contract Review by a Construction Contract Attorney

It is clear that an owner must manage the owner's construction risk for a project, and the best way an owner can manage construction risk is through a construction contract. It is equally important that owners use experienced construction attorneys for the construction contract review. The majority of people would agree that the professional with the most education and experience in a particular industry should be the one performing work in that industry. For example, if you were constructing a large suspension bridge would you hire a botanist, fireman, painter, teacher, a jack-of-all-trades handyman, or even an electrical engineer to design the bridge? Or, would you hire a structural engineer with suspension bridge experience?

Just as you would hire an structural engineer with bridge experience to design your bridge, an owner should hire a construction attorney with contract experience to review the construction contract. An attorney, when reviewing a contract, examines the contract provisions and applies relevant law to the contract. Although many attorneys may review contracts, the average attorney does not review construction contracts. Attorneys – just like engineers – have experience in certain practice areas within the law, which other attorneys do not have. For example, some attorneys have an enormous amount of experience with wills, while other attorneys have significant experience in real estate. Likewise, construction attorneys have a tremendous amount of construction contract experience.

The Conclusion

In conclusion, the greatest legal or financial risk for a capital project is the construction, and owners must manage this risk with the construction contract. Owners routinely and appropriately hire attorneys for real estate and finance transactions, which have the lowest risks to the project. Here, owners are paying legal fees for low risk matters while refusing to pay for legal review of the highest risk transaction with the most financial exposure – this is money well spent. Moreover, rather the using attorneys without construction law experience, owners should select construction lawyers with experience drafting, reviewing, and negotiating construction contracts. Otherwise, owners, at peril of expensive litigation, are ignoring the greatest risk to their capital expenditure construction projects.