

**ELEVENTH ANNUAL  
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CONFERENCE**

**RELETTING A UNIT PRICE CONTRACT  
HOW NOT TO LOSE YOUR SHIRT**

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## **RELETTING A UNIT PRICE CONTRACT HOW NOT TO LOSE YOUR SHIRT**

You will note that we have not cited any case law or statutes or court of claim decisions. This paper is intended to be a practical discussion of the unique issues that arise in the context of a default on a unit price contract. The paper is based upon practical experience of architects, engineers, and contractors associated with Forcon. It is our hope that the paper and our discussion will provide a starting point for handling claims involving unit price contracts.

A performance bond claim involving a unit price contract presents the surety claims handler with a number of potential pitfalls that if not identified and addressed can lead to disastrous results. The purpose of this paper is to try to identify these pitfalls and also provide some tips on how to minimize or eliminate the impact of these pitfalls.

A unit price contract is one in which the contractor agrees to perform various portions of the work on a fixed unit price but in which the number of units is variable. For example, in a highway contract the contractor agrees to supply and install stone base for a certain price per ton and to provide pavement marking for a certain price per linear foot. In this way the Owner may control the quantity of work performed and the contractor eliminates the bid risk in mis-estimating the quantities of work. Unit price contracts are commonly used on highway projects and pipeline projects.

### **CLAIM SITUATION**

For purposes of this paper we can assume that the termination of the unit price contract was proper and that there are no defenses to the default termination. Also for purposes of this paper we are assuming that the bond form allows the surety to either tender a bid or takeover and complete the contract.

One of the first steps to be taken by the surety in addressing a default and termination of a unit price contract is obtaining the principal's original bid from either the principal or the obligee. It may be prudent to obtain the information, if possible, from both sources. In addition, the Surety should obtain copies of all other bids for comparison. Often times the bid and related documentation may be different or reveal information that will assist the surety in evaluating its obligations. The original bid should be reviewed in an effort to determine problem areas with the bid. The principal may have under-bid the project in a number of key areas. The principal may have bid the project believing that a certain quantity would increase substantially over the estimated quantities and adjusted his price accordingly; however, the increase in the specific unit did not materialize. This information will help the surety in the rebid process particularly when it comes to analyzing the reprocurement bids.

If the defaulted contract was a unit price contract the surety should rebid on a unit price basis. There are almost no situations in which such contracts should be rebid on a lump sum basis. There is always the chance that the estimated quantities will decrease and if the unit price contract is rebid at a fixed price the surety may be stuck with paying the completion contractor more than it is entitled to. In addition, dealing with many quantity changes by change order to a lump sum contract can become an administrative nightmare.

The preparation of the bid package is the first opportunity that the surety has to address the unique problems that can arise in rebidding a unit price contract. There are a number of components of the bid package that the surety must pay close attention to in preparation and subsequent review of the reprocurement bids.

## **QUANTITIES**

The surety should never assume that the remaining estimated quantities are correct. In some instances the original estimated quantities are mere projections based on an early assessment of needs; final quantities will reflect changes in budget or priorities. The surety's actions in investigating the remaining quantities are perhaps the most important component of the reprocurement bid package. The surety should try to limit the margin of error in this component by determining as close as possible the remaining quantities. Generally, the Owner approves additional quantities on each pay application thereby progressively revising the approved quantities. For some items, however, progress payments are made on an estimated basis subject to final review by the Owner. A common example is borrow material. Progress payments will usually be made based upon a load count estimate. The load count is an easy but inaccurate means of estimating borrow excavation. Therefore, at the end of the project the Owner will cross section the borrow pit to determine the actual amount of excavation and make an adjustment to the final approved borrow material quantity. Thus there is often a large positive or negative adjustment to the borrow material quantity shown on the final pay application even though no material was removed for that pay period.

In an effort to get a handle on the remaining quantities the surety should obtain the previously approved payment applications. The pay applications will have the original contract estimated quantities as well as the quantities supplied by the principal. This will give the surety a starting point in ascertaining the remaining quantities. The surety should also consider a request to the obligee to again survey or inventory the remaining quantities necessary to complete the project. The obligee may balk at this request due to the cost involved; however, it may be in the surety's best interest to reach some type of cost sharing agreement with the obligee to determine the remaining quantities. If this is not possible the surety should try to determine the remaining quantities itself. This may be difficult and expensive since the surety may not have access to information necessary to make this determination. In addition the Surety will want to have an accurate estimate of quantities for line items that are paid on an estimated basis (like borrow material). To do this the Surety may have to insist on the Owner performing cross sections or the Surety will have to perform its own survey.

