

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6515

To: Members, Subcommittee on Contracting and Workforce and Subcommittee on Investigations, Oversight, and Regulations
From: Committee Staff
Date: May 22, 2017
Re: Hearing: “All Work and No Pay: Change Orders Delayed for Small Construction Contractors”

The Committee on Small Business Subcommittees on Contracting and the Workforce and Investigations, Oversight, and Regulations will meet for a hearing titled, “All Work and No Pay: Change Orders Delayed for Small Construction Contractors.” The hearing is scheduled to begin at 10:00 A.M. on Thursday, May 25, 2017, in Room 2360 of the Rayburn House Office Building. This hearing seeks to understand: (1) the impact delayed processing and payment of change orders has on small business construction contractors, (2) whether agencies are deliberately delaying change orders, and (3) if the legislative solution proposed will alleviate the small business issues raised.

I. Overview

a. The Need for Contract Modification

Modifying contracts to mitigate unknown or changing factors discovered during contract performance is practically unavoidable on construction projects¹ and is essential to fulfill the needs of the procuring agency. Without this ability, taxpayer dollars could be unnecessarily spent on goods and services that no longer suit the purpose of the procurement.² For example, changes to a construction contract may occur to correct flawed specifications, adapt to unforeseen circumstances, and/or include improvements in design. Authorized contract modifications allow equitable compensation be paid to the contractor for the extra work and costs associated with the changes.³

The Federal Acquisition Regulation (FAR) governs the acquisitions process used by most executive agencies of the United States government to procure goods and services through the use of federal contracts. The FAR also regulates activities of government personnel in carrying out that process. Generally, there are two types of contract modifications under the FAR: (1)

¹ Jaydeep N. Desai et al., *A Review on Change Order and Assessing Causes Affecting Change Order in Construction*, 2 J. OF INT’L ACAD. RES. FOR MULTIDISCIPLINARY 152, 152-153 (2015).

² DONALD H. GATCHALIAN, *A STUDY OF CONSTRUCTION CONTRACT MODIFICATION: CAUSES AND IMPACTS* 16 (Ga. Ins. of Tech. ed., 1990).

³ *Id.* at 23-24.

bilateral modifications reflecting a mutual agreement to modify the terms of the original contract;⁴ and (2) modifications made by the government within the scope of the contract without the contractor's consent.⁵ Change orders are written directives falling under the latter category.

b. The Source of Authority for Change Orders – the Changes Clause

A "change order" is a written order, signed by the contracting officer (CO) that unilaterally directs changes in the terms and/or conditions of the original agreement between the agency and the contractor.⁶ This authority derives from the changes clause found within most government contracts⁷ and vests the CO with the sole authority to bind the government to changes to a contract, with limited exceptions.⁸ The CO may seek expert consultation;⁹ however, the decision to issue a change order ultimately rests with the CO. This sole authority ensures that the contractor performs only authorized work for payment. Work performed pursuant to improper direction by unauthorized personnel can result in claims brought against the agency and puts the contractor at risk of losing compensation for the work rendered.¹⁰

In addition to limiting issuance authority to the CO, the changes clause is limited to changes made within the general scope of the contract.¹¹ This limitation provides the government with a vehicle to order additional or modified work quickly and relatively easily without expending additional resources to initiate new and lengthy acquisitions procedures.¹²

II. Small Contractor Issues with the Federal Change Order Process

Federal regulations and agency guidance, when it exists, require change orders be made promptly and equitable adjustments be negotiated in the shortest amount of time practicable.¹³ Contractors collectively agree that delays in processing and payment of change orders are critical issues threatening the success of projects, adversely impacting business viability.¹⁴

a. Work on a Promise Without Guaranteed Payment or Risk a Lawsuit

⁴ FAR 43.103(a). Bilateral modifications fall outside the scope of this memorandum.

⁵ FAR 43.103(b). Unilateral modifications are used for several other reasons besides issuing change orders, i.e. to terminate a contract, extend options years, or suspend work, which are all outside the scope of this memorandum.

⁶ FAR 43.201; FAR 2.101.

⁷ Almost all government construction contracts contain a changes clause. FAR 42.201(a). There are three changes clauses for construction contracts contained in the FAR: 52.243-1 (Fixed Price), 52.243-2 (Cost Reimbursement), and 52.243-3 (Time and Materials).

