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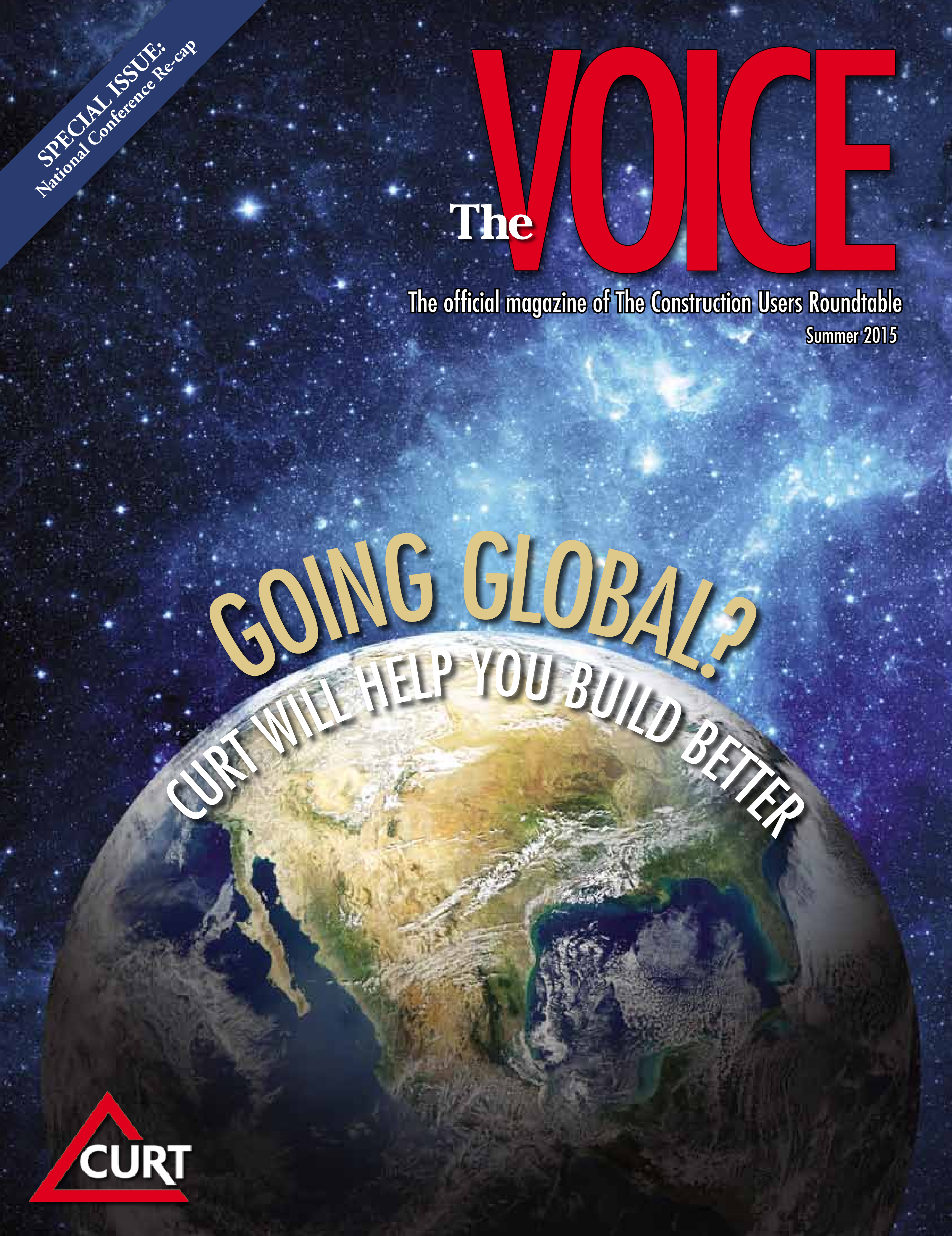

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WHAT THE Skilled Labor Shortage Means for OWNERS

By Samuel T. Reaves, Esq., Troutman Sanders LLP

The skilled labor shortage in the construction industry has been a hot topic for several years. Much of what has been written focuses on the shortage either from a "state of the industry" perspective, or from the perspective of the contractors and subcontractors on the front lines who are losing workers. Little has been written about what the shortage means for project *owners*.

