CLIENT ALERTS & INSIGHTS

COVID-19: Developer Claims Toolbox

MAY 8, 2020

Authors: Thomas O. Crist, Jeffrey J. Wild

1. COVID-19: Two Sides of the Same Coin

Introduction

Globally, the construction industry is largely in the excuse business. And, especially with the advent of COVID-19, that business is booming. Progress of construction projects is uniquely tied to both an efficient supply chain for materials and equipment and the ready availability of properly trained on-site labor and supervision. When the flow of either is disrupted, projects may finish later than planned, the costs of the contractor's performance may increase, and owner/developer's exposure to claims will grow. In the case of this particular pandemic, labor constraints and supply chain fractures are nearly universal, which severely blocks typical avenues to recover lost time, such as expediting procurement of replacement materials or aggressively increasing manpower. As a result, projects will take longer and will cost more to build. Who will ultimately bear these unplanned costs remains an important open question.

Delay and disruption are not treated equally

Simultaneously, federal, state, and local government restrictions on or near project sites have and will continue to hinder contractor and subcontractor assignment of properly trained personnel to projects. Such unforeseen hurdles and distractions will decrease labor productivity and require a greater investment of labor hours and expense for contractors to perform their planned scopes of work. Labor is often a contractor's greatest risk and variable expense. Force majeure or other impossibility-of-performance defenses will be an important tool for all project participants. Some will use force majeure defensively as a figurative shield; others as a sword. To manage your risk, every project participant must know when to swing and when to block.

Most of the presently available construction industry advisories comprise a rolling how-to list for contractors who wish to assert COVID-19-related defenses or claims against project owners and developers. Almost all of that information focuses on late completion-delay. Contractors typically use force majeure defensively to immunize themselves from developer claims for liquidated damages or other top-down costs associated with late project completion. Contractor claimants will argue that an unforeseeable event outside of its control rendered its performance not only more difficult or impracticable, but also impossible. Contracts, no matter how well written, cannot compel a contractor to achieve that which is truly not possible. Other contractors will use the force majeure or impossibility concept as a sword to affirmatively shift to the owner the unplanned costs they incur to deliver the project either later or differently than intended. Those contractors will characterize the impacts as owner-driven changed conditions and seek not only a compensable time extension but also additional payment from the owner to cover the increased cost of labor. Many will come armed with both tools. And, some of them will know how to use them.

Make informed choices on matters you control

Developers must prepare themselves to defend and manage both delay and disruption claims, and to use force majeure defenses themselves to excuse their own inability to perform as a result of unforeseeable events and impossibility. They also have to pick their poison based upon their relative exposure. The pandemic has thrust delay claims on owners. None can control or avoid that fact. Depending upon their response, however, owners might also wade into the world of contractor lost efficiency/disruption claims as a result of their decision to keep projects moving despite the many hurdles created by the pandemic. If they choose that path, they must be knowledgeable and prepared for the likely fallout of that decision.

The line between successful contractor claims and valid owner defenses will be drawn after identifying who or what caused which negative project impacts. If COVID-19 is the answer, then the analysis will shift to what (if any) instructions or directives the developer gave to its contractor after the pandemic arose. While this is often a fact-driven analysis, legal considerations are equally important.

A project owner who directs its contractor to proceed with the work, rather than suspending a project afflicted by the pandemic and accepting late completion, may expose itself to a second wave of claims based upon owner-driven changed conditions and the disruption that follows. A disruption claim may be made even if the work is completed on time, provided that the contractor exerted additional effort and incurred unplanned costs as a result of being compelled to work through the unforeseeable restrictions on its planned productivity. Only with prompt evaluation might the developer save both its occupancy date and its bottom line.

2. The FM Notice

Contractors will also as a reflex send developers “force majeure (FM) notices” to signal their position that they should be excused from liability for late performance because of COVID-19-related impacts. They will often “reserve all other rights to other claims for additional compensation under the contract or at law,” including the right to be paid for the extension period if permitted by their contract. After receiving a notice stating that the pandemic rendered some or all of the contractor’s performance impossible, developers will have a number of difficult decisions to make. Some of the factors driving these decisions are under the developer’s control. As time will be of the essence, a developer must quickly evaluate the relevant factors and make an informed decision.

