

Managing Risk in an Ultra-Lean Bid Environment

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The rules for contractor or vendor procurement in a public environment have been well established and are generally codified. As a general rule, contract awards go to the lowest responsive bid from a responsible bidder. Further explanation of these concepts is in many industry publications including numerous references from CMAA's *Construction Management Standards of Practice and Cost Management Procedures*.

Ultra Lean Bids—The New Risk

What has changed is the dramatic economic situation for the construction industry and its impact on contractors. The volume of work available has decreased dramatically. Contractors that didn't bid government work or projects below a certain value are now actively pursuing such work. Bid invitations that may have drawn three to five bidders before are now drawing multiples of that number, all of them desperately trying to get the work to survive long enough for the economy to come back.

Owners report that bids have gone down 25–35 percent from the engineer's estimate. Yet costs have not decreased by the same amount. Contractor profit margins are declining and the *ultra-lean bid*, based on the best-case, hoped-for scenario has become less of a fringe practice and more of a necessary way to survival. Solid bidding practices, such as bidding on work where you really have experience, including an adequate contingency, selecting subcontractors based on experience and reliability, avoiding questionable material suppliers and confining bids to projects within a reasonable geographic area are all giving way to the current need to cut costs and survive. It is a great boon to owners that prices are low and budgets can be stretched to get even more value. It is no boon however, if the project fails or the contractor relied upon for warranty work is no longer available.

Once a project has been won, the pressure to deliver the hoped-for gross margin, if not increase it, is also greater than before. Change orders are opportunities to profit from an otherwise marginally profitable job.

"Or equal" clauses are not simply alternatives, they are valuable revenue centers. And if anything goes wrong, some contractors cannot weather the storm, regardless of who caused it.

The risk of ultra-lean bids and bidders ultimately rests at the owner's feet. In the past, owners have taken comfort in payment and performance bonds. It is assumed that if the contractor can get the bond, it must be healthy enough to qualify and if something goes wrong, the surety will rescue the project. But the industry is rife with true stories of sureties that didn't act quickly enough to keep the project on track, and the impact of delays can ripple throughout the project. Even though bonds provide some measure of protection, they are not the best solution. Prevention is.

Ultra Lean Bids—The New Response

As indicated, the need for responsible bidders and responsive bids is not a new requirement. What is a new requirement is to pursue these objectives with a degree of robustness not previously practiced. The fact that you've worked with or known a contractor for many years is no longer enough comfort. The new economy has changed the rules.

The strategy for protection against ultra lean bids is threefold:

1. Enhanced efforts to specify and review criteria for responsible bidders.
 - a. Establish a process to check past and current references of the company and its management team.
 - b. Establish a process for a robust review of a company's financial strength. Ensure that contractors can meet their operating costs with progress payments less retainage and while keeping the contract in balance.
 - c. Use the same process used to vet your general contractor on all major subcontractors and suppliers.

2. Enhanced efforts to review a bid to determine its achievability.
 - a. Establish processes to identify line item prices that do not appear achievable or are the result of bid gaming.
 - b. Establish a process to objectively identify front end loading outside reasonable limits.
3. Establish an early warning system for contractors/subcontractors going into failure mode, i.e. project oversight.
 - a. Establish resource, progress and cash flow metrics for use in project oversight.
 - b. Move quickly when clues arise as to the contractor's/subcontractor's impending failure

All of these initiatives will encounter challenges in their implementation. Most require taking steps or gaining information that is often considered confidential or prejudicial. All require a more active role on the part of the CM to seek information or monitor contractors.

Reviewing Contractor Responsibility

Many jurisdictions and owners already have prequalification systems; most rely heavily on past experience or affirmations of the contractor. Both methods have disadvantages.

Past experience is not always an indicator of future abilities. In the 1990s, the largest heavy and highway contractor in the United States ceased doing business. Until that point, no one would question its experience or ability to complete work. Its downfall was actually a few years in the making, but unless specific independent inquiries were made, there was nothing in the public knowledge that would have indicated its impending collapse.