The shortage certainly means that owners in many markets expect to pay higher prices and accept longer schedules for construction, since the shortage both increases the cost and decreases the quantity of available labor. The shortage also means that owners who employ some form of skilled labor themselves, such as energy and industrial sector owners who employ project managers and engineers, have a harder time filling positions and keeping them filled. These owners are in a similar position to contractors and subcontractors in needing to focus on training, mentoring, bonuses and other methods of increasing retention.

However, the shortage also presents other significant increased risks for owners, including: (a) the risk of contractor / subcontractor default and resultant delays in completion; (b) the risk of cost overruns, which the contractor may try to pass along to the owner; and (c) the risk that the contractor may be forced to utilize under-skilled labor, increasing the chance of construction defects.

Owners cannot assume that merely entering a contract or paying a higher price takes care of these problems or shifts them to the contractor. Instead, owners should take extra steps from the outset to address these problems head-on. Some of those suggested steps are discussed in more detail in the following article.

Ask More Questions: Contractor and Market Diligence

The owner should consider additional diligence on contractor candidates prior to and at the bid or proposal stage. Owners should check references more extensively than in the past. Even if the owner has worked successfully with the contractor previously, the contractor emerging from the recession may not be the same contractor who successfully completed a prior project. Owners will also want to ask more questions of bidders, such as:

- How many project managers and supervisors have you lost over the past three years?
- What is your training / mentoring / bonus program like?
- What is the specific experience of your proposed project supervisors on similar projects?

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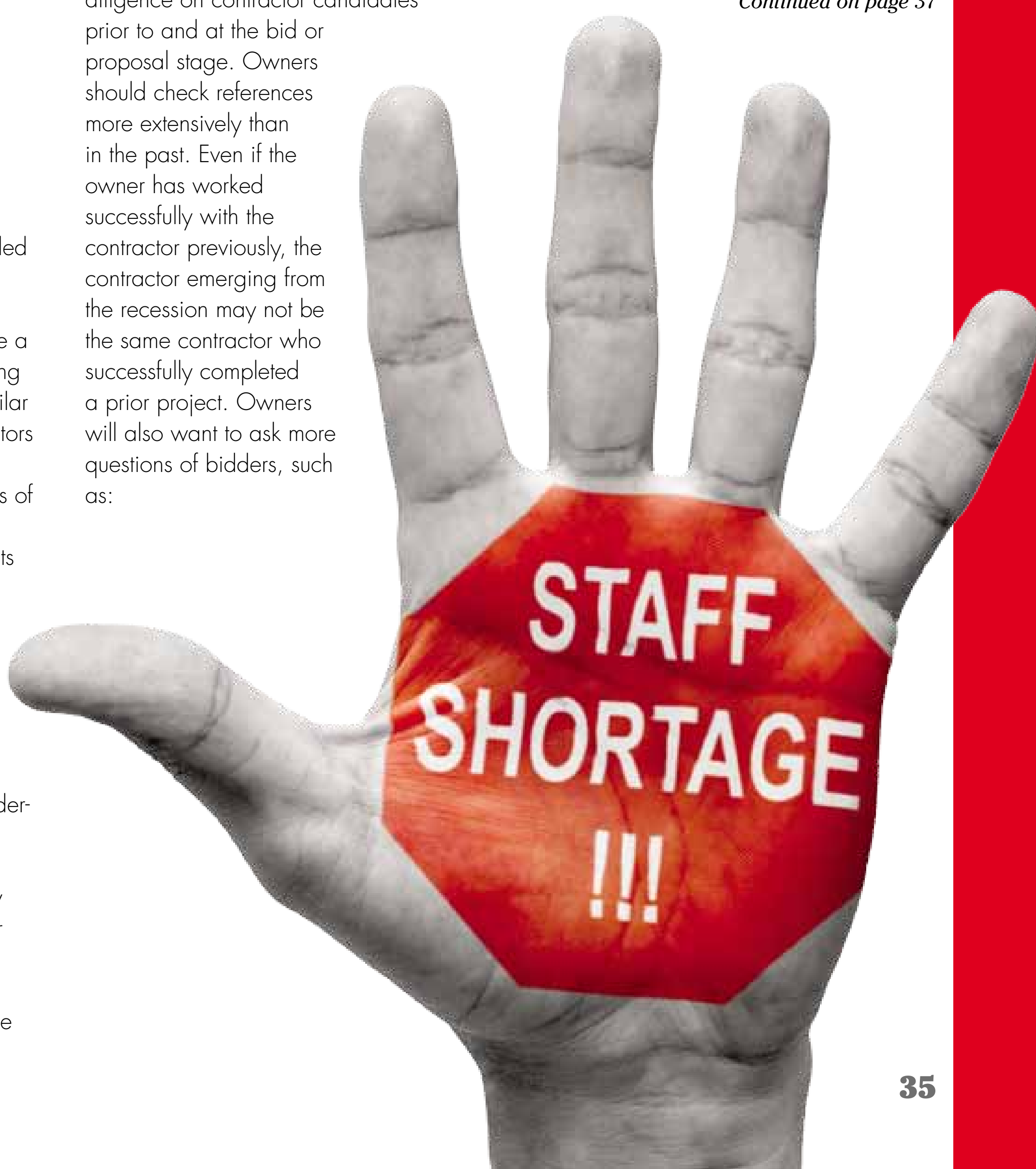