To Suspend or Proceed

In order to eliminate exposure to labor inefficiency/disruption claims, suspension of the work or termination of certain contracts may be the best option for some owners. More often than not, developers will attempt to dampen the projected economic loss caused by COVID-19 by instructing their contractors to continue their performance despite unforeseen changed conditions. In doing so, the developer must balance the financial risk associated with a work stoppage against the potential exposure associated with compelling contractors to perform their work under significantly different circumstances that may entitle them to greater financial recovery.

Largely, construction contracts only loosely address liability for or shifting of costs caused by impacts as significant as COVID-19, despite the industry having experienced SARS, MERS, H1N1,

and Ebola. Over time, contractors and their associations have done a much better job than developers in modifying force majeure or impossibility provisions to their benefit. Many of the force majeure provisions today afford contractors the opportunity to pursue valid claims for additional compensation in circumstances such as those driven by a pandemic. Developers who do not choose the correct course of action may be faced with unmanageable financial consequences, including loss of rents, carry on their debt, and exposure to contractor claims for extended general conditions costs for staffing the work for longer than planned, and to claims for lost labor efficiency. Those who are prepared to manage the impact of work stoppages and external factors that restrict labor productivity are likely to fair best.

Sometimes the contract protects you

Construction contracts around the globe generally address force majeure events in a short list of ways. Some standard form agreements actually use "force majeure" language that, in the direct French translation, means "superior force." The AIA documents, including the A-201, do not include those magic words. Other standard contracts imply a force majeure concept by referring to an exhaustive or non-exhaustive list of excusable impacts to contractor progress such as natural disasters, war, terrorism, strikes, acts of God, or epidemics. Even others describe a force majeure-type event as any "other cause[s] beyond the parties' control." Contractors will run through this final catch-all provision like an open barn door.

As remedies for financial harm caused by a force majeure event, many construction contracts limit a delayed contractor's entitlement to a non-compensable extension of time. This operates much like an enforceable no damage for delay provision. For the time period impacted by the force majeure event, the contractor is excused from liability for liquidated or other owner lateness damages. The contractor, however, will not be paid more money for working on and supporting the project for longer than planned. In this instance, a temporary work stoppage might be the owner's best course of action.

Sometimes the contract does not protect the owner

Other force majeure provisions allow the contractor an excusable extension of time and compensation in the form of extended general conditions recovery for the full delay duration. To the extent that the contract is silent about force majeure or any of the other specific items enumerated above, most states have developed case law related to impossibility of performance, frustration of purpose, or other contractor-friendly legal concepts that a well-prepared contractor will use to escape liability for late completion. There is almost uniform support in the U.S. for contractors to use force majeure as a shield. If the contract does not bar contractor recovery of its prolongation costs, the owner may also be liable to cover those costs. Tendering of a force majeure notice, however, is only the start of the process of the contractor protecting its right to assert both delay and disruption claims.

What If You Can't Stop?

Developers who are contemplating suspending or terminating a construction contract as a result of COVID-19 should carefully consult their funding/loan instruments to determine whether they must first obtain lender or investor permission or consent to stop work. More often than not, though,

unless a contract is in its very early stages, developers will favor continued work despite receiving a facially valid force majeure notice from their contractor.

Owners should carefully evaluate the status of procurement for the project and its percentage complete in order to determine the likely impact of COVID-19's fractured supply chain. For instance, if all of the floor tile for a building is delayed in a port in Italy, but the building has yet to emerge from the ground, the actual impact to progress might not be critical, might not increase costs, and might instead be easily managed. On the other hand, if the owner is supplying expensive tile, wall coverings, and fixtures, and the building was scheduled to complete in June of 2020, then the loss of these materials coupled with a directive to proceed could decimate progress and cause contractor costs to balloon. If developers direct their contractors to proceed and to work around missing materials, equipment, and similar hurdles, then they should also assess what the likely impact will be on the contractor's labor productivity.

Pandora's box

If a developer elects to require that the project proceed despite COVID-19, it may expose itself to contractor claims for loss of labor productivity, also known as "disruption claims." This is where the big dollars will change hands on construction projects afflicted by the pandemic. The analysis of delay claims and tacking on time to the project's original end date to accommodate a COVID-19 work suspension is fairly straightforward. Disruption claim analysis, which focuses upon a reduction in the contractor's planned labor productivity, and resulting increased cost of labor due to external factors, can be much more complex, especially when considered under force majeure conditions.

