

**THE USE AND MISUSE OF
ALLOWANCES AND
CONTRACTOR CONTINGENCY**

By

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ALLOWANCES¹

Allowances are funds allocated for known future costs that have not been specified with a high enough degree of detail to enable an accurate estimate of costs to be created. Allowances are usually associated with materials the owner intends to select after the contract is formed. Allowances should never be confused with contingencies, although they often are. The difference between the two might be described using terms coined by Donald Rumsfeld, the secretary of defense under former presidents Gerald R. Ford and George W. Bush, as the difference between “known unknowns” (allowances) and “unknown unknowns” (contingencies). “Allowance” has been defined in one dictionary as:

An amount established in the contract documents for inclusion in the contract sum to cover the cost of prescribed items not specified in detail, with provision that variations between such amounts and the finally determined cost of the prescribed items will be reflected in change orders appropriately adjusting the contract sum.²

Allowances are most often used for material selections, such as the selection of lighting or plumbing fixtures, where the selections have not been made or the specifications have not been finalized when the contract is signed. They are also used for discrete scopes of work that cannot be quantified until the work is performed or uncovered. For example, the cost of drilling a well often is not known until the well is drilled and water or other material is located. Similarly, the extent of floor preparation costs in a remodel project may not be knowable until the existing flooring is removed.

The AIA A201-2017 General Conditions document contemplates material allowances as follows:

§ 3.8 ALLOWANCES

¹ The authors acknowledge the contribution of Michael J. Cannon to an earlier draft of this article.

² National Association of Women in Construction, *Construction Dictionary*, 9th Ed. (2003).

§ 3.8.1 The Contractor shall include in the Contract Sum all allowances stated in the Contract Documents. Items covered by allowances shall be supplied for such amounts and by such persons or entities as the Owner may direct, but the Contractor shall not be required to employ persons or entities to whom the Contractor has reasonable objection.

§ 3.8.2 Unless otherwise provided in the Contract Documents,

- .1** allowances shall cover the cost to the Contractor of materials and equipment delivered at the site and all required taxes, less applicable trade discounts;
- .2** Contractor's costs for unloading and handling at the site, labor, installation costs, overhead, profit, and other expenses contemplated for stated allowance amounts shall be included in the Contract Sum but not in the allowances; and
- .3** whenever costs are more than or less than allowances, the Contract Sum shall be adjusted accordingly by Change Order. The amount of the Change Order shall reflect (1) the difference between actual costs and the allowances under Section 3.8.2.1 and (2) changes in Contractor's costs under Section 3.8.2.2.

§ 3.8.3 Materials and equipment under an allowance shall be selected by the Owner with reasonable promptness.

Under section 3.8.2, an allowance covers only the cost of the materials and not the cost of labor to unload and install. Conflict is fairly rare when allowances are used for something as straightforward as the selection of materials or equipment. However, allowances can become traps for the unwary when they are drafted to include entire scopes of work, because without modification of the form clause, the contractor would probably get no relief for labor increases resulting from the increased work. If the water well had to be drilled 20 feet deeper than planned in order to find water, the contractor might recover costs for the additional pipe and machine time but might not recover the additional labor of drilling the extra 20 feet and installing the extra materials.

When an allowance covers a scope of work where the installation cost varies with the types of materials selected or with the amount of work needed to achieve the desired result, the allowance must be defined to include all the variable costs, such as labor and markup. Sometimes, the parties

will negotiate unit costs in situations where the labor, general conditions, and equipment costs for the allowance scope are not capable of being fixed.

Most form contracts, including the AIA General Conditions, do not discuss the process for administering allowances or the consequences for failing to do it right. Most form contracts state that a change order will be issued to adjust the actual cost to the allowance amount. (See, for example, AIA A201-2017 § 3.8.2.3.) While this may work for a materials-only allowance, it is inadequate for an allowance that covers a discrete scope of work, such as winter conditions.

For a discrete scope-of-work allowance, the parties need answers to the following questions:

1. Must the contractor notify the owner when the allowance is about to be exceeded?
2. Does the owner have the ability to reject the contractor's decision/ recommendation to perform additional allowance work that exceeds the allowance amount?
3. Who becomes responsible for the consequences of not performing the additional allowance work?
4. Must the change order issue before the additional allowance work is performed?
5. If the contractor fails to follow the required procedure, what are the consequences?
 - a. Do such excess costs no longer qualify as costs of the work in a cost-plus contract?
 - b. Can they nevertheless be paid from contingency?

