Statement of

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to the

U.S. House of Representatives

**Committee on Small Business' Subcommittees on Contracting and Workforce and Investigations, Oversight, and Regulations**

For a hearing on

# "All Work and No Pay: Change Orders Delayed for Small Construction Contractors"

May 25, 2017

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Chairman Knight, Chairman Kelly, Ranking Member Murphy, Ranking Member Adams and members of the committee, thank you for inviting me to testify on the important topic of change order delays in the federal construction market. My name is Ed DeLisle. I am a partner with the law firm of Cohen Seglias, where I co-chair our federal contracting group and work very closely with our federal construction clients. I regularly counsel federal contractors on a wide variety of small business issues, including advice on affiliation rules; mentor-protégé programs; small business and set-aside strategy and compliance (8(a) contracting, ANC, NAC, HUBZone, SDVOSB); small business subcontracting plan compliance; and small business size protests.

Construction projects are subject to a wide array of variables that may require a federal agency to alter their initial plans. Consequently, reasonable delays and changes may be required to meet conditions on the ground. The concern is not with reasonable delays and changes to the initial contract. Rather, the concern rests with agencies failing to execute change orders and make payment to contractors for months—and even years—at a time. Unsurprisingly, this delay causes serious harm to the project schedule and has a deleterious impact upon payment to the prime and subcontractors, especially small businesses which depend upon that cash flow to remain in business. To avoid these impacts, small business prime contractors, or subcontractors, may walk off a job, as a protracted change order delays can impede the small business's very ability to operate and survive. When that occurs, small businesses can be with non-small business prime contractors or subcontractors.

In this testimony, I will discuss:

- Define change orders;
- How they typically come about on a construction project;
- The steps involved in submitting a change order;
- The FAR provisions giving authority to change orders; and
- The significant challenges small businesses face in the change order and claims processes when working for federal agencies.

## Overview of Change Order Process

Change orders and contract modifications describe the same action. You may hear these terms used interchangeably, but these terms are essentially synonymous. In this context, we are referring to contractual changes between construction contractors and the federal government. Broadly speaking, a change order is any change to the scope of work of an already existing

contract and the price to be paid, and/or the time to complete, the new work. Federal construction contracts contain a "Changes" clause, which permits the government to make changes in the general scope of the contract, including modifications to the drawings, specifications, materials, manners of performance or method of performance. *See, e.g.*, Federal Acquisition Regulations (FAR) Part 52.243-4. This clause requires the government to make an equitable adjustment in the contract price for these changes. This clause also permits the contractor to assert that a change has occurred if the government gives any written or oral order (such as an instruction, interpretation, direction) that causes a change to the contract. This concept is known as a constructive change. Under the language of the clause, these changes are treated as if the government ordered the change, entitling the contractor to an equitable adjustment.

**Differing Site Conditions**

Changes orders can arise through several avenues. Federal construction projects are typically large and complex. The agency may realize that a size of a room does not match the intended purpose, and may need to expand, or reconfigure it. This is a common issue for federally owned hospitals, where modern medical equipment, such as Magnetic Resonance Imaging (MRI), may change size in the years since the design specifications were agreed upon. This problem occurred on the much maligned VA hospital project in Aurora, Colorado and resulted in increased costs of approximately $1.1 billion.

There may be a differing site condition at the worksite that was unknown to either party or not listed in the contract specifications. Differing site conditions[1] generally arise in two way, and are sometimes referred to as "Type 1" or "Type 2." Type 1 conditions are physical conditions that are materially different from those described in the contract. An example of a Type 1 condition occurs when the contract documents identify the expected ground conditions, do not show rock and the contractor encounters rock during excavation, which requires extensive, unanticipated effort to remove. Type 2 conditions are "unknown physical conditions of an unusual nature which differ materially from those ordinarily encountered and generally recognized as inhering in work of the character provided for in the contract." For example, the contractor begins to excavate the site and there is an unknown subterranean issue, such as a high, undisclosed water table in a place where water would not be expected. Finding such a condition would require different, extensive excavation efforts and increase the cost to the project.

When either Type 1 or Type 2 differing site conditions occur, the contractor must notify the federal agency's contracting officer, who is obliged to investigate the site conditions and determine if an equitable adjustment should be made and the contract modified to reflect the actual cost to perform given the unexpected conditions.

[1] FAR 52.236-2

## Bilateral and Unilateral Change Orders

FAR Part 43.103 discusses the different types of change orders available to a contractor. On a federal construction project, there are bilateral change orders and unilateral change orders. A bilateral change order, or modification, to a contract is a supplemental agreement where the parties have negotiated and agreed the specified additional work that will be accomplished in return for specified consideration, normally additional money and/or time. Where a contractor accepts and signs without reservation or protest a bilateral contract modification, it is generally barred by accord and satisfaction from later claiming an additional adjustment.

A unilateral change order, or modification, is one which is issued by the contracting officer without requiring the consent or signature of the contractor. Unilateral change orders typically arise when the parties agree that there is a changed condition, but cannot agree on the extent of the change, price and/or impact on schedule. It is a one-sided directive from the federal agency to perform and, although a contractor must abide by a unilateral directive, it is free to file a claim for the additional costs or time incurred beyond what set forth in the modification. Since a unilateral change order does not require the contractor's signature, the change order cannot act as a release of further claims.

## Submitting a Change Order

Bilateral change orders are common in both the federal and private construction markets. In either context, parties can agree upon changes in scope of work. The difference in the federal market is that a federal agency does not act like a private entity. The federal agency does not have the same incentives to quickly finish a project or act in the best interest of the construction project. The federal agency has the luxury of time and vast resources that small businesses, in particular, simply do not have. To that end, contracting officers will often try to force a contractor to sign a bilateral modification for less time and money than a contractor has requested knowing that the bilateral contains binding release language. A contractor may sign that modification for the sake of certainty, particularly if the CO has indicated that there may be some dispute regarding scope of work. That said, the contractor at least has a choice.

