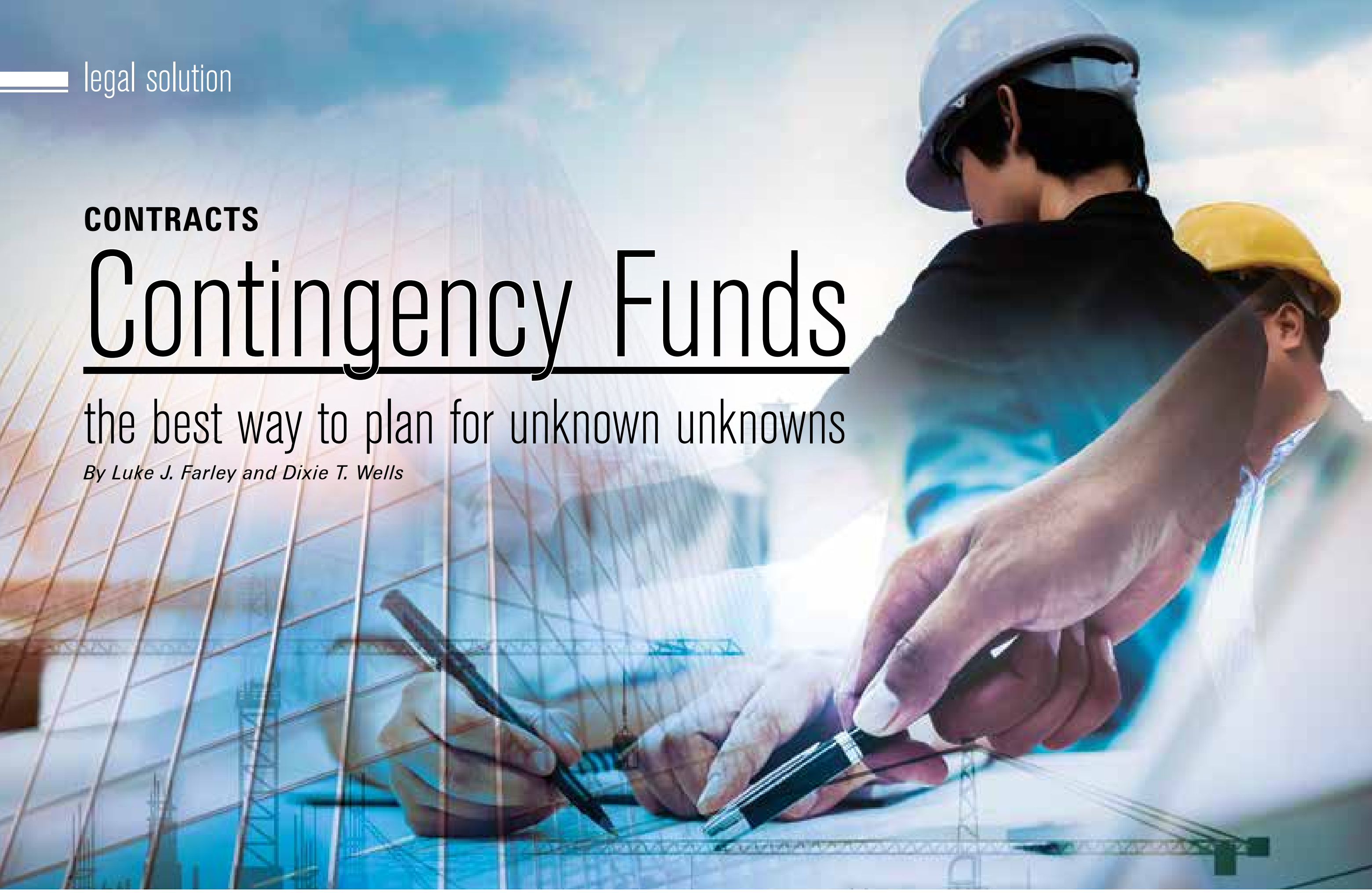

CONTRACTS

Contingency Funds

the best way to plan for unknown unknowns

By Luke J. Farley and Dixie T. Wells

For contractors, there are three things in life that are certain—death, taxes, and unwelcomed surprises on their jobs. Surprises are often bad for the bottom line—sometimes very bad. One of the best ways to hedge against costly uncertainties is for contractors to include a contingency fund in their contracts. This article provides an overview of contingency clauses and key points to consider when negotiating them.

WHAT IS A CONTINGENCY?

A contingency is, simply, an amount of money set aside to address the "unknown unknowns" on a construction project—those surprise costs that the parties know, through experience, they will encounter but cannot be quantified at the start of the job. A contingency is in contrast to an allowance, where the parties know they will incur a certain cost (say, flooring) but do not know the precise amount (will the owner select carpet, tile, marble?).