Allowances are unique to each circumstance, so they do not lend themselves to many rules of drafting. Rather, they represent a potential area of conflict that should be approached cautiously in each case, with careful attention devoted to drafting the particulars so that disputes can be minimized in the long run. At the very least, these provisions must include a careful definition of what the allowance is and for what it will be used. The parties should anticipate an allowance fund shortfall with a plan for addressing costs in excess of the planned amount.

CONTRACTOR CONTINGENCY

Contractors and owners often find themselves drawn into disputes that arise from their differing views about the meaning and use of contingency in construction projects. These disputes generally involve questions of who owns the contingency; who controls the contingency; and what costs the contingency may be used to pay.

Avoiding conflict requires that both parties share a common understanding of the terms of their agreement and that the contract be an accurate and detailed expression of that understanding.

Different Types of Contingency

The Association for the Advancement of Cost Engineering defines “contingency” as:

An amount added to an estimate to allow for items, conditions, or events for which the state, occurrence and/or effect are uncertain and that experience will likely result, in aggregate, in additional costs.³

Even with a working definition, however, it is important to recognize that there are at least two different types of contingency common to construction projects, and there is at least one term that is often confused with “contingency” in the vernacular.⁴

A. Owner Reserve

The first type of contingency is a fund set aside by an owner when it plans its budget for construction projects, particularly in dealings with lenders, to cover any unforeseen contingency.⁵ We call this “owner reserve.” Although it is often referred to as a “contingency fund,” it is instead an amount intended to be used for additions to the project’s scope. For example, improvements in

³ Ripley, Peter W., “Contingency! Who Owns and Manages It?,” *Professional Practice Guide to Contingency*, 2nd Ed. (2005): CSC.08.01; see also England, K. & Moreci, J. (2012). *Contingency—are you covered?* Paper presented at PMI® Global Congress 2012—North America, Vancouver, British Columbia, Canada. Newtown Square, PA: Project Management Institute.

⁴ This article deals only with cost contingencies. Two other types of contingencies—schedule contingency (float) and specification contingency (tolerance)—are beyond the scope of this article.

⁵ Weissman, David A., *Construction Lending from the Ground Up*, 21 GPSOLO 26, American Bar Association (September 2004).

technology and changes in foreseeable needs for a structure may cause the owner to order alterations throughout the construction process. Those scope changes are paid from the owner reserve, a term more accurately descriptive of the reason for and function of that fund.

B. Contractor Contingency

The other type of contingency is an amount built into the contractor's anticipated price for the project. We call this "contractor contingency." The reason for a contractor contingency is that a number of risk factors, present when the estimate is being prepared, cannot otherwise be accounted for in a schedule of values presented to an owner. These risk factors may include:

1. incomplete designs;
2. scope errors;
3. construction disturbances (e.g., strikes, accidents, or breakdowns);
4. bankruptcies;
5. regulatory risk;
6. estimating inaccuracy;
7. technological change;
8. calamitous weather; or
9. unanticipated price or interest rate increases.⁶

Some of these risk factors occur more frequently than others, but what they each have in common is that none has a particularly high probability of occurring during the course of any given project. In the aggregate, however, it is entirely likely that one or more of them will afflict a project—with unpredictable, but possibly expensive, results.

In examining contractor contingency, it is helpful to understand what it is not. It is not potential profit. It is not for scope changes or escalation rate variations. It is also not an allowance.

⁶ Querns, W. R., "What is Contingency, Anyway?," *Professional Practice Guide to Contingency*, 2nd Ed. (2005): B.9.1; Noor, I., and Tchachek, R., "Contingency Misuse and Other Risk Management Pitfalls," *Professional Practice Guide to Contingency*, 2nd Ed. (2005): RISK.04.1.

Uses of Contractor Contingency

Contractor contingency is a money buffer intended to manage risks that are not completely foreseeable or certain to occur. It covers unforeseen elements of cost within a defined project scope,⁷ reflecting the recognition that unexpected and costly occurrences are likely before a project is over.⁸ Therefore, it is money set aside to cover occurrences that are likely to arise, even though we cannot predict when, where, why, or exactly how the events will occur or how much they will cost. It is there because we can say with some statistical certainty that unpredictable individual costs will arise, so the amount established for Contractor Contingency is set at a level that balances the desire to have liquidity with the need to control risk. Contingency funds are added to the estimate to reflect the most-likely final cost of the project, and, therefore, should be viewed as funds that are likely to be fully expended as the course of the work progresses.⁹ The way those funds are used as a risk-management device varies depending on whether the contract with the owner is for a fixed fee or instead is based on the contractor's cost plus a fee, with a guaranteed maximum price.

