



# CONSTRUCTION ADVISOR

WINTER 2011

## W E L C O M E

*A message from*  
**Aaron Abraham and**  
**David J. Pfeffer**



*Aaron Abraham*



*David J. Pfeffer*

In spite of continuing instability in certain markets, there is some good news to be found in the real estate and construction industries as a whole. We continue to see some new markets open, business models grow and an increased level of creativity leading to growth in certain sectors. Furthermore, some investors are commanding profitable margins on distressed assets and creative financing structures are reviving stalled projects.

We have been fortunate to have been able to assist many of our clients in these new transactions – and we believe that opportunities for these adaptive and forward-looking firms continue to be unprecedented.

TKD's clients are involved in some of New York City's cutting-edge projects. They are opening dance studios, movie theaters and restaurants in vibrant neighborhoods including Williamsburg, Bushwick and Harlem. Our not-for-profit clients are developing new headquarters and expanding health care facilities. Indeed, some of our other clients are utilizing current market conditions to renovate their homes.

We hope you find the articles in this issue informative and useful, and we welcome your comments and suggestions. If you have a specific topic that you would like to see addressed in a future issue of the *Construction Advisor*, we would be pleased to research your topic and write about it.

Best,

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## FALSE BILLINGS AND KICKBACKS:

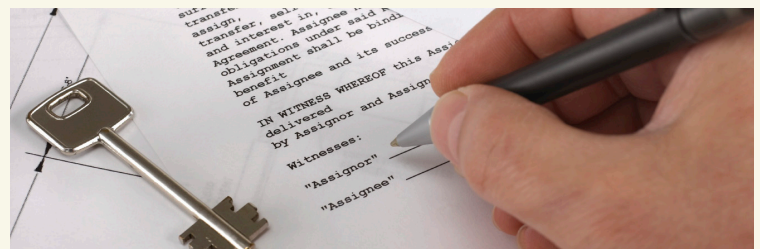
### How Building Owners Can Protect Themselves

*By David J. Pfeffer*

Building owners spend billions of dollars a year to construct and refurbish their properties, yet many are unaware of the hidden costs some contractors charge improperly. Building owners are often vulnerable to this kind of corruption because they:

- do not know how to select the appropriate contractor for the project,
- do not have the experience or knowledge to analyze construction costs, or
- need to build quickly.

Major corruption in New York City's construction industry came to light in 1998 when a false billing and kickback scandal surfaced. The scandal resulted in two dozen companies and many executives pleading guilty to bribery and other related charges. Although City prosecutors met with success at the time, there is still corruption in the construction industry. Prosecutors raided the offices of three prominent New York City area subcontractors and in January 2010 charged another company for allegedly stealing over \$7 million from clients. These companies are just a few among those under the scrutiny of City officials. This is not to say that all contractors are corrupt; the vast majority are honest and hard-working people.



### One Way Overcharging Occurs: Inflated Bills

When a building owner hires a general contractor or construction manager, that contractor will generally delegate certain aspects of the

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## FALSE BILLINGS AND KICKBACKS

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project to subcontractors. Overcharging may occur when the building owner pays out a false or inflated invoice that is submitted by the contractor for the subcontractor's work. When the subcontractor receives payment on that inflated invoice, the contractor may seek a "kickback" from the subcontractor. The owner is at risk of losing substantial (but hidden) sums if he is careless or does not understand the inner workings of the construction industry.

There are several ways building owners can protect themselves from false billings and kickbacks in the construction industry. In selecting a contractor, the owner should:

- *Obtain as many bids as possible.* Encouraging competition among contractors and knowing the fair market rate of the project will help decrease the possibility of corruption between the contractor and subcontractors.
- *Conduct an intense due diligence process* when analyzing the contractors' prospective bids. By asking prospective

contractors for license information, verifying the license information, and obtaining references, the owner will limit the odds of selecting a contractor who is prone to corruption.

The owner and his representative should examine invoices for work, services rendered and change orders very closely. Keeping accurate records and demanding complete accountability from the contractor can help the owner notice any suspicious invoices.

### **Hiring an Independent Inspector**

Another way to protect the owner from corruption on a larger project is by hiring an independent inspector. Many owners rely on public inspectors to police the progress of the project. An independent inspector is on the job regularly, works directly for the owner, and ensures that the project is free from corruption, waste and negligence. Depending on his background, he may also ensure that the building is being built to code.

An owner who decides to hire an

independent inspector should consider the inspector's:

- *Level of experience and qualifications* in all the major systems of the project. Having an inspector qualified in one area but not another will leave the owner open to a substandard work product and corruption.
- *Availability to pay attention to the owner's project.* It does not matter how experienced or qualified an inspector is, if he is too busy or distracted with other assignments.
- *Degree of credibility* and assertiveness when dealing with contractors. A credible inspector is essential to sustaining leverage over the contractor and subcontractors on the project.

Knowledge is power in the construction industry. Many contractors and subcontractors rely on the fact that owners do not know the inner workings of the industry. An owner who is active in the project and asking questions will minimize the opportunities for a contractor to take advantage.