- Have you experienced labor shortages on other projects, and if so, how have you dealt with those?
- Do you have a labor mitigation plan if there is a shortage on this project?
- Have you been late in delivering any projects in the last three years?

Owners should conduct personal interviews with the contractor supervisors who will be dedicated to the project, in order to assess the true nature of the supervisors' similar project experience. Owners should consider whether the contractor will be using subcontractors it has used regularly in the past (giving the contractor the leverage of a continuing business relationship), or whether the contractor is instead out of its geographical "sweet spot" and is using subcontractors for the first time.

In terms of market diligence, owners should consider their project timing in light of surrounding projects—not just projects that will compete with the owner's project in the relevant market segment after construction, but nearby projects that may compete for labor *during* construction.

Invite Other Parties to the Party: Sureties, Insurers and Inspectors

Bonds or SDI

Owners who do not normally incur the additional costs of bonds or subcontractor default insurance (SDI) may want to reconsider those options. Although there are pros and cons to consider with either option, obtaining bonds or SDI can provide protection in multiple ways against the risks created by the labor shortage.

Bonds or SDI could: (a) provide a source of cash to remedy a contractor or subcontractor default; (b) result in a second evaluation and pre-qualification of the contractor or subcontractor by a surety or insurer; and (c) in many states, with a performance bond, offer protection against even latent defects discovered after project completion, assuming that the notice provisions, time limits, and other bond conditions are met.

Therefore, the extra cost of bonding or SDI may be justified in the current market for projects on which it was not justified in the past.

CGL

Especially in states in which commercial general liability (CGL) coverage may cover construction defects, the owner should include insurance requirements that increase the chance of coverage being available, including, for instance, specifying that completed operations coverage be maintained for the full length of the statute of repose and requiring that the contractor's CGL coverage contain a "subcontractor exception" to the "your work" exclusion.

Inspections

Owners may also want to consider increasing inspections and construction monitoring by an independent design professional, construction manager or other consultant, so that there is a greater chance of catching and addressing delays and defects earlier in the project. The help of a knowledgeable risk

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manager is of increased importance in today's construction marketplace.

Say What Happens When Delay Happens: Defining Contractual Remedies

Right to Require Acceleration / Supplementation of Forces

Many form construction contracts require the contractor to meet an overall completion date, and to provide and generally comply with a schedule, but do not provide in detail for what happens if the contractor falls behind schedule. Owners will want to make sure their contracts contain a clear acceleration / extraordinary measures clause, which provides that if the contractor falls behind schedule, the owner can require the contractor to submit a detailed plan to cure the delay and to work overtime, work additional shifts, and take other measures to accelerate the work and make up the schedule.

