

Zero is Not the Smallest Number:

Proven Strategies for Limiting Risk and Maximizing Profit associated with Change Orders and Construction Change Directives

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- Modifying contracts to address the risk imbalance posed by Construction Change Directives (CCD's)
- Negotiation tactics when asked to make a concession on price.
- Why owners balk at change order pricing and how to alleviate their concerns
- Capturing and billing for indirect costs
- Best practices for handling the notification clauses found in contracts

Why CCD's Can be Dangerous:

The rationale behind why Construction Change Directives exist is straightforward; if the owner of a construction project desires to make a change to the contract scope, the contractor cannot hold the schedule hostage over a dispute regarding the cost of said change. Thus, the Owner (or GC), can use a CCD to compel the (sub)contractor to proceed with the change while price negotiations are deferred to a later date.

This contract provision can be a potential nightmare for contractors, as the associated work *typically* cannot be billed until a formal change order has been issued (until the Owner has agreed to the price). What is more, most construction contracts are written so that there is no limit on the total number, or dollar value of CCD's that can be issued. This ostensibly means that the owner can unilaterally issue a multitude of directives that the contractor must execute, with little recourse to seek payment.

In such cases, an unscrupulous client might deliberately and strategically use CCD's with the intention of reconciling very few (if any) of them. The end game is to aggregate all outstanding claims into a global settlement once the project is complete. At this point, the contractor has lost all negotiating leverage, as the client already has what they want, a completed project. The contractor might therefore be negotiating for pennies on the dollar.



What Attorney's Usually Recommend:

A quick Google search on CCD's will yield numerous articles from construction law firms. While they offer a few obvious approaches, such as asking "strongly" to get paid, the only contractual recourses found are proceeding under protest (kicking the can down the road), or claiming the occurrence of a Cardinal Change (which effectively accuses the client of breach of contract).

While much could be said here regarding the nature of cardinal changes, their existence is exceedingly hard to prove. If the contractor refuses to proceed with a directive under the guise of a cardinal change, they are exposing themselves to a high degree of liability if it is later determined that a cardinal change had not occurred.

A Better Option:

One way to optimize the distribution of risk across stakeholders is as follows:

Include a contract rider, or addendum that establishes an upper limit on the total value (in aggregate) of directives that can be issued before previously issued directives must be reconciled in the form of a fully executed change order. The language might read as follows:

"In the event that that the sum total (or aggregate) dollar value of outstanding change order requests submitted by Contractor exceeds X% of the Contract price, Owner agrees that no further change directives may be issued until such time that previously submitted change order requests have been resolved in the form of a fully executed change order."

For example, on a \$10 million project, let's say the owner has issued Five (5) CCD's for which no billable change orders have been issued. The contractor has submitted estimated costs for this work totaling \$300,000 (or 3%).

If the cap on the aggregate value of CCD's that can be issued is 2.5% (or \$250,000), no further CCD's can be issued until some number of the previous five directives are reconciled in the form of an executed change order. Thus, bringing the value of outstanding directives back below the established limit of 2.5%.

The value of this upper limit will vary by project, but as a rule of thumb, the percentage should decrease as the contract value increases. For most projects, this range should fall between 2% and 10%.

Most standard form AIA contracts leave the ultimate determination of a fair and equitable adjustment to the Architect or owner's representative. If the change in question affects a near-term critical path activity on the project schedule, the owner's representative may direct the contractor to proceed on a T&M basis. In such instances, it is a good idea to provide the Owner with Rough Order of Magnitude (ROM) or Not-to-Exceed estimate for the final cost of the change. While this may not satisfy the strict definition of a Change Order Request, it does give contractors leverage when seeking resolution on outstanding requests.

Documenting for Defense:

When CCD's are issued on a T&M basis, the GC and subcontractors will be required to keep a detailed accounting regarding the cost of the work. Assuming the value of the change is negotiated timely, and a subsequent change

order issued, the risk to the parties performing the work is minimal. However, construction claims consultants are adept at picking cost estimates apart when they believe that the documentation has been compiled post hoc. For this reason, it is essential that Superintendents and Foremen understand the importance accurate documentation has on the firm's ability to seek recovery for the change event.

