Long Term Obligations

Background and Trends

Contracts with longer term obligations for the contractor's performance can create substantial risk for contractors. This durational risk is a result of the obligations created by the contract extending well beyond a time normally anticipated by a contractor during the bidding process.

Trends in the construction industry indicate that contractors can expect to encounter an increasing number of construction project contracts which create long term obligations, such as extended warranties and maintenance obligations. Extended or long term warranties, and maintenance obligations are becoming increasingly popular with public agencies, including state Departments of Transportation, and can further shift the risk for product performance, and the expense of maintaining highways to the construction contractor. Long term warranties shift responsibility to the contractor for not just defective workmanship, also but for how a road surface may wear or perform over its intended lifespan. Some contracts include warranty and/or maintenance obligations to owners with terms of five to ten years and beyond commencing at project completion.

Additionally, many construction projects have become larger, increasingly complex and are being built over longer periods of time. This requires the contractor to commit significant human, financial and equipment related resources for the duration of the project. The longer term project durations, combined with the long term warranty and/or maintenance obligations, force the contractor to commit its resources to the project for many years beyond what that same project would have required just 5 years ago.

In these situations it is sometimes possible to negotiate favorable changes to contracts and policy, particularly if the durational risks created by the contract make the contract unattractive to the sureties of the potential bidders. Negotiations with an owner can result in changes to contract terms that contain unreasonable warranty and maintenance provisions.

Definitions

Warranties are assurances or promises given by a contractor upon which the owner may rely that a particular result will be achieved. The following are samples of express (written) warranties:

1. "Materials and equipment used by the contractor will be new and of good quality"
2. "The contractor's work will be free from defects"
3. "The contractor's work will conform to the requirements of the Contract Documents"

An express warranty will often obligate the contractor (and possibly its surety) to respond to any claim of breach of the warranty for the term stated in the warranty or, in the absence of stated warranty period, until the suit limitation in the bond or applicable statute of limitations expires.

Maintenance Obligations also referred to as the "correction remedy" period, is a contract provision that obligates the contractor to return and correct defects caused by faulty workmanship or material for a given period of time. The time period usually commences upon substantial or final completion of the project. The contractor will only be responsible to correct defects in its workmanship or material; however, during the maintenance period there is typically a presumption that any defect is due to faulty workmanship by the contractor. Any problem an owner experiences during a maintenance period is likely to give rise to a demand upon the contractor to fix the problem.

Duration Risks. Some projects by their nature call for completion dates extending many years after project commencement. As the duration of any given the project increases, so too does the risk of contractor default. The default risk is further increased on those projects with long term maintenance or warranty obligation.

"Pass through" and "pass around" warranties from manufacturers may serve to reduce, but not eliminate, the contractor's exposure to long term warranty obligations. These warranties are provided direct to the owner from what is most typically a manufacturer of materials or components that were incorporated into the project. Often they are specified in projects involving roofing or for components of wastewater and water treatment plants. The use of these warranties as required by project owners will provide the owner warranty protection, but should not be viewed as eliminating this warranty exposure to the prime contractor. It is possible that when the time comes to make a claim, the manufacturer may no longer be around or the manufacturer may raise defenses to performing, perhaps alleging workmanship issues and improper installation, in order to void the warranty. Also, it is important to note that these may only provide remedy on materials and not labor.

Long Term Warranties Compared to Latent Defect Liability

No discussion of long term obligations would be complete without a mention of latent defects. Warranty obligations are generally easy to identify; they are typically in writing for a defined period of time. A latent defect is a hidden, concealed defect which was not readily apparent to the owner at the time of construction. The contractor's obligation to provide a project free from latent defects is often implied by case law or statute in the jurisdiction where the project lies. In addition, many contracts contain the express warranty that the contractor will provide a project free of defects.

In the event that the contractor fails to perform its work in accordance with plans and specifications, he may be liable for latent defects even if the defect is discovered after the warranty period has expired.

To determine the length of time the contractor could be held responsible for latent defects one must review: 1) any statutory limitation period in the jurisdiction concerning latent defect suits, and/or 2) the statute of repose in the relevant jurisdiction.

Long Term Obligations and Contractor Risk

1. As the project duration increases, it becomes more likely that the contractor will have to forgo other bidding opportunities as he is forced to invest critical resources for long periods of time. This reduces the contractor's ability to respond to varying market conditions.

2. As the contractor's duration exposure increases, it is exposed to increased subcontractor/supplier risk of nonperformance and other unforeseen risks that may not be adequately priced in the bid.

3. In a warranty/maintenance situation, there are no remaining contract balances to offset a contractor's costs. The longer the duration of the warranty, the more difficult it is for the contractor to price this future exposure.

4. How is the project being financed; public or private? If privately financed, a contractor on a long duration project should give consideration to the financial stability of the project owner.

5. The contractor should give consideration to including provisions within the contract to handle delays caused by public protest or other public related causes, time extensions for scheduling impacts due to design problems and potentially weather related issues. The contract should address both time and extended overhead (both field and home office).

6. Does the contract have price escalation clauses for key components (asphalt, fuel, concrete and steel)? Particularly on long duration projects, the contractor should consider steps to mitigate against the risks of increased prices for raw materials.

7. In order to properly price the work, the contractor should review the contract for both explicit and implicit warranty/maintenance requirements. Implicit requirements could include such things as joint and several manufacturers' warranties that a joint venture partner may be obligated to sign.

Warranty/Maintenance Duration

1. Specific attention should be paid to what triggers the start of the warranty/maintenance period.

2. The contract should clearly define what the triggers are for a warranty claim against the contractor, how the nonperforming work should be corrected, and what the appeal process is in the event of a dispute.

3. What is the surety's obligation for the warranty? Often, owners require the performance bond to continue through the warranty period. Since the performance bond is often the full value of the contract, this can expose the contractor to correct defective work up to the full amount of the contract. A contractor should consider negotiating for a specific surety bond penal sum applicable only for the warranty/maintenance obligation. The penal sum can be based upon a percentage of the total contract price or for the specific value of that portion of the project to which the warranty or maintenance obligations applies.

Potential Negotiation Points When Faced with Long Term Obligation Provisions

Specific proposals that can be made in an effort to mitigate undesirable risk in warranty and/or maintenance obligations include:

1. Create a line item in the bid for the contractor for long term obligations. These funds can be disbursed to the contractor over the life of the warranty and/or maintenance obligation. This would also serve to illustrate to the owner the premium it is paying for the extended warranty or maintenance.
2. Reduce the amount of the bond to a percentage of the original contract price, for example ten percent (10%).
3. Owner accepts manufacturer's warranty as sole remedy for any warranty issues relating to the product provided by that manufacturer.

Summary

Pricing of extended duration projects should be done after careful consideration of the risk being assumed by the contractor and the long term costs of discharging its obligations under the contract. The greater the duration of the obligation, the greater the uncertainty faced by the contractor and the greater the difficulty faced by the contractor in properly pricing the project in order for it to be profitable. Consideration should be given to the mitigation of long term risks through negotiation of onerous contract terms and through mitigation of a contractor's additional exposure through its surety bond.

TRAVELERS

Travelers Casualty and Surety Company of America and its property casualty affiliates, One Tower Square, Hartford, CT 06183
travelersbond.com