If your contractor provides a force majeure notice stating that many of the materials it requires to advance the work cannot be timely procured, then you may elect to stop the work until those materials are available. If your project stops for four months until the materials are procured, and your contractor restarts work and doesn't lose more time, you may obtain occupancy four months later than planned, but owe your contractor nothing for the delay.

If your agreement provides that your contractor is entitled to a non-compensable extension of time, then you will have lost four months of rents, and will have additional interest and other measurable costs of extending your financing. However, you will be immunized from other contractor claims that can only arise from hampered on-site performance. During a suspension, a contractor cannot assert a valid claim for decreased labor productivity related to COVID-19 because it was not made to work inefficiently and/or differently than planned. Its efficiency cannot suffer and it cannot be disrupted if it isn't working.

For a variety of reasons, it may not be wise or possible for a developer to simply accept a four-month extension of the project duration and substantial completion date. Many developers who elect to proceed, rather than suspend, will characterize their contractor's force majeure notice as one stating an impediment or impracticability, but not impossibility, of performance. Many developers will instruct their contractors, by words or actions, to keep going and find available work to perform until missing equipment or materials arrive that will allow the pre-impact plan and productivity to resume. Doing so will open up the contractor's tool box to an entirely separate series of claims referred to as loss of productivity or disruption.

What does disruption look like?

The hallmark of a disruption, or decreased labor productivity/added cost of labor, is a contractor's claim that it is being forced to "jump around" on the project to seek out and perform discontinuous and less efficient work than it had planned. If a contractor is directed to proceed despite COVID-19, it might be required to break its crews into smaller groups, add shifts and overtime, spread personnel throughout a project, and simultaneously work in more areas than originally planned. It may also have to add supervision to the project to manage more crews working simultaneously over a larger work area. It will have to work around missing equipment and install temporary flooring, railings, lifts, windows, or whatever else cannot be built as originally planned. Its intended sequence of installation may become piecemeal, discontinuous, and slow. Whenever a contractor is required to perform differently than planned, or under "changed conditions," or when the owner assumes control over the contractor's "means and methods" of performance, it is likely that the contractor's labor efficiency will decrease. It will expend more work hours than it estimated, and it will cost more than expected to complete the work. Contractors will log these costs and ask the owner to reimburse them, with mark-up. They will argue that COVID-19 was the initial delaying event, but that the owner's decision to forge ahead instead of stopping work actually caused the increased cost of labor for which the owner is liable.

Moreover, COVID-19 and its impact on projects will be experienced both on-site and off, and include restrictions by the government that are outside any of the project participants' control. For example, large urban construction projects typically require manpower to be bused to the job site. If a contractor has a large crew, it will typically require the team to gather at a single rally point and then transport them to and from the site at the beginning and end of each workday. Social distancing requirements have taken what might have been a four-bus convoy and a 10-minute trip and converted it to a four-bus convoy making 10 trips from multiple different collection points over a period of an hour and a half. This can result in lost work hours for the entire crew on a daily basis that aggregate over time. No contractor envisions that type of impact or includes enough cushion in its price to absorb such costs.

Once on-site, elevator restrictions, waiting in line to have their temperatures taken, repeat testing, providing and monitoring use of PPE, additional training, safety checkpoints, on-site showers, unusual disinfecting of work areas, and questions about all of these requirements are all time and productivity killers. Although wise, appropriate, and mandatory for the moment, these kinds of one-off requirements destroy contractor-planned productivity and work flow and can exponentially increase the cost of delivering the project. Contractors will not voluntarily absorb these costs.

Have you fundamentally changed the deal?

Contractors will assert disruption claims against developers and argue that the owner's compulsion that work proceed triggered the "changed conditions" provisions in the construction contract. Relying on those provisions, the contractor will claim that it is entitled to recover all unplanned costs associated with proceeding differently than it would have but for the owner's direction. If developers stop the work, contractors may argue that work should have continued. If owners continue despite the pandemic, contractors may argue that work should have stopped. You should involve your designer and contractor in the decision-making process to eliminate or blunt that criticism and be ready to either cover or defend claims for extra costs. Sometimes, paying a disruption claim but finishing the project on time will be the most economical decision for you and

your contractor. Other times, the opposite will be true. Developers have to fully evaluate both concepts, delay and disruption, to make a smart decision and plan for their added exposure.

