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RISKY BUSINESS

BEST PRACTICES BEFORE THE SHOVEL HITS THE DIRT (OR, HOW I BEGAN TO REDUCE LOSSES AND CLAIMS BEFORE THEY HAPPENED)

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I. EXECUTIVE SUMMARY

The construction industry is highly risk prone. Since the days of Hammurabi[1], the construction industry has faced some of the greatest risks of all businesses and disciplines—safety, poor weather, collections, litigation, and numerous, overlapping regulations, to name a few. Not only is the industry vulnerable but it also has a disappointing record in coping with risks. Disappointing because many known risk factors are readily identifiable.

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[1] Hammurabi was the sixth king of Babylon and established the Code of Hammurabi which contained 282 laws chiseled on twelve stone tablets placed in public view. Some of the laws pertained to construction, including:

- 229. If a builder builds a house for someone, and does not construct it properly, and the house which he built falls in and kills its owner, then that builder shall be put to death.
- 230. If it kills the son of the owner, the son of that builder shall be put to death.
- 231. If it kills a slave of the owner, then he shall pay, slave for slave, to the owner of the house.
- 232. If it ruins goods, he shall make compensation for all that has been ruined, and inasmuch as he did not construct properly this house which he built and it fell, he shall re-erect the house from his own means.
- 233. If a builder builds a house for someone, even though he has not yet completed it; if then the walls seem toppling, the builder must make the walls solid from his own means

As the United States continues its trek out of The Great Recession, managing construction's internal and external risks remains paramount for the success of all stakeholders: owners, builders, designers, engineers, insurers and sureties alike.

Risk has many faces. It can be a threat or an opportunity. It can be known or unknown, predictable or unforeseeable, quantifiable or simply subject to gut instincts and intuition. No matter the shape or form it takes, risk must be accepted, accounted for and addressed.

Risk management is designed to reduce or eliminate the risk of certain kinds of events happening or having an impact on a business. This requires a proactive (as opposed to reactive) approach, as the success or failure of any enterprise is often determined in the planning stage, not after risk's consequences have resulted in a claim or lawsuit.

Four elements comprise effective risk management:

1. Risk identification
2. Risk assessment
3. Risk containment
4. Risk review and improvement

When successful, risk management keeps your company viable, reduces legal and financial risks, and prevents injury or harm to persons and property. However, it is a complex, inexact science. To be successful, you must build a culture and organization that can respond to and sustain unanticipated events.

This article will outline the fundamentals of effective risk management, including best practices beyond traditional risk transfer and allocation. Just as there are no two construction projects the same, nor are there two risks the same. Rather than examine the multitude of risks facing the construction industry, the following provides a baseline approach to managing risk.

II. RISK IDENTIFICATION

Risk is fluid and carries with it varying degrees of unknown and unwanted events. It is the probability or threat of damage, injury, liability, loss or any other negative occurrence that may be avoided through preemptive actions. The worst kind of risk is the unidentified risk, mandating a need to anticipate what could go wrong.

There is no patented method to identify and categorize all risks inherent with construction. As a result, stakeholders will often undertake only a superficial analysis of a project's risks. The better practice is to rely upon the experience of key personnel assigned to the project. In those instances, an organization's ability to identify risk is only as strong as the experience of the individuals assigned to the project.[2] This "human factor" can make or break the success of a project.

[2] Dickmann, Sewester and Taher, Risk Management in Capital Projects, published by the Construction Industry Institute, Source Document 41 at p. 14 (October 1988).

Related to this is a natural instinct to avoid dwelling on "what can go wrong."[3] Or, in the immortal words of Alfred E. Neuman, "What, me worry?" While this approach can decrease stressors attendant to any project, it ensures a party's exposure will only increase.

Instead, parties must strive to anticipate what can go wrong. This includes thorough document review and an examination of historical risks within the industry, the project's locale and the company.