⁸ FAR 43.202; FAR 1.602-1.

⁹ FAR 1.602-2(c). For example, the CO may consult with a transportation expert concerning a metro-rail contract.

¹⁰ FAR 43.104. Contractors must confirm with the CO whether changes are officially sanctioned.

¹¹ FAR 43.201(a). Out of scope changes are considered new procurements and can be sources of contract disputes.

¹² GATCHALIAN, *supra* note 2, at 17.

¹³ FAR 43.204(b)(1); GAO, VA CONSTRUCTION: ADDITIONAL ACTIONS NEEDED TO DECREASE DELAYS AND LOWER COSTS OF MAJOR MEDICAL-FACILITY PROJECTS (GAO-13-302) (2013).

¹⁴ Daniel F. McLennon, *California Needs Legislation Requiring Timely Processing of Change Orders on Public Construction Projects*, ENGINEERING NEWS-RECORD LAW TODAY, May 30, 2016, at L9.

On federal construction projects, the prime contractor is responsible for managing a number of subcontractors, while also overseeing a tight project schedule. When the government requests changes to a contract, timelines adjust and contractors must stay on schedule as required by the terms of the contract, or risk being found in default. Many small contractors take a proactive approach and proceed with performing change order work—without waiting for a formal, written change order notice from the federal agency. They may instead rely on verbal promises that they will obtain payment for the change order work later. Until a formal change order is processed, there is no contractual amount for the contractor to bill against. Therefore, small business contractors end up performing upon verbal promises, financing portions of the agency’s construction project for extended periods of time, awaiting the formal order.¹⁵ This risky gamble leaves small businesses unprotected and unpaid for work performed at the instruction of the federal representative without official notice.¹⁶

b. Change Order Delays Increase Financial Burdens on Small Subcontractors¹⁷

Construction subcontractors, largely comprised of small businesses, are generally at the greatest risk of financial distress.¹⁸ Large businesses have more flexibility because they have greater amounts of working capital.¹⁹ Conversely, smaller operations have limited working capital and thus require a predictable and stable cash flow... Yet, they are the farthest removed from payment. Having a steady, uninterrupted cash flow to meet payroll and other required expenses is critical to small contractor sustainability.

On contracts where the prime contractor takes a management role as opposed to actual construction, the small subcontractors are the main entities performing the bulk of the labor. Thus, it is the small subcontractors that must pay “out of pocket” (for extra building materials, more workers, expensive machinery rental, etc.) and perform the changed work ordered by the agency, despite the financial strain this causes.²⁰ Delayed change orders invariably mean an extension of overhead, labor and equipment costs, and loss of future work. For many small contractors, this situation is untenable. Many rely on bank loans and lines of credit to bridge the gap, raising the risk of bad credit or worse, becoming insolvent due to the inability to pay back loans on time due to delays in agency payment.²¹ Small businesses that have completed change

¹⁵ *Id.*

¹⁶ *Continuing Challenges for Small Contractors: Hearing Before the Subcomm. on Contracting and Workforce of the H. Comm. on Small Business*, 114th Cong. 8 (2015) [hereinafter *Hearing*] (statement of Edward T. DeLisle).

¹⁷ Subcontractors are afforded some legal protections through the Miller Act of 1935, the 1988 Amendments to the Prompt Payment Act, and Section 8(d) of the Small Business Act. However, these protections do not address the problems outlined here and are outside the scope of this memorandum. KATE M. MANUEL, CONG. RES. SERV., LEGAL PROTECTIONS FOR SUBCONTRACTORS ON FEDERAL PRIME CONTRACTS (2014).

¹⁸ AM. SUBCONTRACTORS ASS’N., CONTRACT CHANGES AND CLAIMS: CONTRACTUAL AND LEGAL BASIS OF ENTITLEMENT TO SUBCONTRACT ADJUSTMENT 1 (2015),

<https://www.asaonline.com/eweb/upload/Contract%20Changes%20and%20Claims%20-%20Contractual%20and%20Legal%20Basis%20of%20Entitlement%20to%20Subcontract%20Adjustment.pdf>.

¹⁹ McLennon, *supra* note 14.

