

The Unfair Pricing Of Change Orders – NYC Needs To Address Insurance Costs

By: Henry L. Goldberg

The pricing of change orders is often a critical factor in the overall financial success of a project. The overall profitability of a job can easily turn on whether the owner is fair, equitable and accurate in this process.

It's time, therefore, for the industry to address what New York City agencies are doing in this regard. In particular, a review of the change order reimbursement "formula" in New York City's new Standard Construction Contract is long overdue. Under the apparent "catchall" rubric of "overhead," the City has included large, additional cost items – all at the same 10% overhead rate the City previously allowed. I often refer to this as the City's attempt to "shove ten pounds of manure into a five pound bag!" In all fairness, what needs to be done is for City agencies to use either a larger bag (i.e., greater than a 10% overhead allowance) or to shove fewer cost items into that same 10% overhead allowance.

Article 26 of the Standard City Contract entitled, "Methods of Payment for Extra Work," governs the pricing of change orders. It allows for the pricing of change orders through either (1) contractual unit prices, if any, (2) payment of the "actual and reasonable" cost of seven scheduled direct cost items (e.g., materials, direct labor, equipment related costs, sales and personal property taxes), plus a 10% markup for "overhead" items and a 10% profit factor, or (3) an agreed, negotiated fixed sum.

Many, if not most, change orders with New York City agencies are determined, at least in part, via the second - direct costs plus 10&10% method.

This would be simple enough, but for one conspicuous, recent omission from the direct costs category – all insurance charges for the insurance coverages required in the City's standard insurance coverage Schedule A.

This glaring inequity has gotten far too little attention. This is all the more problematic because (1) it is contrary to the City's own, long-term prior practice of correctly including all insurance charges as a direct cost item to be paid as incurred (rather than including them in the same 10% overhead limitation), and (2) it comes at a time of an historic crisis in both insurance coverage underwriting and insurance pricing.

As reported in the January 9, 2004 edition of the General Contractors Association's Newsire, quoting Jack Endryck, the Chairman of the New York State Construction Industry Council:

Construction industry members have reported to the Council that their insurance industry premiums are spiraling out of control... 'Some say their insurance costs have increased as much as 500 percent in a single year. Others report one-year increases of 300 percent. Some say they cannot buy insurance at any price.'

Schedule A insurance requirements invariably include, at a minimum, 100% performance and payment (surety) bonds, workers compensation coverage, commercial general liability insurance automobile liability insurance and builder's risk insurance. In addition, Schedule A can also require items such as Jones Act and U.S. Harbor Workers and Longshoreman's Compensation Act coverage, professional liability insurance, collision liability coverage, etc. To arbitrarily include all of these huge, additional insurance costs into the same 10% overhead factor is grossly unfair. In fact, as acknowledged privately by "undisclosed sources" within City government – it is "simply wrong," "a mistake," and "should be corrected."

The former "overhead" provision in Article 26 (i.e., pre-October 1, 2000) read:

Ten (10%) percent of the total of Items 1 - 7 (i.e., direct cost categories including one for all "insurance required by reason of the performance of the extra work") as compensation for all other items of cost or expense including administrative, overhead, superintendence, and small tools;

The new provision in Article 26 of the Standard City Construction Contract (10/1/00) states:

Ten (10%) percent of the total of items in Article 26.2.1 and 26.2.5 (i.e., the seven (7) direct cost categories, excluding all insurances required by Schedule A) as compensation for overhead except that no percentage for overhead will be allowed on payroll taxes or on the premium portion of overtime pay or on sales and personal property taxes. Overhead shall include without limitation, all cost and expenses in connection with administration, management, superintendence, small tools, insurance required by Schedule A of the General Conditions and Performance and Payment Bonds. (Emphasis added.)

Can there be any justification for “forcing” these huge additional insurance expenses into the same 10% overhead factor? Of course not.

□ Goldberg & Connolly February 2004