When CCD's Can be a Good Thing:

Some will argue that the best way to deal with change directives is to avoid them altogether. Reasoning that contractors obviously don't want to be compelled to prosecute work without an agreed upon price, and that they can erode relationships by the contentious atmosphere that can result. While this approach by the owner can seem heavy handed, it is important to remember that receiving a directive is [acknowledgement](#) that a change has indeed occurred.

Seasoned construction professionals can point to an instance in which they proceeded with a scope change in a good faith effort to keep the project moving, only to have their claim denied on the basis that they were never officially directed to proceed with a change in scope, or that they did not notify the client within the timeframe stipulated by the contract. Therefore, beware of ambiguous language that leaves the door open for the client to later claim that the work in question should have been included in the original scope of work. CCD's should be explicit in their acknowledgement that the contractor is being directed to proceed with a change to the contracted scope.

Maintain Price/Scope Integrity:

The concept of Price/Scope Integrity simply means that a contractor should not make an arbitrary concession on price without getting something in return. When a contractor agrees to a reduction in price simply because it is viewed to be too high, the client is conditioned to ask for a reduction on all future changes because they know that there is enough fat in the estimate for the contractor to, in return, reduce the price. In turn, the contractor is conditioned to add additional dollars to the cost of the change so that they have something to give back when the client comes asking for a break on price.

There are several strategies that prove effective in getting something in return for giving a client relief. Two that I have seen work consistently are:

- 1) Insist that the change order be billed immediately or in the next Application for Payment, regardless of whether the work is complete. This improves the contractor's cash position on the job, and positively affects the risk profile of the project.
- 2) Ask for no retainage be held on the work associated with the change order, OR for a reduction in retainage entirely.

The True Impact of Unrecovered Costs

Clients who represent a key account for your business are likely aware of this fact. As such, they feel entitled not just to ask for concessions on pricing, but perhaps to not be charged at all. If a project is generating an acceptable

gross margin, the PM might acquiesce in an effort to maintain a healthy client relationship. However, I frequently encourage PM's to not think of the impact of change orders merely in terms simply of their direct cost. Instead, they should consider the total amount of revenue the company must generate in order to recoup those unrecovered costs.

For example, let's say the cost of a change order is \$15,000, and the construction business averages a net profit of 6% on annual basis (slightly above average for CM/GC's). This translates to \$250,000 in additional revenue that the company must generate in order to simply recoup the cost of the change ($\$15,000 \div 6\% = \$250,000$).

This is not to suggest that PM's should fight tooth and nail over every penny, and there may indeed be instances in which it makes sense to grant such a request. However, PM's should have, at the ready, a running list of all previous cases in which a concession on price was made, or the Owner wasn't charged, as effective counter arguments.

The Owner's Point of View

Project managers are frequently frustrated by Owner requests to go back to subcontractors in attempts to negotiate a lower price on change orders. But it's important to note that on lump sum or cost-plus contracts, the greater the cost of work, the more markup the GC will receive. Thus, Owners understand that GC's actually have a perverse incentive to drive for the highest possible price. To address this dilemma, contractors should consider the following practices:

- 1) Provide Options: taking a strict "plan and spec" approach to changes will not give owners a sense that the contractor is a good steward of their investment. For sizeable changes, demonstrating to the client that due diligence was performed to ensure maximum value will garner much needed goodwill.
- 2) Connect the Dots: In terms of cost substantiation, contractors generally take an approach of "the more, the better". While insufficient backup is obviously undesirable, there does come a point in which the owner can no longer make sense of what is presented. I've found this most pronounced with electrical packages, in which estimating software can produce hundreds of indecipherable pages. If the Owner cannot make sense of the information presented, they are much less likely to trust it's validity. While some GC's may be loathe to put their trade partners in front of their client, there are times when it indeed makes sense to get the person most qualified to explain and quantify the change in the same room.

