Avoid These Five Mistakes When Hiring a Contractor

By: Jeffrey Lerman, attorney

In all of real estate, there is perhaps no transaction that more frequently dissolves (or escalates) into litigation than the one between real estate owner and contractor. This fact has lead one judge to remark, with respect to home construction: "No reasonable homeowner can embark on a building project with certainty that the project will be completed to perfection. Indeed, errors are so likely to occur that few homeowners would be justified in resting their peace of mind on [its] timely or correct completion." Yet it is astonishing how frequently real estate owners -- from homeowners to large commercial property landlords -- fail to minimize their construction risks by exercising some basic strategies when negotiating construction contracts.

Five mistakes to avoid

Following are five negotiating errors most frequently made by real estate owners even before the first nail is hammered.

- **Insufficient scope of work** -- The single most important provision in construction contracts is the scope of work, where the parties describe precisely what will be done. In buying real estate, the mantra is "location, location, location;" in preparing the scope, it is "details, details, details." The owner must provide as much specific information as possible in communicating to the contractor precisely what is expected, what he is trying to accomplish, what the finished product should look like, and what it should do. Owners are often lulled into a false sense of security that if they simply give the contractor a set of plans, their task is complete. That is not so.

  Owners must be vigilant in their plan review, both with the architect and the contractor, to make sure they understand as much as possible in these often-technical drawings. Moreover, there are often accompanying specifications and working drawings that become part of the scope. The more plain the language included by the owner the better. For example, if the project is an office building, consider including language such as "the HVAC [heating, ventilation, and air conditioning] shall be sufficient to allow all offices on the west (sunny) side of the building to be cooled to a temperature of 72 degrees even during the hottest days of the year at the hottest times of the day." A good exercise for the owner is to sit down and list his or her most important objectives and concerns and then include that list as part of the scope.

- **Failure to consider lender requirements** -- In most projects, a construction lender is involved, and, if so, it is critical to get the lender involved as early as possible. Ask the lender to recommend two or three

contractors with whom it has had excellent experiences. By using a lender-recommended contractor, owners can leverage off that relationship to obtain assurance that the contractor will go the extra step to make it a positive experience. Also, ask the lender up front for its required inclusions in the construction contract. This avoids the necessity of having to negotiate the same contract twice (first for owner's concerns, then again for the lender's), and it enables the owner to use the "good cop, bad cop" negotiating strategy, keeping the working relationship with the contractor as positive as possible.

- **Not understanding and evaluating pricing options** - Many owners do not realize they have several pricing options. The three most common are cost plus, stipulated sum, and a hybrid: a cost plus with a guaranteed maximum (G-Max). Cost plus is the most favorable to the contractor, because it allows the contractor to be compensated for time and materials plus a percentage for overhead and profit. Stipulated sum is arguably the most even-handed, because it most closely reflects what both parties believe is a reasonable price for the agreed scope at a particular point in time. The most advantageous for the owner, however, is the hybrid. That is the only structure that gives him the benefit if a cost-efficient contractor completes the job for less than the G-Max, yet provides protection from the cost overruns frequently associated with construction projects.
- **Failing to include retention** -- It is human nature to focus your attention where you have the possibility of the greatest pleasure (profit) or the greatest pain (loss). In the context of construction, there is a real risk that as one job draws to a close and a new job begins, the contractor will be more focused on the significant profit potential of the new job rather than the relatively minimal loss potential that may result from being inattentive to final punch list (loose-end and repair-item) details of the old job. To keep the contractor's attention at the end of the job, the owner should hold back some portion -- usually 10% -- from the contractor's compensation. That way, even on a relatively small $500,000 job, the owner is still holding $50,000 at the end -- enough to hold the attention of most contractors.
- **Not including an attorney's fees clause** -- The most commonly used construction agreement form is published by the American Institute of Architects. Yet the form does not contain an attorney's fees clause. So, if you sue your contractor and win, you will not be entitled to collect your attorney's fees and costs, which could be significant. Accordingly, it is incumbent upon the owner to add this important clause to the contract.

While the above list is by no means comprehensive, if the prudent owner addresses these issues at a minimum, he will have taken important steps toward achieving that elusive peace of mind when signing the dotted line.
Jeffrey Lerman will be one of the featured speakers at East Bay Wealth Builders Wealth Builders Conference on Saturday May 21, 2005 at the San Ramon Marriott from 9 am to 4 pm. Jeffrey is a lawyer, investor and real estate broker.

He is a partner and co-founder of Lerman & Lerman and Co-chair of the Marin County Bar Association Real Estate Section. He can be reached at Lerman & Lerman, a law firm with offices in San Rafael, Los Angeles, and San Francisco that specializes in business and real estate law and estate planning; 800-553-7626 or jeff@lermanlaw.com.