There are both owner contingencies and contractor contingencies. An owner contingency is often nothing more than a reserve set aside by the owner to pay for changes in the project scope, differing site conditions, etc. By design, contractors are often unaware of the existence of these owner contingencies, because they exist outside the terms of the contract—the owner puts aside money for unexpected situations and the contractor never hears about it (but usually assumes the reserve fund exists).

Contractor contingencies, on the other hand, can take one of two main forms. For contracts where the basis for payment is a lump sum price, the contingency is a cost cushion baked into the contract price to account for the unknown unknowns. In those instances, the owner does not know the amount of the contingency because it is included in a lump sum price. For contracts where the basis of payment is reimbursement for the cost of the work plus a contractor's fee with an overall guaranteed maximum price (GMP)—the most common type of commercial construction contract—the contingency must be separately negotiated between the parties. In a GMP contract, the contractor must demonstrate to the owner the actual costs incurred in performing the work so that the contractor can be reimbursed for them, meaning the contingency cannot be tucked away in a line item. A contingency in a GMP contract must, therefore, be specifically negotiated by the parties and included in the terms of the contract. The contractor bills against the contingency fund when it encounters one of the permitted contingencies (see below). The rest of this article considers the key negotiating points for a contingency clause in a GMP contract.

COVERED CONTINGENCIES

One of the toughest negotiating points for owners and contractors is determining permissible uses of the contingency funds. Owners will naturally push for a narrow set of permitted uses, while contractors will seek a broader set. Owners will typically prefer enumerating a handful of specific situations or conditions that would justify the contractor accessing the contingency funds, such as gaps in the scope of work between subcontractors and incomplete details in the design documents. Owners may also seek to define uses of the contingency that are explicitly prohibited, like costs incurred due to the negligence of the contractor.

Contractors, on the other hand, should seek a clause which grants them the broad right to apply contingency funds to a variety of different situations. One such clause might allow the contractor to access the contingency to cover "all cost overruns, unanticipated charges, and additional expenses due to errors in estimating both time and money and other charges or costs which may result from unforeseen challenges or conditions encountered by the Contractor during the course of the Work."

Who controls the contingency? A contractor should be entitled under the terms of the contract to access the contingency funds any time one of the stated contingencies exists (see above). Owners instead might seek a clause that provides that "the Contingency is for the use of the Contractor as approved by the Owner." By granting the owner the right to approve billing against the contingency, the contractor has essentially given the owner a veto over use of the contingency funds. Instead, as a compromise, contractors should negotiate language that only requires the contractor to provide advanced written notice of the contractor's intent to bill against the contingency and a monthly accounting of the funds.

Is the contingency part of shared savings? The amount of the contingency will usually be included as a line item in calculating the GMP. GMP contracts also frequently have a shared savings clause where if the total cost of the work comes in less than the GMP, the difference between the actual cost and the GMP is split between the owner and the contractor at some ratio (60%-40% or 75%-25% are common splits). Owners often view the contingency as the owner paying for the contractor's mistakes.

Consequently, owners often seek to have the contingency totally excluded from calculating the shared savings—not making mistakes is not the kind of "savings" that should be shared. Instead, the unused portion of the contingency is returned 100% to the owner, as opposed to the ratio established for the shared savings. By taking this approach, owners may inadvertently be encouraging disputes about the contingency. Returning 100% of unused contingency funds to the owner creates a "use it or lose it" mentality for the contractor, which might encourage the contractor to bill against the contingency for questionable uses. This will in turn lead to disputes between the owner and the contractor about the proper use of the contingency. A better approach for both parties might be to narrow the permitted uses of the contingency but allow unused portions to be included in the shared savings.

Must the contingency be used for cost escalation? The rising cost and unavailability of materials continue to be major problems for contractors. In the pandemic era, owners are largely coming around to the idea that contractors cannot bear those risks entirely. Many contracts now make some provision for cost escalation (see our article in Modern Contractor Solutions from October 2021). Should a contract have both a cost escalation clause and a contingency? From the contractor's perspective, yes. Owners will often insist that cost escalations should be covered by the contingency—after all, such increases are classic unknown unknowns. But from the contractor's perspective, the problems with the availability and price of materials are a "new" problem caused by the COVID-19 pandemic. The problems meant to be addressed by a contingency clause have always been a concern. If the contractor must now also account for inflation and supply chain problems in the contingency, then there is a good chance the contingency funds will be consumed by those new problems, leaving nothing for the usual things that contingencies are meant to cover. In short, contractors need a contingency for everything else besides cost escalations and should, for now, insist on both a cost escalation clause and a contingency clause.

CLOSING THOUGHT

Until contractors can see the future, contingency clauses will need to be a part of most GMP contracts. While owners may be resistant to contingencies, thoughtful negotiation over the key issues discussed above should result in a clause that both the owner and the contractor can live with. ■

This article is not legal advice and does not create an attorney-client relationship.

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