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Prevention and Resolution of Contractor Claims

EPA Construction Grant Program Guidance for Municipal Grants

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CLAIMS MANAGEMENT GUIDANCE

PREAMBLE

The purpose of this guidance is to assist the grantee in reducing the frequency, cost and impact of contractor claims in the construction grants program. As such it is not a regulatory requirement but should be used as appropriate to improve project management.

EPA requires that grantees apply good management practices throughout the program, including the critical area of contractor claims. A claim, as used in this guidance, means a written demand or written assertion by one of the contracting parties seeking, as a matter of right, the payment of money, the adjustment or interpretation of contract terms, or other relief. A voucher, invoice, or other routine request for payment that is not in dispute when submitted is not a claim; however, such a request may be converted to a claim, upon rejection by the grantee.

Grantees are solely responsible for project management. The grantee's failure to prevent or successfully resolve contractor claims in a timely manner will greatly increase project costs with no corresponding benefits. This is particularly important to a grantee because EPA may not participate in certain costs associated with contractor claims.

This guidance is an effort to assist grantees in claims management, to assist reviewing agencies in making appropriate allowability determinations and to distinguish between proper and improper management practices in specific situations. The guidance discusses many of the common causes of claims, recommends claim prevention and resolution techniques, and outlines applicable criteria to be used in claim related allowability determinations.

COMMON CAUSES OF CLAIMS

Although claims occur for many different reasons, the most common causes are:

1) Defects in plans or specifications;

2) Differing site conditions;

3) Inadequate construction inspection and management;

4) Failure to promptly and fairly address contractor grievances, requests for time extensions, or other problems;

5) Failure to enforce contract provisions on scheduling and completion time;

6) Failure to negotiate time extensions and/or delay costs, if any, associated with change orders;

7) Failure to mitigate effects of delay;

8) Unusually severe weather conditions;

9) Strikes; and/or

10) Acts of God.

The effects of any of the above causes are usually compounded by a breakdown of communication at the field level.

CLAIMS PREVENTION

Through experience, good project management practices have been identified which will reduce the occurrence of claims. A grantee must assure that good management practices are employed throughout the project cycle. Even though certain management tasks may be performed in the grantee's behalf by another party, the grantee remains fully accountable and responsible. It is, therefore, imperative that any subagreement for management services specify immediate notification to the grantee of any and all unresolved change orders or disputes. Evidence of good management for the prevention of claims should include the following practices:

1) The grantee evaluating its design engineer's ability to oversee construction (previous record with claims, cost and schedule control, for example) and the possible need for construction management early in the design phase. If found to be necessary, obtaining services of a construction manager prior to the start of construction, while design changes to improve constructibility can still be made;

2) The grantee insuring that an adequate soils and subsurface investigation is performed during planning and design stages and the results incorporated into the contract documents;

3) The grantee taking actions to insure accurate and complete plans and specifications, such as providing for independent third party review prior to requesting bids, holding prebid conferences, and assuring other grantee responsibilities are performed, such as site access;

4) The grantee insuring that a subagreement provision allowing for arbitration requires any arbitration based settlement or award to include findings of fact, allocation of award to each issue, conclusions of law, basis of award and rationale;

5) The grantee recognizing the importance of scheduling as a key management tool by specifying that the contractor provide an adequate schedule commensurate with the complexity of the project: by enforcing the schedule provisions; and by requiring periodic updating to show the adjusted project progress and completion date;

6) The grantee maintaining a fully and completely documented record of all aspects of the work, such as photographs and a daily log of work progress, personnel, and equipment on site;

7) The grantee demonstrating a knowledge and understanding of common sources of disputes or situations likely to result in claims during construction (such as inordinate delays in reviewing shop drawings), and exercising effective techniques to avoid such situations;

8) The grantee exercising effective management of properly submitted change orders (40 CFR 33.1030, Clause 3), resolving all costs and any necessary subagreement time extensions associated with each change order as the change order is executed and in the event a contractor reserves impact costs, executing a change order bilateral as to direct costs and unilateral as to the impact costs and including the best estimate of what the impact costs should be; and

9) The grantee providing timely responses to contractor requests for direction, clarification, and adjustment.

These good project management practices will not only reduce the number and frequency of contractor claims but will also provide a better opportunity for an early and less costly resolution after a claim arises.