Another possible way to address the potential for increase in quantities is to obtain an agreement from the obligee to limit the remaining quantities to a finite number or in the alternative to obtain the obligee's agreement to limit the possible increase in quantities to an acceptable percentage of the remaining estimated quantities. This may not be possible. However the surety should consider this approach if there is a large spread between the principal's original unit price on a particular item and the completion contractor's price. This is especially important when the surety suspects a substantial increase in the quantity of that item.

Since the quantities in a unit price contract are variable there may be no way to accurately determine or predict the remaining quantities. However, even obtaining the remaining estimated quantities would be beneficial to the surety. As stated, this exercise can start with a review of the pay applications.

Why all the concern regarding the identification of the remaining quantities? By identifying the estimated quantities remaining the surety is in the better position to prepare a thorough bid package and undertake a knowledgeable evaluation of the reprourement bids.

For example, the bidders may have information that certain quantities will increase while other quantities will decrease and price the units accordingly. That is, the bidders could price the units in such a fashion so as to take advantage of the quantities that are going to increase but still appear to have a competitive bid. The profit laden items when extended (multiplied) by the remaining estimated quantities may appear to be small, however the bidder knowing that those quantities will over-run expects to profit from the imbalanced bid. The surety, if they do not have the same information, is not alerted to the potential problem. The problem, of course, is that on the increased quantities the surety will receive compensation based on the principal's original unit price but have to pay the completion contractor at a substantially higher rate.

As part of the investigation process the surety should review the status of any change orders that may increase the estimated quantities. In doing so the surety should try to interview the principal's project manager and superintendent as well as a representative of the obligee. There may be some knowledge on the part of these individuals that there is going to be an increase or even a decrease in estimated quantities. This information can assist in the evaluation of the reprourement bids.

If the surety has a handle on not only the remaining estimated quantities but also the potential for increase in the estimated quantities it can at least be aware of the potential increase exposure and even take steps to minimize the potential impact on the performance bond loss. The effort to minimize this potential impact can be done either through capping the possible increase in estimated quantities through negotiations with the obligee or through negotiations with the completion contractor on the unit price.

Generally, the surety should request bids using all of the items in the original bid. However, it is often appropriate to add a mobilization item. The completing contractor will have to cover the cost of mobilization somewhere and it would be far preferable to earn that amount in a separate line item than to load up, say, the concrete item only to have it over-run (increasing the surety's loss) or under-run (resulting in the contractor calling foul). Likewise if remedial work is required a separate line item could be added for just the remedial work. Adding these items also eases pay application administration because the surety can compute the earnings for each pay period based on the approved quantities plus the few special items added by the surety.

## **UNIT PRICE**

The surety has to closely review the bids received by the bidders to make sure that an apples to apples comparison is being made. The surety should also review the bids against the principal's original bid. In order to do this the surety should utilize the same bid form as submitted by the principal. Reviewing the unit price may disclose issues relative to the remaining estimated quantities. A substantial spread in the unit price may be indicative of some knowledge on the part of the bidder of potential increase or decrease in certain quantities. The surety should undertake a thorough review and analysis of the bids.

## **BID REVIEW**

The investigation conducted by the surety to prepare the bid package can be in vain if the bid review is not given the same attention. This statement is true not only for a unit price contract situation but is true for any contract performance bond default. It is imperative that the review process also includes the original bid from the principal. The surety is only going to receive compensation from the obligee based upon its original unit price and not those of the successful bidder whose prices are invariably going to be higher.

The bid review process also makes it clear that utilization of the original bid form is important. As stated the surety must be comparing apples to apples. If the surety develops its own bid form to take into account issues not relevant in the original bid the surety should use the original bid as a framework.

The bid review process may reveal heretofore unknown potential quantity overruns. You can count on the fact that the bidders will probably know more about the project than you do. For the most part they will have bid the project when the principal did. Also, the previous bidders will know if it was this particular unit price that lead to or contributed to the principal's situation.

The bidders may include alternates in their bids to the surety. The surety, unless it requested the alternates in the bid package, should not consider an alternate in the bid evaluation. The surety, after award, may want to discuss the proposed alternate with the obligee. Even though the alternate may propose a less expensive and quicker method of accomplishing a contract requirement considering the alternate in evaluating the bids is not comparing apples to apples.

## **MATERIAL**

In anticipation of preparing the bid package the surety needs to identify and quantify material stored on-site, material stored at other locations such as principal's office or in a warehouse, and materials stored at other projects. The surety also needs to determine if the materials have been paid for by the obligee. The surety also needs to determine if there are any specially fabricated materials that have been ordered prior to the default. The stored material for which the obligee paid the principal prior to default presents the greatest challenge.

If the material (other than specially fabricated material) is on site or stored off-site but not yet paid for the surety can send the material back to the supplier. The surety will probably have to pay a restocking fee. The lead time in reordering this material should be considered. Another option for the surety is to advise the bidders in the bid package of the fact that there are materials available but not yet paid for and give the bidders the option of utilizing the material which would

also include the payment obligation. The completion contractor's first pay application could include payment for the materials in questions. This procedure could work in the situation where the surety has tendered the completion contractor to the obligee. However, if the bidders decline the surety may have to return the material and pay the restocking fee.