Tariff Considerations

This topic may deserve its own article, but until 2025, most construction contracts were silent with regard to cost escalation impacts due to tariffs. A few things to consider:

- Include a "Change-In-Law" Provision: To address the allocation of risk contractually, the most reasonable approach being utilized is to include a "change in law" provision in the agreement. This allows for adjustments to contract (cost and schedule) due to legal or regulatory changes that occur after the contract is signed.
- Establish a Threshold: include in the contract a provision that reads something similar to the following:

“If the cost of specific materials (e.g., steel, aluminum, lumber) increases more than X% between the time of bid and delivery, the Contractor shall be entitled to an equitable adjustment to the contract price”

- Set a Contingency: If the project budget includes any contingencies (whether Owner, Contractor, or Project), make sure it is clearly articulated whether these funds can be used for material escalation or delays due to tariffs.
- Invoke a Force Majeure Claim: Many contractors have wondered if the impact from a tariff could qualify as a Force Majeure event. In short, the answer is Probably Not. Even if that was case, it may only qualify as an excusable but non-compensable delay.
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Billable Costs and Allowable Markups:

When situations arise in which the two parties cannot agree on the total amount of the change order, contractors are within their rights to ask specifically which elements are in dispute. “It’s just too much” should never be an acceptable response. Line-item costs not in dispute should be billed for whether or not a formal change order has been executed.

Despite the perception of most Owners, contractors on average make less margin (as a percentage) on change order work compared to what is included in the base contract. Limits on markups, indirect costs, and productivity loss are among a few of the reasons why this occurs.

Capturing Opportunity Cost

A frequent point of contention often involves the inclusion of salaried PM or Superintendent time needed to execute the work. The obvious argument from Owners contends that the GC is not incurring any additional costs associated with salaried project staff. However, what is often overlooked is the opportunity cost the GC is incurring as a result of having to manage a project with a multitude of changes. In other words, if a project requires management time (or project overhead) in excess of what was originally forecast, the contractor cannot deploy those resources towards other profit generating ventures. This argument takes a page from the often cited and generally accepted Eichleay Formula for calculating unabsorbed home office overhead (HOOH) on delay claims.

Quantifying Your Risk

One issue frequently plaguing contractors is a large, unexpected margin fade that occurs at the end of a project. A common source of such surprises is the project manager classifying change orders as “Approved”, when in fact they only had a directive issued, but no final agreement on price in the form of a fully executed change order. Having perfect operational clarity on how to log and categories change orders mitigates this risk. DCS recommends the following:

- *Approved and Executed* – this only applies to fully executed change orders. This terminology is understood current company policy.

- *Proceeding Under Directive* – the client has acknowledged a change in scope, and company is proceeding with the work. However, there is no agreement on final price, and thus no executed change order.
- *Proceeding at Risk* – the change is necessary for the project to satisfy the client’s performance criteria. Company is proceeding with the work, but no certainty as to whether any payment will be received.
- *Proposed* – price has been submitted. The project does not require the change. There is no decision by owner, and company is NOT incurring any cost.
- *Potential* – no price has been submitted. It is unknown if the change will result in a scope change.

Official Notification and Change Order Status Reports:

Much could be written here regarding the notification clauses within contracts. I will simply state that it is critically important that the Project Manager knows EXACTLY what the contract says in this regard. Even if a drawing revision, RFI response, or submittal change OBVIOUSLY has an associated cost impact, without explicit notification, an owner may be within their rights to reject the request if official notification has not been issued.

One strategy I often recommend is the submission of a weekly Change Order Status Report. If the notification clause dictates that the contractor has seven (7) calendar to submit notification (which should be the minimum), the weekly report can serve as notification of all outstanding changes for which the contractor intends to be paid. Even if the cost of the change is not yet known, a placeholder line item that captures the nature of the change event, the date of origination and what initiated it (RFI, ASI, drawing bulletin, etc.) should suffice. This report should also include the number of days outstanding that submitted change orders have been in the queue.

For project managers, this serves as a non-combative way to satisfy the notification requirement, while also applying steady pressure on the owner regarding outstanding costs.

In Summary:

Throughout my career as both a consultant and as a project manager, I’ve encountered many distressed projects. While the reasons why these projects went off the rails varied greatly, the one common attribute they all shared was a backlog of unresolved change orders. By structuring the contract so that risk is appropriately shared, maintaining quality documentation, and following prompt notification protocols, contractors and owners alike can mitigate the worst effects that change orders can have.

Though simple in principal, the nuances of each project present a unique set of challenges for project executives and managers trying to strike a balance between protecting the interests of their company and maintaining a healthy client relationship. Please contact me if you would like more information on the concepts discussed in this article, need assistance with a claim, or are looking for ways to elevate the skillsets of your project teams.