CLAIMS RESOLUTION

Good management practices also have been developed for the resolution of claims. After a dispute arises, a grantee must assure that everything possible is done to address the issues raised and to mitigate future costs of a claim. Since a claim can be a huge potential liability, the grantee must take full control of the situation and, using legal and technical staff for advice and assistance, mount a well organized, thoroughly prepared resolution effort. Evidence of good management for the resolution of claims should include the following practices:

1) The grantee taking immediate steps to mitigate further costs being incurred by the contractor or any other party, due to the claim issues;

2) The grantee performing a timely, complete, and thorough review of the issues raised by the claim to determine the degree of merit that each issue may have;

3) The grantee negotiating with the contractor on the issues in a good faith attempt to resolve each issue;

4) If (3) is unsuccessful, the grantee utilizing the services of a consultant that is independent of the grantee's engineer and construction manager to provide the grantee a fresh perspective and confidential review of the merits of each issue and the potential liability of the contractor, engineer, and grantee;

5) The grantee making a renewed effort to negotiate a fair and reasonable settlement of the meritorious issues and a reduction or elimination of the issues found to be without merit; and

6) The grantee maintaining a fully and completely documented record of the negotiation process used to resolve the claim.

Where arbitration is deemed to be necessary, it is imperative that the grantee insure that any arbitration award contains a decision setting forth in detail its factual and legal basis. Otherwise, it may not be possible for the reviewing Agency to determine allowability of costs awarded. Therefore, as a condition precedent to any agreement to arbitrate, the grantee must obtain agreement by the contractor that the grantee and the contractor will require, at the time that the request for arbitration is made, that any award contain findings of fact, conclusions of law, basis of award, and rationale.

The application of these and other good management practices for claims resolution will be reviewed in determining whether the grantee has done everything possible to avoid arbitration or litigation. EPA has a significant interest in the equitable and expeditious resolution of all meritorious claims without employing time consuming and costly arbitration or litigation.

CLAIMS ALLOWABILITY

40 CFR Part 35, Subpart I, Appendix A, governs the review and allowability of claims costs. Appendix A was first published as an Interim Final Rule on May 12, 1982, (47 Fed. Reg. 20450), and was then revised on February 17, 1984, as a revised Interim Final Rule (49 Fed. Reg. 6224).

When determining grant allowability, the settlement of a claim must be carefully reviewed by the reviewing Agency for reasonableness and necessity, as well as sound grantee management. The cost of claims analysis, resolution, and defense can also be considered allowable, keeping the same concerns in mind.

The guidance provided in the discussion of Appendix A and the principles of claims allowability should be used by State and Regional project officers in their reviews of claims originating from any construction grant project. The regulations which were in effect at the time of the grant award should be cited in any determination of allowability. However, the fundamental criteria used in the determination of grant allowability for tests of reasonability and necessity are common to all construction grants. The guidance provided with respect to Appendix A represents EPA's position on what demonstrations a grantee should be prepared to make in support of an allowability determination.

The rules in Appendix A are based upon the fundamental principle that Federal grant recipients have responsibility to efficiently and effectively manage grant projects to successful completion, incurring only those costs which are necessary and reasonable. Accordingly, the Appendix A rules may be relied upon to determine the allowability of change orders, claims and related costs under grants awarded both before and after the Appendix was published.

To provide national consistency and to clarify the intent of the February 17, 1984 regulation, it has been segmented below and additional explanatory comments have been made. Pertinent sections of the regulations are indented, and reproduced as they appear in the Code of Federal Regulations [40 CFR 483(July 1, 1984)]:

> APPENDIX A - DETERMINATION OF ALLOWABLE COSTS
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> A. Costs Related to Subagreements
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> 1. Allowable costs related to subagreements include:
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> ...
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> f. The costs (including legal, technical, and administrative costs) of assessing the merits of or negotiating the settlement of a claim by or against a grantee under a subagreement provided:

Discussion: The reasonable costs incurred by a grantee to (a) analyze the claim and (b) negotiate a settlement can be characterized as negotiation costs. These costs which are incurred prior to either party filing a complaint with the courts or making a demand for arbitration will be treated as explained in this section. On the other hand, those negotiation costs incurred after the filing will be treated as costs under paragraph A 2.c. of Appendix A (page 9 of this document).