Everyone gets in line

Construction managers and general contractors who employ dozens of subcontractors on their projects will also receive claims from those lower tiers. General contractors will aggregate such claims and pursue them against the developer. It is important to understand the state laws applicable to the project, the terms of your prime contract, and your contractor's subcontracts to accurately evaluate this risk and determine what your exposure may be to aggregated pass-through disruption claims.

What may have been no exposure, or a $5,000/day exposure to the contractor for a project extension if you suspended the work, could become a multimillion-dollar disruption claim if you direct the constructor to proceed and it and all of its subcontractors are all materially impacted by that decision. The size of the disruption claim will largely depend upon the availability of materials that can be delivered to the job site and the complexity of each contractor's efforts to chase and find available work in a different manner than planned.

3. What To Do With the Claims

Contractors will submit claims of high and low quality. Some will convincingly establish entitlement. Some will quantify costs better than others. Many will act in good faith. When a contractor asserts a claim against you and contends that COVID-19 destroyed its procurement schedule and decimated its labor force, and your directive to proceed exacerbated that and entitles it to be paid more money, there are some basic steps you should take to quickly separate the potentially valid claims from the likely invalid ones. Raw data, before it is manipulated or sorted, is the best place to begin.

Get the Estimate

Ask your contractor to produce its original, detailed estimate for the project. If a contractor contends that it incurred unplanned costs because of COVID-19, it first has to establish what its planned costs were for the work. That is the "baseline" against which it must measure increased costs. With the assistance of counsel or a consultant, evaluate whether the contractor's original plan was actually achievable pre-pandemic for the estimated sum, or if the contractor was already off its planned labor burn rate before COVID-19 appeared in the U.S. If a contractor argues that it has spent $100,000 for some specific aspect of the work, but only planned to spend $20,000, it first must demonstrate that its $20,000 planned cost was achievable pre-COVID-19. It is important that you require the contractor to establish that its cost expectations were readily achievable for all aspects of the work that it now contends have been impacted negatively by COVID-19 and your instruction to continue the work. The claimant has the burden of establishing that it incurred unplanned costs and why.

What All Is In This Claim?

It is also the contractor's obligation to fully segregate its costs associated with any claimed impact from its reasonable planned costs or other impacts that are separate from COVID-19.Some contractors will have a number plugged in their estimate for all mobilization costs for the project. If a contractor is asserting that COVID-19 quadrupled its mobilization costs, it will first have to establish that all of the components of its estimated ingress and egress costs were reasonable. For example,

if the contractor had $10,000 in its estimate for mobilization, which would have really cost it $50,000 under optimum conditions, then its maximum claim for an impacted mobilization is the difference between its actual costs and $50,000, not $10,000. The contractor may not use COVID-19 as an excuse to fix bid errors that would have resulted in direct losses it would have absorbed in the absence of the pandemic. But, if the accurately planned cost of mobilizations doubled because of social distancing, the entire delta might comprise a valid claim.

Invariably, some contractors will work hard to establish the impact of COVID-19 on each component of the work and will share their financial data. Others will attempt to use COVID-19 as an excuse to recover for poorly explained labor inefficiencies and lost time. It is important that you ask your contractor to share its detailed job cost reports and records. The most successful contractor claims will be those in which the claimant establishes that the way it planned, scheduled, and priced its work was valid and achievable before COVID-19 and the sole reason that was not achieved is because of the pandemic and your order that it proceed with the hindered work. The successful contractor claimant will demonstrate: (1) that it actually performed in accordance with its plan before COVID-19; (2) that much but not all of its work was negatively impacted by COVID-19; and (3) that its costs can be accurately segregated and tied to its job cost reports. Such a claimant will also establish a return to normalcy of its man-hour burn rate after COVID-19's impact on the supply chain and labor productivity ceases.

Did the contractor protect itself?

Many construction contracts will require that the contractor include a "flow-down" provision in its subcontracts with lower tiers that incorporates the prime contract requirements for the work. If well drafted, many prime contracts will also require a provision that directs the contractor to include in its subcontracts the same limitations on unplanned cost recovery that exist in the prime contract. Regardless, there will be circumstances in which a construction manager or general contractor has left itself exposed to subcontractor claims for delay and/or disruption that the contractor has forfeited its right to pursue against the developer. This will be fertile ground for major disputes that will result in contractors asserting claims against owners that they would typically forego because they have left themselves in a "whipsaw" position in which their liability downstream far exceeds their ability to recover from the project owner.