²⁰ Kim Slowey, *The Dotted Line: How Construction Firms can Manage the ‘Necessary Evil’ of Change Orders*, CONSTRUCTION DIVE (July 12, 2016), <http://www.constructiondive.com/news/the-dotted-line-how-construction-firms-can-manage-the-necessary-evil-of/422390/>.

²¹ *Hearing*, *supra* note 16 (statement of Edward T. DeLisle); David Migoya & Mark Matthews, *Aurora VA Hospital Project Spooked Subcontractors, Causing Cost Hikes*, DENV. POST (May 15, 2015), <http://www.denverpost.com/2015/05/15/aurora-va-hospital-project-spooked-subcontractors-causing-cost-hikes/>.

order work but are waiting for payment have a minimized bonding capacity, making it harder for them to obtain new jobs.²² If the small contractor reaches its maximum bonding capacity due to these delays, the bonding surety may be unwilling to bond the small contractor for any additional new work.²³ The impact of delayed change orders compound when multiple orders accumulate.²⁴ Many small business contractors go out of business due to unprofitable projects, many of which involve excessive change-order related delays.²⁵

c. Dispute Resolution

The FAR 43.201(b) directs the contractor to continue performance of the contract as changed, even when the change order is disputed,²⁶ with limited exceptions.²⁷ The continue-to-work requirement is necessary to mitigate project schedule delays and other issues that might throw a project off course.²⁸ This provision flows down to lower-tier subcontracts. Once a prime directs a change to the subcontractor, the subcontractor must give prompt and clear written notice to the prime identifying the particular action, condition, or direction of the change to the original agreement. Subcontractors usually have no legal or contractual right to stop work and must perform, particularly when the work is essential to complete the subcontract.²⁹

If the subcontractor refuses to perform, the prime contractor could terminate the subcontractor for breach of contract and hold the subcontractor liable for excess costs incurred. If the subcontractor chooses to perform, the subcontractor bears the resource burdens until the dispute is resolved. Faced with this decision, many small subcontractors opt to perform. The dispute may end favorably, resulting in an equitable adjustment for the subcontractor. When the subcontractor loses the dispute, consequences can be extreme.³⁰

III. Case Study – Department of Veterans Affairs Change Order Processes

In 2013, the Government Accountability Office (GAO) examined the Department of Veterans Affairs (VA) construction processes, finding deficiencies in its change order process

²² 40 U.S.C. § 3131. Any federal construction contract valued at more than \$150,000 requires a payment bond and performance bond be furnished as a precondition of contract award. A payment bond ensures suppliers and subcontractors are paid for the work performed under the contract. A performance bond ensures the contract will be completed according to the terms and conditions of the federal construction contract.

²³ E-mail from Lenore Marema, Change Orders & Surety Bonds Comm'n. to author (May 1, 2017, 14:54EST) (on file with the Committee).

²⁴ *Hearing, supra* note 16 (statement of Edward T. DeLisle); Reginald M. Jones, *Lost Productivity: Claims for the Cumulative Impact of Multiple Change Orders*, 31 PUB. CONTR. L.J. 1, 8-11 (2001).

²⁵ GATCHALIAN, *supra* note 1, at 36.

²⁶ FAR 52.233-1(i).

²⁷ FAR 43.201(b).

²⁸ Small businesses claim COs direct changes in the scope of work even when they lack funding to do so. Neither FAR subpart 36 nor FAR Part 52.243.4 impose obligations on COs to ascertain whether funds are available prior to directing a change despite the requirements of FAR Part 43.105 (Availability of Funds) and the prohibitions of 31 U.S.C. § 1341 (Anti-Deficiency Act). Letter from Design-Build Instit. of Am., to Anne Rung, Admin. for Fed. Procurement Pol'y (Mar. 18, 2015),

http://www.dbia.org/advocacy/federal/Documents/150318far_petition_to_fund_change_orders.pdf.

²⁹ AM. SUBCONTRACTORS ASS'N., *supra* note 18.