Risk comes in a variety of forms. It can be:

- An *unwanted event.*
- The *cause* of an unwanted event.
- The *probability* of an unwanted event.
- The statistical *expectation value* of an unwanted event which may or may not occur.[4]

Risks can be internal (i.e., your project team and key personnel) or external (i.e., weather, competition, the economy). When there is a risk, there must be something that is unknown or has an unknown outcome, or an opportunity to shift that risk. Therefore, knowledge about risk is knowledge about lack of knowledge, or an opportunity to capture and shift or mitigate known or

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[3] Id.

[4] Hansson, Sven Ove; Edward N. Zalta, editor (Spring 2014). "Risk," *The Stanford Encyclopedia of Philosophy*.

suspected risks. This combination of knowledge (or lack thereof) contributes to making issues of risk complicated.[5]

III. RISK ASSESSMENT

Once a project's risks are identified, what next?

Again, an off-the-shelf formula does not exist to measure or quantify risk. Instead, experience and the human factor comprise this equation.

Risk assessment has three goals:

- Uncovering known risks, those which can be identified and understood because they have been experienced in the past.
- Making the known risks transparent and easy for those involved to see and comprehend.
- Understanding and identifying unknown and unanticipated risks a company has not experienced before.[6]

For each identified risk, a potential loss is associated with it. That loss could be schedule impacts, cost increases, safety, or bonding capacity. Each of these could result in tighter margins and less profit. In other words, money.

Part and parcel of risk assessment is estimating the likely occurrence of potential losses, and the scope of those losses.[7]

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[5] Id.

[6] Coleman, Thomas S., *A Practical Guide to Risk Management* (2011).

[7] Williams, et al., Management of Risk and Uncertainty in Systems Acquisitions, Proceedings of the 1983 Defense Risk and Uncertainty Workshop, Fort Belvoir, VA.

The Federal Emergency Management Agency ("FEMA") provides an example outside of the construction industry which outlines risk assessment through a hurricane.

- A hurricane forecast to make landfall near your business could change direction and go out to sea, or the storm could intensify into a major hurricane and make landfall.
- There are many "assets" at risk from hazards: Injuries to people, buildings, information technology, utility systems, machinery, raw materials and finished goods. Moreover, the impact an incident could have on your relationships with customers, the surrounding community and other stakeholders.
- Consider situations that would cause clients and partners to lose confidence in your organization and its products or services.[8]

As risk is assessed, look for vulnerabilities and weaknesses which would expose you to claims. Those impacts can be reduced through risk mitigation. Risks with the potential for the greatest impact should take priority when it comes to mitigation.

Once assessed, risk can then be allocated and managed.

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[8] http://www.ready.gov/risk-assessment

IV. RISK CONTAINMENT

When the topic of risk containment, or its counterpart risk transfer, is discussed, contractual risk allocation and insurance immediately come to mind. Those are but two of the tools a construction professional has. As courts, insurance carriers and legislatures have pared back the efficacy of these traditional risk management mechanisms, the importance of the human factor has become paramount in this discussion.[9]

A. <u>Pre-Contractual Risk Containment</u>

For decades, the owner-general contractor contract and the general contractor-subcontractor contract ruled this space. In each instance, risk was transferred "downstream." This has traditionally allowed the "upstream" party to "finance at least a portion of the liability they risk whenever they construct a project."[10] Contractual risk-shifting provisions include:

- Indemnity and defense provisions.
- Additional insured obligations.
- Warranty provisions to bridge gaps in insurance coverage.
- "No damages for delay" clauses.

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[9] Moreover, the increased cost of insurance has impacted overall project costs. In the mid-1980s, insurance-related costs accounted for 1-2% of total project costs; by the mid-1990s, those costs rose to 5-7% of total project costs, and have only increased since that time. Construction Industry Institute, Allocation of Insurance-Related Risks and Costs on Construction Projects, Pub. 19-1, at V (Nov. 1993).

[10] Associated General Contractors of America, White Paper on Additional Insured Endorsements, February 2006.