Some contractors will simply package all claims received by subcontractors and forward them to the owner for "consideration." When those claims are denied, contractors will inform their subcontractors that they are simply out of luck, potentially relying upon pay-if-paid provisions in their subcontracts to avoid payment. This tactic will be met with mixed results depending upon state law and specific contract provisions. It is not the developer's job to evaluate a pile of lower-tier claims. Ask your contractor to evaluate and vouch for any claim it submits to you. It is not simply a blind conduit for claims.

The Schedule Doesn't Lie

If a contractor's disruption claim is based at all on supply chain issues, then ask to review your contractor's detailed "procurement schedule." If your contractor was supposed to order needed equipment by August of 2019, but did not order it until December of 2019 for reasons it cannot explain, the fact that those materials are now caught up in the overseas supply chain remains its problem and not the developer's. Likewise, if the project specifications have a "Buy American"

requirement and your contractor contends that its materials are caught-up in Europe, it may have no grounds to assert a force majeure clause either as a defense or to support a disruption claim. If your contractor had an option to choose American or foreign materials for the project but elected to order materials from China to save money, then you might be able to compel it to cancel the order and purchase the materials locally at its cost-with the contractor absorbing any related disruption.

Should you find other materials?

Be careful about modifying specifications to address a materials shortage caused by the pandemic. For example, the project's specifications required certain materials be acquired from Italy. Your contractor timely ordered those materials, but they are locked in port in Italy due to the pandemic and there is no announced release date. If you choose to change your specifications to allow the purchase of similar materials from the United States, you, and not the contractor, will likely bear the additional costs associated with obtaining the domestic materials along with any disruption associated with their late delivery to the project. In this scenario, by changing the contract requirements, you will have arguably created a changed condition and, under many construction contracts, will have entitled your contractor to additional compensation. You might also wind up with twice the materials you need and double the potential liability to pay for them.

Some contractors will do their best to claim only the costs associated with COVID-19 impacts, will give appropriate notice, will work with you and produce documentation validating their original plan, and will seek in good faith to demonstrate the delta in costs which they incurred as a result of your instructions. Others will give a blanket force majeure notice (and likely already have), will reserve the right to pursue any and all claims, and will wait until the end of the project to present a claim for the full difference between their planned and actual margins. These claims are disfavored by most courts, but require special handling to rebut.

Can you audit?

To evaluate and negotiate claims raised by contractors, you need documentation and information. Owners may use audit provisions in their contracts, if available, to request the documentation needed to evaluate and react to a claim. You should resort to such a formal request if that becomes necessary to obtain the basic information needed to react and plan.

If you conclude that you have been confronted with a valid prospective claim by a likely entitled contractor, you should consider negotiating a "line in the sand" change order. In that circumstance, you will either fix or release the project's end date, price the cost of performing disrupted work and/or for extended performance duration, and agree to an all-in change order that precludes the contractor from pursuing any other claims for impacts that have already occurred and acknowledges that the COVID-19 impacts have concluded. The more readily and quickly you realign your contract and everyone's expectations, as well as understand your exposure to contractor claims for delay and disruption, the more quickly you can get back to business and forecast the final cost of the work.

4. Conclusion

There is no silver bullet available in these circumstances and one size does not fit all. The construction industry has survived prior pandemics. Ebola was on the forefront outside of the United

States only five years ago, yet to most people it seems like an ancient event. While we will get through this, owners must promptly evaluate contractor claims and know when to pay the valid claims and dispute the others. Any advice that begins with “all you have to do” should be summarily dismissed. These are hints about how to issue-spot and ask some of the right questions, but are in no way a substitute for open owner-contractor communications. While good project and claims hygiene practices must be followed, a direct evaluation of the contract and law, as well as the contractor’s planned and actual costs of the work, will provide you the best information upon which to make these hard decisions.

For additional information:

Please contact Tom Crist, partner and co-chair of Benesch’s Construction Practice Group, or Jeff Wild, Chair, Real Estate & Environmental Practice Group, with any questions regarding your project or contract.