³⁰ *Id.*

for select VA construction projects.³¹ GAO found that no time frames were established for processing change orders, and the VA did not systematically track time frames, despite delays impacting project cost and schedules.³² Change order processing averaged 2-3 months, but sometimes took as long as 6 months, even though staff were directed to minimize delays.³³ Officials from other agencies that construct buildings of comparable size and value told GAO that issuing change orders should take only a few weeks to a month.³⁴ Separate reports showed the VA halted processing change orders altogether from September 2011 to 2012 for one hospital building,³⁵ leaving small business contractors without payment or resolution. GAO stated in its March 2017 follow-up report that the VA is taking steps to improve their change order process, but still lacks essential milestone data (i.e. processing timeframes, reasons for change orders) and is unable to clearly measure the impact of its improvements.³⁶

This delay in payment and processing of change orders had devastating effects. According to statements made by the head of Colorado's Small Business Administration Office in 2013, \$41 million in payments to subcontractors had not been made. At that time, the project was only 15 percent complete; however, at least 33 subcontractors were already in financial distress due to lack of payment for work completed. Some subcontractors had not received payment for work completed over a year ago,³⁷ and two small businesses filed for bankruptcy.³⁸ In February 2013, a letter written to then-U.S. Rep. Ed Perlmutter noted more than 100 change orders totaling \$10 million remained untouched for months. Nearly two dozen small subcontractors were left unpaid. The letter also indicated some small subcontractors, including minority-owned firms, experienced financial insolvency due to the delay.³⁹

IV. The Effects of Change Order Delays on the Government

Agencies and projects with a reputation for poor change order processing also cause unnecessary over-expenditures of taxpayer dollars to finance increasingly higher bid prices forced upon agencies. For example, GAO testified before the Senate Committee on Veterans' Affairs that deficiencies in the VA's construction processes resulted in cost-overruns of over \$2.4 billion.⁴⁰ Schedule delays ranged from 14 to 86 months.⁴¹ Many small subcontractors intentionally avoided bidding, opting to invest in less-risky options instead.⁴² This severely

³¹ *Id.* at 28-32.

³² *Id.* at 24.

³³ *Id.*

³⁴ *Id.* at 25.

³⁵ Migoya & Matthews, *supra* note 21.

³⁶ GAO, VA CONSTRUCTION: IMPROVED PROCESSES NEEDED TO MONITOR CONTRACT MODIFICATIONS, DEVELOP SCHEDULES, AND ESTIMATE COSTS (GAO-17-70) (2017).

³⁷ Cathy Proctor, *Colorado SBA Complains of Small Businesses Not Being Paid for Work on VA Hospital Project*, DENV. BUS. J. (Apr. 4, 2013), <http://www.bizjournals.com/denver/news/2013/04/04/colorado-sba-chief-raises-concerns.html>.

³⁸ Cathy Proctor, *SBA: Progress being made on Helping Unpaid VA Hospital Subcontractors*, DENV. BUS. J. (Apr. 4, 2013), <http://www.bizjournals.com/denver/news/2013/04/04/sba-urges-va-to-speed-payments-for.html>.

³⁹ Migoya & Matthews, *supra* note 21.

⁴⁰ GAO, VA CONSTRUCTION: ACTIONS TO ADDRESS COST INCREASES AND SCHEDULE DELAYS AT DENVER AND OTHER VA MAJOR MEDICAL-FACILITY PROJECTS (GAO-15-564T) (2015).

⁴¹ *Id.* at 3.

⁴² Migoya & Matthews, *supra* note 21.

diminished the pool of competitive subcontractors willing to assume the risk of non-or late payment by the VA. Bidders inflated prices to account for the risk, in some cases over \$1 million higher than VA had budgeted.⁴³

Furthermore, government projects plagued with excessive change orders are more likely to suffer indirect effects, such as a decrease in productivity, quality, low morale, and operational problems. Excessive change order delays can also poison the relationship between the parties (government, contractors, subcontractors, and suppliers) creating an adversarial atmosphere, resulting in lengthy and costly litigation to resolve disputes.⁴⁴

V. Allegations of Unfair Change Order Negotiation Strategies Used by Agencies

The construction community has voiced concerns that agencies may be engaging in unethical negotiation practices. For instance, agencies may deliberately leave change orders unpaid and unexecuted until the project nears completion as a means to leverage its position for discounted payments for earlier performed changed work. Contractors that have already completed and self-financed the work may be desperate to reclaim any payment, thus agreeing to a lesser amount than owed.⁴⁵