In a fixed-fee contract, the risk represented by the contractor contingency is entirely the contractor's. The owner typically is not involved in setting or accounting for contractor contingency in a fixed-fee contract, just as the contractor is not involved in the owner's establishing an owner reserve with its lender. Unless the contingency is disclosed in the schedule of values, the owner may not even know that a contingency exists. Any money left unused in the fixed-fee contractor contingency simply becomes profit for the contractor at the end of the project.

⁷ Moselhi, O., "Risk Assessment and Contingency Estimating," *AACE International Transactions* (1997):A.06.02.

⁸ Samid, G., "Contingency Revisited," *Cost Engineering*, Vol. 36/No. 12 (December 1994): 23.

⁹ Jackson, Richard Lee, Kinsey, John W., Cotton, Wayne E., Moore, Susan K., "The Why and How of Contingency Management," *AACE Transaction* (1985), *Professional Practice Guide to Contingency*, 2nd Ed. (2005): N.0.1.

Contractor contingency as it is used in a cost-plus contract with a guaranteed maximum price (CP/GMP) is where disputes arise. In a CP/GMP, the contractor is paid its base cost (including general conditions costs and subcontract costs) plus a negotiated fee. Contractor contingency is a budget amount added to the base cost and fee to establish the guaranteed maximum price, accounting for anticipated but unknowable risk events. In such a scenario, the owner funds the contractor contingency, from which costs arising from the enumerated risks are drawn until the contractor contingency fund is exhausted and the guaranteed maximum price is reached. Any unspent contractor contingency funds at the end of the project typically revert to the owner because those funds are neither costs of the work nor the fee component of the contractor's contract. A deductive change order is used to reduce the guaranteed maximum price by the amount of the unspent contractor contingency.¹⁰ Significantly, if costs defined as a part of contractor contingency exceed the amount in the contractor contingency fund, and are not offset by savings elsewhere in the schedule of values, the contractor is forced to absorb those additional costs.

Misunderstanding the Role of Contractor Contingency

Owners often misunderstand the role of contractor contingency, considering it a source of potential savings as long as the contractor has prepared an accurate estimate and competently manages the project.¹¹ For such an owner, every deduction is evidence that the contractor has made some kind of mistake, and the owner may become increasingly combative as the contractor contingency fund becomes depleted during the course of the project.

¹⁰ Often, unspent contingency is shared with the contractor as a method of incentivizing the contractor to conserve the contingency. Some CP/GMP contracts have elaborate pour-over provisions in which savings from other line items within the schedule of values pour into and "recharge" the contingency. This setup permits the owner greater management control over individual line items and correspondingly less freedom to the contractor to use savings in one area to offset cost overruns in another.

¹¹ Jackson, Richard Lee, Kinsey, John W., Cotton, Wayne E., Moore, Susan K., "The Why and How of Contingency Management," *AACE Transaction* (1985), *Professional Practice Guide to Contingency*, 2nd Ed. (2005): N.0.1.

Owners often misunderstand the role of contractor contingency, treating it as if it were a substitute for approving change orders—particularly “gray-area” change requests. Keeping in mind that change orders exist to accommodate changes to the scope of the work and risk factors borne by the owner, and that contractor contingency exists to mitigate project-related risks for which the contractor is responsible, disputes can sometimes arise when the owner refuses to execute a change order and instead requests that the contractor deduct the value of a scope change from the contractor contingency. Contractors often accede to such demands in order to avoid conflict and ensure steady payment. The consequence for the contractor is that the contractor contingency fund becomes depleted by costs that should have increased the guaranteed maximum price, leaving the contractor to bear all the risk of future misfortune.

A related development has been the advent of shared savings in the contractor contingency. Under such an arrangement, the owner and contractor agree to split savings in contractor contingency according to a predetermined ratio. This is viewed as a kind of extension of the practice of sharing savings in the base cost, which is a sensible way to give the contractor an incentive to keep costs down. But when applied to the contractor contingency, it reveals a basic misunderstanding of the role of the contractor contingency in the project budget, treating it instead as a kind of allowance. This ignores the true function of the contractor contingency, which is to serve as a hedge against unknown risk. Entering into an agreement to share the balance of these funds serves only to further contribute to the misunderstandings that pervade contractor contingency negotiations.

Contingency, the GMP, and the Schedule of Values

Disputes over contingency often are related to a misunderstanding of the relationships among the guaranteed maximum price, the schedule of values, and the contingency. The schedule

of values is a billing and tracking device that permits the parties to monitor how various trades or scopes of work are performing compared to the original budget and schedule. Many owners mistakenly think that the line items in the schedule of values may not be altered without owner approval, thus creating a guaranteed maximum price for each line item. Often, savings from subcontractor buyouts are moved to the contingency line. In contracts where the use of contingency is limited to certain types of costs and requires owner approval, and the movement of funds within the schedule of values is restricted by contract or by the owner's perception of the contract, the contractor and owner are bound to run into disputes over proper cost allocation and use of contingency. In this scenario, the contractor would risk any line item overrun and would likely be unable to fund such overruns from the contingency.