Unilateral change orders are a different story and are unique to the federal market. Here, the government holds all the cards and can decree by fiat that a contractor will change the scope of work. There is no “submission” process per say. The government agency simply issues a modification, requiring the contractor to proceed for the price indicated. The contractor, especially a small business contractor, has little recourse but to comply with the federal agency’s directive, or suffer the consequences, financial or otherwise.

The process for submitting a bilateral change order begins when a party to the contract realizes a desire or need to modify the scope of work. A request for a change order may be generated from the contractor and sent to the federal agency, typically to the CO. FAR Part 43.204 states that a CO "shall negotiate equitable adjustments resulting from change orders in the shortest

practicable time." Unfortunately, the time is seldom short, but the contractor is told that it must continue to perform and not delay job completion. Failure to comply could result in default, a poor performance rating, or both. Alternatively, a change may be requested or directed by the government and sent to the contractor. The contractor will price the cost for additional work and submit it to the CO. Only contracting officers can sign change orders and bind the government.[2]

Often the COs are not very involved on a construction project. Typically, the project engineer, or other lower level government personnel, are the only ones who are personally involved in and physically at the project and understand the problem. This is especially problematic when a change order is needed quickly. Lower level government personnel will often tell a contractor to do the extra work prior to receiving a change order. This puts the contractor in a difficult bind. Delays in changing the scope of work can have a ripple effect, costing the government and contractor excess money and delaying the overall completion of the project. If the contractor proceeds without a change order, however, the contractor is put at risk and faces potential liability should an issue arise.

**Issues Facing Small Businesses with Claims against Federal Agencies**

When small business contractors and federal agencies disagree as to when work is, or is not, covered under a construction contract, a contractor may file a claim for equitable adjustment, or a certified claim, wherein it demands payment from the government. The claims process is often long, expensive and risky. Small businesses neither have the luxury of deep pockets to bear long periods of time without payment, nor can they generally handle such risk. The claims process generally takes years—sometimes five or more years—to conclude. During that time, small businesses may have to pay thousands, or tens of thousands, of dollars in legal fees for the potential benefit of being paid pennies on the dollar later through a settlement that it is forced to accept simply to cut its losses and survive. That is the simple reality of the process.

These problems were most recently publicized on the Department of Veterans Affairs' Aurora Hospital project in Colorado, which was referenced above. On the VA Aurora Hospital project, the refusal of the VA to process appropriate contract modifications left the general contractor and its subcontractors without proper payment for extended periods of time with severe consequences. The contracting officer there had a practice of issuing unilateral change orders for 10% of the value claimed for the additional work. He promised that these modifications represented "part one" of what would be a "two part" change order. The problem was that "part two" often never came and the costs for additional work totaled tens of millions of dollars. Along the way, the VA simply stopped processing change orders.[3] Small companies rely on prompt payments to meet payroll and expenses, often unable to cover those costs for very long.[4] Many rely on bank loans and lines of credit to bridge the gap, but on the Aurora project some

[2] FAR 43.102
[3] David Migoya & Mark Matthews, *Aurora VA Hospital Project Spooked Subcontractors, Causing Cost Hikes*, DENV. POST, May 15, 2015 *available at* http://www.denverpost.com/news/ci_28125325/aurora-va-hospital-project-spooked-subcontractors-causing-cost
[4] *Id.*

banks balked at letting small business clients rely on its money to continue work.[5] According to the Colorado SBA, at least 33 small businesses were not paid for work in a timely fashion, and some were waiting more than a year after work was completed for payment.[6] Of those 33 companies, at least two filed for bankruptcy.[7] The prime contractor even paid subcontractors several million dollars out of its own pockets while waiting for payment from the VA, which was highly unusual.[8] While the project in Aurora is a recent and, unfortunately, well-known example, problems with processing change orders happen in every federal construction agency on a regular basis. The problem is that those change order delays are happening on projects worth $5 million, $10 million and $100 million, over which Congress does not ordinarily conduct oversight. The issue is that when the dollar amount is not high, and media attention is not existent, meaning that there's a lack of public outrage, the problems persist but go unnoticed by everyone except the small business that may have to close its doors.

There will always be legitimate discrepancies between a small business contractor and the government based on the terms and scope of a contract. That's normal. However, our concern is when the claims process is used unfairly—where the government fails to act in good faith—to the detriment of small businesses. Generally speaking, project funds come from a different budget account than the funds used to litigate and pay claims. Consequently, with project budgets tight, some federal contracting officers may tell contractors that there will be no change orders issued on a project, or no further change orders issued, regardless of how apparent the need may be for a modification. That happens. If there is an issue, the contractor will have to do the work and file a claim. The expense of litigating the claim, in the long run, will often cost more to the government and taxpayers than issuing the change order in the ordinary course. It will certainly result in additional costs to the contractor. However, forcing a contractor into this situation is not something that will typically impact the contracting officer on the project or that project's budget. As such, it is easier for the government to simply kick the can down the road and use the unlimited time and financial resources of the federal government to wait the small business out until it can no longer afford to continue, forcing it to settle.

Thank you again for inviting me to testify before the committee on this important topic. I look forward to answering your questions.

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[5] *Id.*
[6] Cathy Proctor, *SBA: Progress being made on Helping Unpaid VA Hospital Subcontractors*, DENV. BUS. J., April 4, 2013 *available at* http://www.bizjournals.com/denver/news/2013/04/04/sba-urges-va-to-speed-payments-for.html
[7] *Id.*
[8] *Id.*