A third option is for the surety to pay for the materials and indicate in the bid package that the surety will be supplying the noted materials. The bid instructions should make it clear that the bid should include the labor for the installation of the furnished material. Payment from the obligee could be included in the first pay application. This concept would work in a situation where the surety is going to takeover and complete the contract; however the surety then takes on the risk that the materials have been damaged while in storage or are otherwise unacceptable.

Another problem regarding materials not yet paid for by the obligee arises in the context of specially fabricated materials. Often the surety is obligated under the payment bond to pay for specially fabricated materials even if they are not actually incorporated into the project. The surety should draft the bid package to make it clear to the bidders that any specially fabricated materials ordered by the principal prior to default are to be used by the bidders without exception. This recommendation holds true whether or not the materials in question have been paid for by the obligee.

The surety also will have to address situations in which the obligee has paid for stored materials. Hopefully the principal paid the supplier for the stored materials. However, the following comments are applicable in any regard. As stated the unit price includes the cost of material as well as labor for the installation. This holds true for the bids received by the surety for the reprocurement and the original bid submitted by the principal.

Once again the initial investigation of the project will help the surety address this contingency. First, the surety must obtain an accurate inventory of the paid stored materials. A review of the pay applications is a good starting place to review the quantity of stored materials as well as determining what portion of the stored materials have been paid for by the obligee prior to default. Although the obligee will have paid for the stored materials the surety should satisfy itself that all the materials are in fact on site and they are good condition. If the inventory reveals a shortage or defective material the surety can draft the reprocurement package accordingly or even resolve the issue of missing and or defective stored material prior to release of the reprocurement package.

In drafting the bid package the surety must require the bidders to give a credit for the stored materials. The credit should be a separate line item in the bid form. The amount of the credit should not be the determining factor in the bid evaluation. However, the credit should be equal to or come close to the amount paid by the obligee for the stored materials. After a thorough evaluation of the bid the surety can tender the lowest responsive and responsible bid.

Although not directly involved with the negotiations of the completion contract between the obligee and the completing contractor the surety has to sell the tender concept to the obligee. The surety will have this burden in almost every tender situation; however, the issue relative to the stored materials may make the surety's sales job a little more difficult.

If the credit to the surety from the completion contractor is the same as the amount paid for

the stored material the task of convincing the obligee to accept a tender will be the same as in a fixed price contract. However, if the credit is less than the amount paid for the stored material the obligee merely has a paper work problem. They will receive from the surety sufficient funds, if required, in excess of the contract balance to complete the project.

## **TENDER OR TAKEOVER**

One of the primary motivations for a surety to proceed with the tender option is that the surety is out of the picture once it pays to the obligee the difference between the completion contractor's bid and the remaining contract balance. However, this particular motivating factor is not completely present in a unit price contract. The difference between the principal's price and the completion price is uncertain until the final quantities have been determined.

The surety may be better served to takeover and complete the unit price contract. Given the inherent problem in a unit price contract in ascertaining the final quantities the surety may need to maintain control over the completion of the project. There may be an issue as the exact quantity of a unit supplied or removed by the principal prior to default that will not be resolved until the final quantities are determined. The surety may want to take over the project and complete under these circumstances to ensure that there is the appropriate equitable adjustment to the amount earned by the principal prior to default of the underlying contract.

The surety will want to draft the takeover agreement so that the payment provision mimics that of the underlying contract. Also the surety should retain the decision as to whether to accept an increase in quantities should the obligee propose to increase the original contract quantities. This must be done because, as stated earlier, the surety will only be paid the unit price under the principal's original contract and will have to pay the completion contractor, more than likely, an increased unit price.

Please note that many unit price contracts have a provision that allows for negotiated increases in unit prices when the quantities exceed the original estimated quantities by a certain percentage. The surety should consider whether to pass this automatic increase down to the completing contractor.

## **CONCLUSION**

As with any default situation the surety has a number of different issues to be concerned with when addressing their bond obligations. The fact that the default involves a unit price contract does not decrease the concerns but adds to them.

The surety has to pay particular attention to the quantity issue and the interplay between the unit price and remaining estimated quantities when evaluating the bids. The surety should gather as much information from as many sources as possible in estimating the remaining quantities. The surety may be tempted to award a completion contractor to the low bidder. However, a thorough review of the procurement bids may reveal that the low bid may not, in fact, be the low. If the surety has done a thorough analysis of the remaining estimated quantities it will be in a position to evaluate the bids and identify the bid that does not gouge on the quantities that the surety has identified the most likely to increase during the course of the project.

To borrow a paraphrase from real estate world, it's investigation, investigation and investigation.