Similarly, agencies may state up front no formal change orders will be issued on a project, however, contractors must continue to perform work and file a claim when changes do inevitably arise. The claims process itself can be protracted, risky, and prohibitively expensive. Unlike the government, small contractors do not have the time and resources to incur thousands of dollars in legal fees for the potential benefit of being paid pennies on the dollar, so again they often settle for lesser amounts.⁴⁶ Agencies often have two separate funding accounts, one for projects and another to litigate and pay claims. With agency budgets becoming increasingly limited, contracting officers may resort to unfair tactics to stay within budget, although the expense of litigating claims in the long run may cost more than issuing a formal change order at the outset.⁴⁷

VI. Legislative Solutions

a. Small Business Payment for Performance Act of 2017

On May 18, 2017, Representative Brian Fitzpatrick (R-PA-08) introduced the *Small Business Payment for Performance Act of 2017*, which seeks to offset some of the financial risk imposed on small businesses when change order processing and payments are delayed. This bill would require federal agencies to make interim partial payments to their small business construction prime contractors for unilateral changes in contract performance directed by the buying agencies. The bill allows a small business prime to request an equitable adjustment – an

⁴³ *Id.* The sole bid on a project was nearly \$4.2million, about \$1.7million higher than the VA had budgeted.

⁴⁴ GATCHALIAN, *supra* note 2, at 41-42.

⁴⁵ ASSOCIATED GENERAL CONTRACTORS OF AM., AGC URGES CONGRESS TO ENACT NEW PROJECT STREAMLINING PROVISIONS IN WRRDA 2016 2 (undated).

⁴⁶ *Hearings, supra* note 16 (statement of Edward T. DeLisle).

⁴⁷ *Id.*

increase in fee – for the additional work ordered by the buying agency. The request must be made timely and specify the estimated cost of performance. Once the agency receives the request for equitable adjustment, the contractor may submit invoices for actual work performed pursuant to the change order. The agency must make an interim partial payment of at least 50 percent of the invoiced work, within the time frame specified by the Prompt Payment Act.⁴⁸ This partial payment does not prejudice the rights of either party in making definite the equitable adjustment amount during subsequent negotiations. To ensure that the partial payments are properly distributed, the small business prime contractor must pay its first-tier subcontractors and suppliers impacted by the change within seven days of receipt of the partial payment. Those entities must pass the appropriate amounts downward, to the last vendor.

b. H.R. 2350 Small Business Know-Before-You-Bid Construction Transparency Act of 2017

On May 4, 2017, Representative Donald Bacon (R-NE-02) introduced the *Small Business Know-Before-You-Bid Construction Transparency Act of 2017* which would provide small business contractors with important information before they make the investment in submitting a proposal. When preparing a bid, a small business must consider the federal customer’s business practices into its price. This includes the time it takes the agency to approve and pay for equitable adjustment and the validity of payment assurances. This bill addresses these concerns by providing prospective prime contractors and subcontractors with this information through a secure electronic system. Agencies would be required to post on the system payment information to the prime contractor, such as the date payments are made, payments withheld, reasons for withholding, and payment bonds provided for the contract as well as modifications to those bonds. This information would give subcontractors visibility and stability, allowing them to anticipate payments and make business decisions accordingly. It would also give the prime contractor insight into reasons why payments are withheld, so they may be corrected.

VII. Conclusion

Federal agency delays in approval and payment of change orders are detrimental for small business construction contractors. Small contractors often choose, as a lesser of two evils, to perform work without an official order in place versus risking contract termination. Small contractors must finance change order work including all associated costs. When change orders are delayed, small businesses are unable to redirect resources elsewhere, resulting in lost opportunities in addition to incurring increased expenses. Even when small businesses dispute the changed work, they still must perform and file a claim with no guarantee of prevailing.

This situation can become unmanageable for small businesses, resulting in financial distress or insolvency. When agencies engage in unethical negotiation tactics, this results in a no-win situation – small contractors suffer heavy losses, the pool of contractors willing to work with the government diminishes, prices for the government go up, and the quality of work

⁴⁸ 31 U.S.C. § 39. The 1988 amendments to the Prompt Payment Act obligates federal prime construction contractors to pay their subcontractors for “satisfactory” performance within seven days of receipt of payment from the federal agency.

decreases. Examining the proposed legislative solutions contractors may be one step forward toward helping small contractors.