# THE CONSTRUCTION CONTRACT: LUMP SUM V. COST PLUS

By David J. Pfeffer



David J. Pfeffer

**B**efore ground is broken on a construction project, an owner is faced with many difficult decisions. Most importantly the owner must decide what kind of construction contract to enter into with the contractor. The most common options available to an owner are the lump sum contract and the cost-plus fee contract. Both of these contracts have advantages and disadvantages from an owner's perspective.

The owner must keep his financial interest in mind, while at the same time, allowing the contractor to make a reasonable profit and build a quality project efficiently.

## The Lump Sum Contract

For an owner who has very tight budget constraints or lacks experience in the construction industry, the lump sum contract is often ideal. The lump sum contract is the most basic form of an agreement between an owner and contractor and is fairly easy to manage. For this kind of contract to be effective, the owner must have sufficiently detailed and complete drawings and specifications. The construction documents must be well defined at the time of the bid to allow the bidders to properly estimate the cost of labor and materials.

Under a lump sum agreement, the contractor is responsible for completing the project within the agreed-upon fixed cost set forth in the contract. If the contractor completes the project under the fixed total cost, then the contractor keeps the difference and makes a profit from the work. The owner is not entitled to any savings if the project is completed below the fixed total cost. A lump sum contract is generally a closed-book arrangement, so the contractor does not have to report the cost of labor and materials to the owner.

## Advantages of a Lump Sum Contract

There are several advantages for an owner to enter into a lump sum contract. It is a huge benefit to an owner that the contract is easy to manage. Payments to the contractor are based on the percentage of completed work. Generally, the payment schedule is created by the contractor and reviewed by the owner and architect during the course of construction.

## Disadvantages of a Lump Sum Contract

There are disadvantages an owner must consider under a lump sum agreement. Perhaps the biggest concerns are cost overruns and lack of flexibility.

In the event that the contractor exceeds the fixed total cost of the

project, the theory goes that the contractor is responsible for any cost within the scope of the work that exceeds the agreed-upon total. In practice, however, the contractor may stop working on the project and blame the owner and others for cost overruns.

In the event the owner wants to make changes to the project during the course of construction, the owner may find that the lump sum contract does not provide for much flexibility. Making changes while construction is in progress can be fraught with difficulty because the contractor bid on the project according to completed plans, not ever-changing plans; the changes may be costly and difficult for the owner to obtain. Since the project is closed book, the owner must specify the materials that the contractor is required to use during construction; otherwise the contractor is likely to use the lowest suitable grade materials to save money.

In order for an owner to protect himself, he must work closely with the design team during the planning stages of the project to ensure that everything he wants is documented in the final plans.

## The Cost-Plus Fee Contract

For an owner who has experience in the construction industry, or for an owner who can not initially define or sufficiently detail the scope of the work, the cost-plus fee contract (known in the industry simply as the "cost-plus" method) is best. In a cost-plus agreement, the contractor is reimbursed by the owner for the actual cost of performing the work. The contractor is not supposed to make a profit on any phase of the construction and the project is open book. Before the project begins, the owner and contractor agree on a fee (often a set monthly fee or a fee based on a percentage of the cost of the work) that the contractor will

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# THE CONSTRUCTION CONTRACT

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retain for profit and overhead. The idea of the cost-plus arrangement is for the owner to pay the cost of the actual work without markups, plus a set fee for the contractor's profit. To avoid disputes, the owner and contractor should specify early on in the process what is a reimbursable expense to the contractor (for his general conditions such as employees on the project, insurance, etc.), and what is considered a cost to the owner.

## Advantages of the Cost-Plus Contract

The cost-plus agreement is ideal for fast-tracked projects or for situations where the contractor becomes involved before the construction documents are substantially completed. The cost-plus contract allows an owner to have more flexibility to change designs and materials as the project proceeds. Furthermore, this agreement usually requires the contractor to obtain several competitive bids for each trade, allowing the owner to review the bids and secure the lowest cost. And, since the project is open book, the owner is entitled to know the cost of materials and labor at each phase of the construction process. If the owner and contractor have a good working relationship, the cost-plus contract allows for a flexible and efficient building experience.

## Disadvantages of the Cost-Plus Contract

The biggest disadvantage of the cost-plus contract is that the costs can rise quickly. Under the cost-plus contract the owner

must verify hundreds and often thousands of claimed costs; such an arrangement is ripe for a dishonest contractor to defraud the owner.

## The GMP Add-On

While the traditional cost-plus agreement does not have a fixed budget, an owner and contractor often agree to cap the price once the project's design is substantially complete. This is known as a Guaranteed Maximum Price (or GMP) provision. Under a GMP agreement, a contractor who exceeds the capped amount is responsible for the difference, and if the total cost of the project is below the capped cost, the owner and contractor often agree to a "shared savings" benefit. Even with a GMP contract, the owner must remain alert and ensure that the contractor does not set the GMP too high or use loopholes in the agreement to get around the GMP cap. Alternatively, some contractors set the GMP higher than need be so that the total cost of the project comes in below the capped cost. In so doing, the contractor can try to receive "extra profit" through the shared savings clause.

If owners are well informed and take an active role in the development of the project, they can avoid the pitfalls of both the lump sum and cost-plus contracts, and enjoy the fruits of a well-constructed, final project that was completed within budget.

*This article appeared in the New York Law Journal on December 28, 2010.*

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