Construction contracts should, but usually do not, clearly provide that the guaranteed maximum price applies only to the aggregate of all qualified costs of the work and that, by extension, the contractor may freely move values within the schedule of values, including the contingency.

At least one court has acknowledged that the GMP equals all line items listed in the schedule of values as a whole, not that each line item is a separate GMP. *Nason Construction Co. v. Bear Trap Comm., LLC*, 2008 WL 4216149, *4-5 (Del. Super 2008) (Not Reported in A.2d – Unpublished Opinion) (Attachment D). *Bear Trap* involved a developer withholding payments due and owing to a contractor in violation of Delaware's Prompt Payment Act. The developer never provided an initial reason for why payments were being withheld. At trial, one of the developer's alleged reasons for retaining the funds was that the contractor's totals exceeded certain line items on its schedule of values. The developer's position was that each line item had to be met, and if any line item was over the schedule, it would be the contractor's problem. In other

words, the developer took the position that each line item was basically a guaranteed maximum contract price instead of considering all the line items in the schedule of values as a whole. The court found this interpretation unreasonable. “To then slice and dice the contract in an effort to ‘line item’ the maximum guaranteed prices was wrong,” the court stated. *Id.* Moreover, the court found that this ruling was “consistent with the building community’s interpretation of a guaranteed maximum price contract.” *Id.*

Where the contractor’s freedom to move funds within a schedule of values is clearly set out in the contract, and where savings in various line items (from subcontractor buyout or good management, for example) do not automatically pour into the contingency, the contingency clause can become less contentious. Otherwise, proper drafting of the contingency clause is critical.

Drafting the Contractor Contingency Clause

The goals of drafting a favorable contractor contingency clause are to:

1. distinguish contractor contingency risks from owner reserve risks;
2. make clear that contractor contingency is to be used only for contractor risks, including contractor mistakes;
3. provide for notice and the mechanics by which the contractor contingency will be spent; and
4. define whether the contractor has a unilateral right to the fund, or whether the fund can be accessed only with the agreement of the owner.

A provision we have seen used to describe the role of contractor contingency is Example 1:

<p>Because documents are not complete at the time this Guaranteed Maximum Price is established, the pricing of this Guaranteed Maximum Price will include a construction contingency. The contingency is developed in order to protect the Contractor from unforeseen and unknown items, including, without limitation, unanticipated bidder and Subcontractor defaults, errors or negligence of Contractor or Subcontractors, omissions between and from the various work categories (excluding work performed by Owner or other contractors at Owner’s direction) that must be incorporated into the final construction of the Project that do not materially change the scope of the</p>

Project. The construction contingency should not be confused with a contingency developed by the Owner for use by the Owner in changing the scope of the Project.

The contingency included in this GMP estimate is for the exclusive use of the Contractor. The use of the contingency is managed by the Contractor with the Owner and Construction Manager reviewing and approving the use to assure that it is being used for the purpose defined, approval of which will not be unreasonably withheld. Contractor shall advise the Owner on a monthly basis of any anticipated savings that will remain in the construction contingency at the end of the job. Any unused contingency upon final completion shall accrue to the benefit of the Owner. Should the actual award amount of Subcontracts under-run the amount carried in the Contractor's GMP, then those savings will be credited 100% to the Owner at the time that Contractor reaches fifty percent (50%) completion of the Work.

The provision above is significant for several reasons. First, it clearly expresses that the fund is necessary to account for enumerated risks, including errors and negligence by the contractor and subcontractors, defaults, and omissions in various work categories. It also states that it is not to be used for scope changes, plainly stating that it is not the same as the owner reserve. It clearly identifies the contractor as having exclusive use of and management over contingency. However, it grants the owner the right to review and approve the use of the contractor contingency. While that feature may be difficult to negotiate out of a contract, the contractor should be aware that granting the owner authority over the use of contractor contingency may lead to problems as the project progresses, particularly if the owner is under the mistaken impression that a significant amount of money is likely to be left in contractor contingency at the end of the project. Finally, it segregates contractor contingency from the shared-savings provision that permits the contractor to benefit from savings in actual award amounts of subcontracts below that amount allocated in the GMP. This part of the clause is very ambiguous.