The negotiation costs are allowable to the extent explained below, provided that a grant amendment is executed covering the costs before they are incurred. To be allowable, the grantee must demonstrate that the pre-filing costs result from a timely and meaningful negotiation process and there was no evidence of grantee mismanagement. Of course, the costs of analyzing payment requests, invoices and requests for change orders, which are incurred prior to such a routine request becoming a claim, are normally included as part of construction management costs or administrative costs and can usually be funded under the existing grant.

Unless clearly allocable to allowable/unallowable cost elements within the approved project scope, claims negotiation costs are allowable to the same extent that the project is allowable provided:

(1) The claim arises from work within the scope of the grant;
(2) A formal grant amendment is executed specifically covering the costs before they are incurred;

Discussion: Here, as with all subagreements for supplies, services, and construction, 40 CFR Part 33 applies to all subagreements under grants awarded after May 12, 1982. These regulations require, among other things, access to records, cost and pricing data, and separate negotiation of profit.

(3) The costs are not incurred to prepare documentation that should be prepared by the contractor to support a claim against the grantee; and

Discussion: Here, the purpose is to emphasize the point that a claim presented by a contractor is expected to be complete and adequately stated on its face, and if it is not, it should be returned with instructions to adequately document and resubmit. No allowability can be made for preparing documentation to complete a contractor's claim.

(4) The Regional Administrator determines that there is a significant Federal interest in the issues involved in the claim.

Discussion: The Federal government encourages a fair and timely negotiation process without lengthly and costly arbitration and/or litigation. In general, EPA has a strong concern in a thorough assessment process to evaluate the merits of the claim and the relative vulnerabilities of the parties involved. Depending upon the results of the assessment, the Federal interest may change. The Federal interest will depend upon the reviewing agency's evaluation of the merits of the claim and the relative merits of the parties' stated positions and their negotiating posture.

A significant category of allowable costs related to subagreements is:

g. Change orders and the costs of meritorious contractor claims for increased costs under subagreements as follows:

Discussion: A "meritorious contractor claim" is a claim which has been stripped of its spurious or nonvalid parts (i.e., a meritorious claim is that portion of the total claim for which the grantee is liable). IT IS THE GRANTEE'S LIABILITY, NOT THE STATE OR EPA'S. The allowability of these costs are adjudged in accordance with the following rules:

(1) Change orders and the costs of meritorious contractor claims provided the costs are:
(i) Within the scope of the project;

Discussion: That is, within the scope of the grant - the eligible portion of the grantee's construction program.

(ii) Not caused by the grantee's mismanagement; and

Discussion: Here the reviewing agency will evaluate the grantee's performance during project construction, noting for example, undue delays in processing change orders, and to what degree the grantee was in full control of the project at all times. See the Claims Prevention and Claims Resolution sections for examples of good management on the part of the grantee.

(iii) Not caused by the grantee's vicarious liability for the improper actions of others.

Discussion: Here the expression "grantee's vicarious liability" means the liability for actions of others for which the grantee must accept responsibility as part of its general management responsibilities. It has the same meaning as the later expression "the grantee's responsibility" as provided in A.2.c.(6) of Appendix A (page 11 of this document).

(2) Provided the requirements of paragraph g(1) are met, the following are examples of allowable change orders and contractor claim costs:

(i) Building costs resulting from defects in the plans, design drawings and specifications, or other subagreement documents only to the extent that the costs would have been incurred if the subagreement documents on which the bids were based had been free of the defects, and excluding the costs of any rework, delay, acceleration, or disruption caused by such defects;

Discussion: Here, following the requirements that the grantee must manage the project properly, that only reasonable and necessary costs are allowable, and that increased costs caused by the improper actions of others are unallowable, the costs of impacts caused by defects are excluded. However, EPA will assist in paying the direct costs to the extent that these costs would have been necessary, if the bidding documents had been free of defects. EPA will not assist in paying the impact costs of changes caused by defects (errors and omissions) in the plans and specifications.

(ii) Costs of equitable adjustments under Clause 4, Differing Site Conditions, of the model subagreement clauses required under §33.1030 of this Subchapter.

Discussion: Here, the reviewing agency must determine that: 1) an adequate site investigation was performed; 2) claimed costs are reasonable and necessary; and 3) the grantee and contractors actions were timely and efficient in resolving the change order to minimize impact costs.