The owner should also include in the contract an express right of the owner to supplement the contractor's forces and charge the cost of doing so to the contractor if the contractor fails to maintain the schedule (or fails to accelerate when directed by the owner). While exercising such a right would often be a last resort, having the option may prove valuable. That is, since the owner's hiring additional forces would likely be more expensive than the contractor's doing so, the contractor has more of an incentive to maintain the schedule rather than risking the owner's exercising this remedy and charging the extra costs to the contractor.

For either of these remedies to be effective, the contractor should be required by the contract to achieve specific milestones by milestone dates, and not just to achieve substantial completion by an overall completion date, so that there can be some clear definition of when the contractor is behind schedule and thus when the owner can exercise the remedy.

Liquidated Damages (LDs)

As a monetary remedy for delay by the contractor, the owner should include an LD provision in the contract. Owners must keep in mind that if there is no LD clause, but there is a contractual waiver of consequential damages, the owner may not be able to recover its most significant damages for late completion, e.g., its lost profits. Some of the issues to be considered in drafting an LD provision include the following: (a) the daily LD amount; (b) whether the amount should be graduated over time; (c) whether LDs should be tied to milestones instead of (or in addition to) overall project completion;

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and (d) whether there will be a cap on LDs, and if so, what it should be.

Owners should be especially careful in drafting and negotiating LD clauses. Owners should avoid broad statements that LDs are the owner's *exclusive remedy* for delay, since the owner has other remedies, e.g., direct damages if the owner supplements the contractor's forces, and termination. Owners should also make sure that the daily LD amount and any LD cap are high enough to protect the owner, since owners often underestimate the actual damages they will incur with a delay.

Contractor's Damages for Delay

The contractor's, and not just the owner's, remedies for delay should be addressed contractually. The labor shortage means that labor rates may continue to rise, resulting in project cost overruns. The contractor will have to absorb these overruns unless they can be passed along upstream to the owner or downstream to the subcontractors. If owner-caused delays, such as owner-issued change orders, push the project into a time / market where labor costs are higher, the contractor may assert a delay claim to recover those increased costs.

The owner could consider the use of a "no-damages-for-delay" clause if enforceable in the applicable state and if the owner has the leverage to do so. In the alternative, the owner should carefully define and limit the damages recoverable for delay, including whether and to what extent labor escalation costs are recoverable by the contractor.

The Carrot is as Mighty as the Stick: Incentivize and Help the Contractor

Bonuses

On the flip side of LDs, it is not uncommon historically for contractors to ask for an early completion bonus, nor is it uncommon for owners to resist such a bonus. In the current market, owners may want to incentivize the contractor to perform by defining early completion criteria or other criteria for a bonus, *and* perhaps by also providing that at least a portion of that bonus be paid to the contractor's staff and / or to subcontractors.

Similarly, many cost-plus contracts provide that bonuses for the contractor's project administrative staff are a reimbursable cost of the work, but only with the owner's prior approval. Owners can anticipate that such a bonus will be requested with more frequency, and they will likely need to give more consideration to approving this type of bonus. In either type of bonus situation, the owner is assisting the contractor with employee retention—though admittedly by taking on some of the associated costs.

Retainage

Ironically, more contractors and subcontractors fail during a recovery than during a downturn, due to the increased cash expenditures required to take on an increased workload. Reputable contractors and subcontractors in the current market who have their choice of projects are often simply not going to accept the cash flow disruption of having

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10 percent retainage held until the end of the project. Owners in the current market may have to—and may want to—promote subcontractor interest in the project and lower subcontractor pricing by agreeing to reduce retainage or release it early.

Such measures may include the following: (a) holding retainage until 50 percent completion, and then ceasing to hold further retainage; (b) releasing retainage on subcontractors whose work is finished early; (c) releasing retainage at defined milestones rather than just on project completion; and (d) eliminating certain items from retainage, such as materials, contractor fee, or insurance costs. Of course, lowering the retainage and how long it is held decreases the pool of money available for the owner to cure a default without using its own funds, but that downside may be a necessity in the current market and may be reduced by some of the other measures discussed in this article.

Conclusion

The labor shortage in the construction industry does not just affect contractors and subcontractors, but presents a number of special risks for project owners. However, as with so many potential problems on a construction project, those risks can be mitigated through better planning, communication, and contract drafting. ●

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