Example 2, below, is the result of a lengthy negotiation and takes a somewhat different approach:

§ 5.2.6.1 In the event that the Guaranteed Maximum Price includes an amount for construction contingency ("Contingency"), such Contingency shall be for the sole and exclusive use of Contractor and shall be used solely to cover unanticipated expenses which are necessary to complete the Work and for which Contractor is not entitled to a Change Order. Contingency may be used solely for the following:

- costs incurred due to Force Majeure Delays (as defined in Section 8.3.2 of the AIA Document A201-2007) to the extent that such costs are not reimbursed by Change Order;
- costs due to latent physical conditions which could not be seen but are not accepted as concealed conditions;
- costs for Work inadvertently omitted from existing subcontracts but arguably inferable from the Construction Documents;
- costs of completing the work of a bankrupt Subcontractor in excess of the subcontract price;
- costs of premium time or multiple shift or weekend time not due to Contractor-Responsibility Delays (as defined in Section 8.3.4 of the AIA Document A201-2007) or other unexcused delays of Contractor or its Subcontractors;
- costs resulting from unanticipated construction disturbances such as strikes or accidents not due to the fault of any Contractor Parties;
- costs due to unanticipated cost escalation for materials not included in an executed subcontract; and
- costs authorized in writing by Owner to be drawn from Contingency but only to the extent so authorized.

The provision acknowledges that the contractor contingency fund is for the exclusive use of the contractor to cover necessary but unanticipated expenses. But it creates a relatively narrow and exclusive list of the types of costs that will qualify. The third bulleted item, which allows costs for scope holes, is a significant “win” for the contractor, while the last bulleted item requiring owner approval for any costs not within the enumerated categories is the corresponding “win” for the owner.

The negotiated clause in Example 2 continues as follows:

§ 5.2.6.2 The first XXX Thousand Dollars (\$XXXX) of Contingency may be used for the items listed in Section 5.2.6.1 above without Owner's prior authorization, provided that Contractor gives Owner prior written notice of its intent to utilize Contingency before making any transfers and updates and submits to Owner on a monthly basis a log showing all Contingency transfers. Any use of Contingency

after the first XXX Thousand Dollars (\$XXX) of Contingency has been expended shall be subject to Owner's prior written authorization in each instance except in the case of emergencies

§ 5.2.6.3 Contingency shall not be used to fund scope increases for which Contractor is entitled to a Change Order or other costs that are the responsibility of the Owner. Notwithstanding anything to the contrary herein, in no event shall Contingency be used to increase the Fee or for costs arising from the gross negligence or willful misconduct of Contractor or its Subcontractors, or costs within the scope of coverage of any Subguard or other subcontractor default insurance policy.

§ 5.2.6.4 Upon completion of the buyout of all Subcontractor trades, the net savings, if any, resulting from such buyout shall be added to Contingency.

Section 5.2.6.2 represents a compromise on the owner's right to approve the use of the contingency. Once the contractor meets a certain threshold number, the owner becomes entitled to veto subsequent uses of the contingency fund.

Section 5.2.6.3 confirms that the contingency is not to be used to fund scope changes; it also prohibits the use of contingency to cover costs resulting from grossly negligent or intentional misconduct. This formulation is somewhat vague and could lead to disputes.

Finally, section 5.2.6.4 provides for a pour-over of subcontractor buyout savings into the contractor's contingency. This provision benefits the owner because it restricts the contractor's ability to move money among the line items in the schedule of values. When subcontractor buyout savings remain in the various line items in the schedule of values, the contractor ordinarily can use those cost underruns to fund cost overruns in other line items without the owner's prior approval, subject to the qualification that the overrun costs must qualify as costs of the work as defined in the contract. By pouring those savings into the contingency instead, the contractor limits its ability to spend those savings during the course of the project to the cost categories for which contingency may be used.

CONCLUSION

At least three basic areas must be clearly defined in all contractor contingency provisions: (1) how contractor contingency is funded; (2) what kinds of costs contractor contingency can be used to cover; and (3) what notice and approval are necessary.

A well-drafted contractor contingency provision should distinguish contractor contingency risks from owner reserve risks and make clear that contractor contingency is to be used only for contractor risks. Additionally, the particular uses of contractor contingency should be set out in broad strokes to preserve flexibility in its use for unforeseen occurrences. Requirements for giving notice that contractor contingency is being used should be set out. But the real difficulty in negotiations usually concerns whether the contractor has the unilateral right to access the contingency or whether the contractor must first obtain the owner's approval. Contractors benefit from exclusive control over contractor contingency, but owners are extremely reluctant to cede that. Often the parties will attempt to negotiate a balance: some uses will require owner approval, while others will not. Whatever the result of the negotiation, the contingency provision must address this point.