Discussion: If these conditions are met, EPA will participate in the direct and (because of the Agency's risk-sharing policy for differing site conditions) impact costs.

> (3) Settlements, arbitration awards and court judgments which resolve contractor claims shall be reviewed by the grant award official and shall be allowable only to the extent that they meet the requirements of paragraph g(1), are reasonable, and do not attempt to pass on to EPA the cost of events that were the responsibility of the grantee, the contractor, or others.

Discussion: Note here that as with all costs, the grantee has the burden of proof in substantiating the allowability of settlements, arbitration awards and judgments. This includes documenting that the incurred costs were not the result of mismanagement by the grantee, engineer, contractor or others. Furthermore, where delay costs are incurred, the grantee must document that they did not occur during a concurrent, overriding delay, and that they resulted from the controlling item of work (e.g., critical path).

In keeping with the agency's preference for achieving a fair resolution without arbitration and litigation, the costs associated with defense and prosecution are unallowable, except under certain conditions, as follows:

> ...
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> 2. Unallowable costs related to subagreements include:
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> ...
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> c. The costs (including legal, technical and administrative) of defending against a contractor claim for increased costs under a subagreement or of prosecuting a claim to enforce any subagreement unless:

Discussion: Defense and prosecution costs (including legal, technical and administrative) are defined as those costs incurred after any party files a complaint with the courts or makes a demand for arbitration against any other party in defending against a contractor's claim for increased costs under a subagreement or of prosecuting a claim to enforce any subagreement.

It is to be emphasized that the term "cost" as used here and throughout this guidance, means reasonable costs, and a judgment has to be made by the Regions/States as to the reasonableness of any costs about to be incurred. This is especially difficult in defense cases, since the grantee does not control the legal action and, perhaps, the contractor increases the amount of its claim as the action progresses (not an unusual occurrence). Defense and prosecution costs are unallowable unless:

(1) The claim arises from work within the scope of the grant;
(2) A formal grant amendment is executed specifically covering the costs before they are incurred;
(3) The claim cannot be settled without arbitration or litigation:

Discussion: Determining whether a claim can be settled is often a difficult judgment call to make at an early stage in the proceedings and, during the course of the proceedings, conclusions concerning the settlement potential mav change. The reviewing agency should request and review the following items from the grantee, as an aid to making the determination that further negotiations would not be productive:

- o A showing of sufficient documentation that timelv good faith efforts were made to pursue negotiations in order to avoid arbitration or litigation, such as:
  - memorandum of negotiation (detailed in EPA Change Order Guidance, p. 10);
  - timely analysis of merits of the claim by the grantee's construction engineer (or other consultant) and legal staff;
  - proof of timely response;
  - record of attempts to perform timely and meaningful negotiations.
- o Engineer's independent estimate of the value of the claim.

- Third party independent consultant's report, where appropriate.

- Any other pertinent correspondence between the contractor and grantee and/or engineer.

(4) The claim does not result from the grantee's mismanagement;

See this guidance at page 8 addressing A.1.g.(1)(ii) of Appendix A.

(5) The Regional Administrator determines that there is a significant Federal interest in the issues involved in the claim; and

See this guidance at page 7 addressing Federal interest under A.1.f.(4) of Appendix A.

(6) In the case of defending against a contractor claim, the claim does not result from the grantee's responsibility for the improper action of others.

See this guidance at page 8 addressing A.1.g.(1)(iii) of Appendix A.

NOTE: EPA has proposed a regulation which would generally limit cost increases to five percent and plans to publish the regulation in final form in the near future. The allowability of claim related costs discussed in this document would be limited for projects which fall under the jurisdiction of such a regulation.

CONCLUSION

This claims management guidance is intended to assist grantees in the management of claims and to assist reviewing agencies in making appropriate allowability determinations.

Grantees are fully responsible for project management. This guidance sets forth some characteristics which distinguish between proper and improper management practices. Improper management practices can cause the grantee to fail to prevent contractor claims or resolve them in a timely manner. Where costs associated with contractor claims are precipitated or exacerbated by the grantee's improper management practices, the allowability of such costs will be unallowable under the EPA regulations. For these reasons, it is imperative that grantees become familiar with the principles explained in this guidance and exercise good management practices.