In each instance, the upstream party seeks to capture and transfer certain risks (some known, some unknown) to the downstream party, placing financial and legal responsibility for potential claims upon the downstream party, often without any consideration for fault.[11] Historically, inclusion of these risk-shifting provisions has been employed to incentivize downstream trades and suppliers to perform quality work. Now, however, with design-build platforms, construction manager-at-risk projects and alternative delivery methods populating the construction landscape, it has become more common (and more important) to allow for partnering and equalized sharing of risk. Through this symbiotic relationship, risk can be spread more evenly resulting in claim-free projects.

Due to the complex nature of construction, it may be impossible to capture each and every risk at the pre-contract stage. Nevertheless, some estimates suggest that two-thirds to three-quarters of construction risks are best managed by means other than traditional insurance programs.[12] With forward planning, many risks can be eliminated or reduced. Once contracts are executed and work begins, opportunities to level the playing field are rare so it is important to patiently and deliberately review and negotiate your contracts.

1. *Do you know the project team?* Nothing is more important than doing business with the right people. Contractors and design professionals

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[11] Id.

[12] Brunner & O'Connor, *Brunner and O'Connor on Construction Law*, Section 7:15 (2013).

are always being pre-qualified by owners or other upstream partners. Why not take the same approach and prequalify the project?

- Who is the owner? Who is the lender? If you do not know or the information is not readily available, perform a title search to confirm the owners and lenders.
- What are their strengths and weaknesses, both financial and practical?
- Run a litigation search and background check.
- Have any of the stakeholders been debarred by a federal agency?
    - Most of this information is available at very low cost and limited time investment

2. *What is the scope and location of the project?*

- Is the work typical? Is the scope of work outside your area of expertise? If so, consider retaining a project manager or construction manager who has more "boots-on-the ground" experience in that locale. The same applies to the estimating team. At the same time, do not take for granted the risks associated with typical work, even if the project is familiar. Such levels of comfort can bias decision making and create false assumptions regarding the risks inherent with the project.

- Is this project outside your geographic footprint? Do you know the quality and availability of skilled labor? What about permitting, licensing, and other laws applicable to the project's locale? And have you accounted for these extra costs in your bid?

3. *Are the design documents complete?* As the means and methods of construction continue to improve, claims based upon resultant damage have decreased. This has generated an increase in claims based upon errors, omissions, conflicts and ambiguities in the design documents. Before a project starts, important questions to ask include: When was the project first envisioned? Last week or last year? How much time has the owner and stakeholders put into design and implementation? Were the project and plans purchased? Or designed from scratch? Who has verified the plans and specs? What value engineering has already been performed, and do you suspect additional work to be carved out?

4. *Is your scope of work properly defined?*[13] Inadequate scope of work definitions always eat into a contactor's profit margin.

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[13] Scope of work disputes are generally attributable to the designer or the contractor. Disputes attributed to the designer include:

a. Failure to provide sufficient detail/particularity in the specifications;
b. Incorporating documents into the contract and specifications which impose responsibility upon the contractor to meet certain criteria (e.g., "the contractor is responsible to furnish whatever is necessary to make a

- Does your work overlap with other trades?
- Is the sequencing correct?
- Who is responsible for what?
- If relying upon other lead trades, who are they?
- The owner and contractor may have certain expectations of each other, but until those expectations are reduced to writing there will inevitably be an "expectations gap." This will lead to payment and/or performance disputes later.

5. *Are there any unreasonable contract terms?* A few years ago, the economy forced contractors and design professionals to sign any contract put under their nose. That is changing as the economy slowly improves, and parties now have more leverage to negotiate. In doing so, try to establish early warning systems. If you think a contract provision might be a problem on the job, alert your team and document accordingly. This has particular application to change order work and

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functioning system, regardless of whether shown in the contact documents"); and

c. Conflicting direction or a failure to coordinate the drawings with the written specifications.