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Pre-qualification packages commonly ask the contractor to affirm that it has the resources and ability to complete the work on which it is bidding. It would be truly unusual for the contractor to indicate it did not; and probably it would sincerely believe that whatever problems it had could be worked through. Such assurances are of little value as a contractor on the verge of collapse is not going to declare that in a qualification package to get the work it so desperately needs for survival.

In the Internet age of a company's financial trouble is often found by a researcher of moderate skill. The proactive approach is to make independent inquiries into a contractor's abilities and condition. Included below is a checklist for these inquiries. Some of these questions will take personal and financial skill sets not normally utilized in today's procurement process or a CM's background. Obtaining supplemental technical support is a good idea.

Contractor Responsibility Checklist

1. Does the contractor have recent (two years) experience with projects similar to the subject project?
2. Who will be the project manager and project executive for the subject project? Do they personally have the experiences noted above? Obtain references and contact data.
3. Has ownership or executive leadership of the contractor changed in the last two years? Are any changes under consideration?
4. Obtain D&B reports, vendor and bank references, and search the Internet for any information on the contractor's performance or situation.
5. Obtain two recent years' financial statements for the contractor. Test ratios for current assets, debt to equity, gross margin and net profit noting comparability with industry averages. Note any negative audit comments in the audit opinion.
6. Obtain evidence that the business is properly registered and authorized to conduct the type of work to be performed.
7. Obtain evidence of all appropriate insurances.
8. Follow the same process for any significant subcontractors and suppliers to be used on the project.

Reviewing the Bid

A bid review process already exists in most circumstances. (See Section 8 of the CMAA *Cost Management Procedures*.) Experience has shown that the review is commonly cursory in nature. Yet resources are generally available to perform a more effective review. The objective is to establish that a bid not only is not unbalanced or front-loaded but that it contains no obvious errors. The historical approach has been to not question the potential of errors under the notion that it is the contractor's problem and responsibility. The notion is true as far as it goes, but the consequences of a bid error on an ultra-lean bid can cause disputes if not failure of the contractor in a fragile financial position.

PROFESSIONAL PRACTICE CORNER

Make the Schedule of Values a part of the bid submission. Mistakes in a bid are generally apparent in a review of the “bid tab” or cross reference document between bidders. A review and comparison of the bidders’ detail often will point to a specific error or trends in the bid amounts. To help the process, a standard protocol should be established and communicated in the invitation to bid. A robust review of this data should be performed due to the risk of ultra-lean bids.

Bid Review Checklist

1. Are there sufficient bids to enable a comprehensive review?
2. Is the low bid amount within a reasonable deviation from the other bidders? A comparison of the low bid against the mass of other bidders can indicate whether the bid is, on its face, arbitrarily low.
3. Is there an indication that the bid is front end loaded? Do the initial bid items total more than others in the bid pool? When a bidder has an overall low price total, but an accumulation of initial work activities has a higher bid total, it is an indication of front end loading. Use the engineer’s estimate to compare the cost (price) of major bid items looking for any significant discrepancies. Other than simple cash flow considerations, allowing a cash strapped contractor to receive the largest portion of its cash flow up front could reduce the contractor’s incentive to complete the contract.
4. Are individual elements of the bid within a reasonable deviation from other bidders? The comparative review of individual elements often will show more disparity than bids as a whole. Although pricing strategies and methodologies differ from contractor to contractor, performance cost is more standardized and the occurrence of large disparity in specific line-items must be particularly scrutinized. Some owners in this situation will notify the bidder that it has a questionable bid item, give no other information (to preserve the integrity of the process) and request that the bidder confirm its price.

Project Oversight

Like the previous interest areas, project oversight is not without existing controls and established procedures. (See Section 6.5 of the CMAA *Construction Management Standards of Practice*.) The primary points of control remain the monthly review and approval of payment applications, the orderly approval of submittals and change orders, the ongoing progress review against an established project schedule and the receipt of lien releases to confirm that subcontractors and suppliers are being paid.