Disputes attributed to the contractor include:

a. Misunderstanding the risks assumed;
b. Bid mistakes; and
c. Failure to adequately understand the contract documents or request clarifications.

Rubin, *Scope-of-Work Disputes*, Practicing Law Institute, Construction Litigation, 2d. Ed at 191-223 (1993).

liquidated damages. If the job does not pass the smell test, proceed very cautiously.

6. *Do you understand all of the contract terms?*
    - You may understand the contract terms because you negotiated them . . . but does your frontline team understand them, especially when it comes to change order documentation and payment terms.
    - Understand and anticipate termination provisions, especially termination for convenience of the owner and your rights to terminate a subcontractor or supplier.
7. *What is your security for payment?*
    - Again, run a title search at the start of a job. If a contract is signed, but the notice to proceed is not issued for another 6 months, run another title search in case the lender has changed and notify all known owners/lenders according to local pre-lien procedures.
    - Follow the contractual dispute resolution procedures, and do not assume the email sent to the project superintendent satisfies the notice procedures.

B. <u>Risk Containment Through Insurance</u>

Just because you have insurance does not necessarily mean you are covered for risks associated with personal injuries or property damage. It is

imperative that you review your policy, but more importantly its exclusions. Although insurance plays a role in managing project risk, it only covers certain risks, primarily personal injury and property damage.

Large deductibles and self-insured retentions will reduce insurance premiums, but they may obligate you to cover significant defense costs for yourself and any indemnitees should a claim develop, thereby eroding already slim profit margins.

Contract negotiation and annual insurance reviews, if implemented properly, can help contain and capture risk. However, as with virtually every stage of construction, execution of these practices is only as good as the individuals involved.

C. <u>The Human Factor</u>

Construction is a series of processes and procedures carried out by a variety of individuals. Although critically important, these operations and controls can be underappreciated. Processes and procedures are not "rocket science." However, losses in these areas have as great (or even greater) impact as any other because they are easily prevented and obvious after the fact.[14]

Successful risk management requires managers and team leaders to understand the risks associated with any given project. They must have a basic

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[14] Coleman, Thomas S., *A Practical Guide to Risk Management* (2011).

understanding and familiarity with the project and its contractual obligations, which may require the managers to have “contractual literacy.”

A common example often arises within the context of change order work. Most contracts have very specific obligations and conditions precedent which must be met before payment for change order work will be made. Too many times in the rush to complete a project, parties will rely upon verbal discussions in the field to execute extra-contractual or modified work.

Depending upon the project and the stakeholders involved, this may not present a problem when it comes time for payment. However, especially on public works projects, if each requirement for approved change order work is not met, the contractor may not receive payment. To avoid this, frontline team members should be well versed in the key contractual provisions governing the project. Doing so will help avoid the unfortunate, but too common, situation of performing work and not receiving payment.

Although it is difficult to take key personnel off-line to educate and instruct them about project risks and tools to contain them, those efforts cannot be overlooked. Even if they only take away the basics of risk management, the time spent training the individuals in your organization will not be wasted and will help strengthen the bottom line.

V. RISK REVIEW AND IMPROVEMENT

Risk is not stagnant. Consequently, even the most robust risk management practices will have their limitations. An organization would be

mistaken if it does not periodically review its risk management practices, even on a project-by-project basis. This includes annual reviews of a company's insurance, contracts and project documentation systems.

The human factor discussed above further dictates the need to review and improve, as with each completed project comes more experience, experience that can help identify, assess and contain risk.

VI. CONCLUSION

With each new project or contract awarded comes a sense of euphoria, particularly in these difficult economic times. Once work begins, the honeymoon can end quickly. When and how a claim, either affirmative or defensive, will arise can be difficult to predict. Being proactive and anticipatory can reduce that possibility. This requires advanced planning and a sound, disciplined risk management plan and approach. When successfully implemented, a company's bottom line can grow and the organization can focus on delivering a claim-free project, no matter the role it played.