To the cash strapped contractor, these control points are a challenge. “Getting ahead” on the payment cycle is part of the survival strategy and self-funding of a change or a delay can be enough to eliminate any balance of cash on the project. As such, owners must maintain the controls already in existence while getting monies properly due to the contractor as soon as possible, and being preemptive on eliminating and resolving potential disputes.

Project Oversight Checklist

1. Establish a payment application and payment procedure that reduces as much as possible the time between completion of the work and payment.
2. With each payment application, evaluate the cost of the work to be completed as well as the value of the work in place with each application to keep the contract in balance.
3. Use joint checks to subcontractors to eliminate the risk of non-payment or late payment.
4. Obtain timely lien releases and ensure that releases are obtained from all subcontractors performing the work for which payment is being sought. The common practice of sending in lien releases with the subsequent payment application allows too much time for a project to get unbalanced and invites project administration lapses during crunch time.
5. Prepare and monitor a revenue loaded schedule to highlight any delays in project performance and to maintain the link between compensation and performance.
6. Streamline submittal, RFI, change order and claim procedures to eliminate uncertainty and/or delays.
7. For change requests that the amount cannot be resolved promptly, consider a unilateral resolution to get some payment to the contractor, even if under a mutual reservation of rights.
8. During the life of long term projects, re-qualify the contractor annually to confirm his or her ability to complete the project. Notify the bonding company if the qualification standards are no longer met.
9. Insist that surety obligations are triggered when a contractor is merely defaulted and not terminated. **CM**

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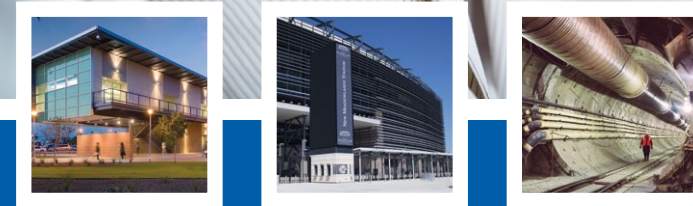
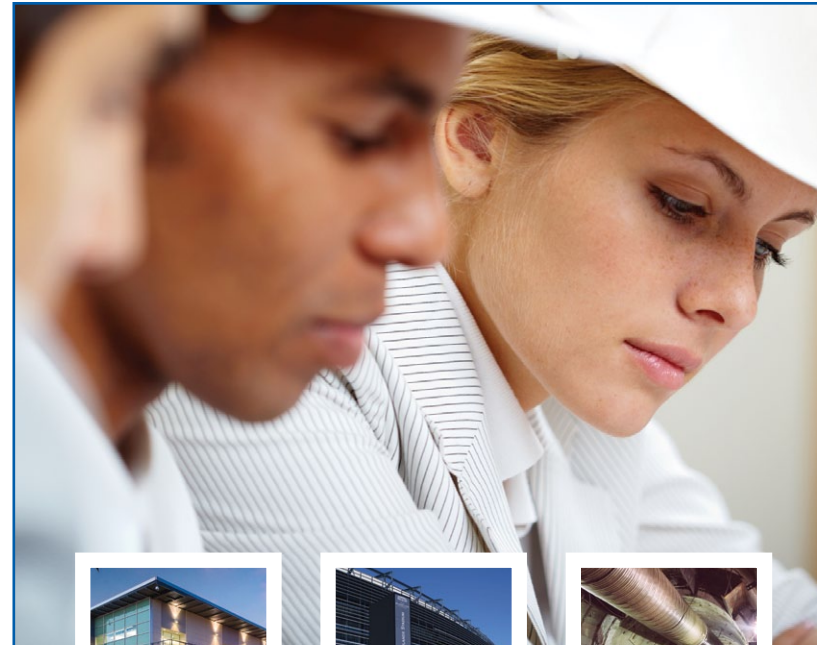
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