

LEPATNER REPORT

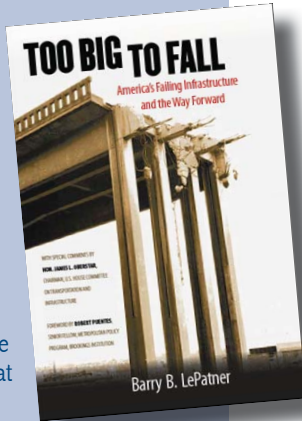
CONSTRUCTION COST CERTAINTY

SPRING 2011 VOL. 31, No. 1

A QUARTERLY FOR OWNERS AND THE REAL ESTATE & CONSTRUCTION INDUSTRY FOR 30 YEARS

TBTF News

Barry LePatner's recently published book about the neglected state of our nation's infrastructure continues to gain traction with industry insiders and thought leaders:



+ LePatner was widely quoted in an article by Nicole Gelinias, "The Tappan Zee is Falling Down," that reveals the sad history of that bridge replacement project in the Spring 2011 issue of the *CityJournal*. [www.city-journal.org/2011/21_2_tappan-zee-bridge.html]

+ LePatner published "Addressing State and Local Funding Shortfalls for Infrastructure Spending" in the Bureau of National Affairs' *Infrastructure Investment & Policy* January issue. [www.barrylepatner.com/documents/LePatnerPDF.pdf]

+ In addition to speaking earlier this year to the Brookings Institution in Washington D.C. and graduate students at Yale University, LePatner will speak at the Manhattan Institute in June on the funding challenges facing infrastructure repair and maintenance, and at the American Council of Engineering Companies annual convention in October, where he will address the failure of the engineering profession to strongly rebut the NTSB's erroneous report on the I-35W bridge collapse [www.dehartandcompany.com/Lindsay/LePatnerNTSBReportAnalysis.pdf].

+ One of the world's largest infrastructure engineering firms has invited LePatner to consult with its new infrastructure development team to discuss an expanded role in public private partnership investments for major infrastructure projects, as well as seeking opportunities to meet with governors and transportation commissioners across the nation.

Four Golden Rules To Eliminate Cost Overruns

By Barry B. LePatner, Esq.

With new construction projects finally underway — and the industry without a single extra dollar to spend on avoidable cost overruns — developers, contractors and lenders can ensure the financial health of their projects by following the "Four Golden Rules of Construction Cost Certainty."

There is simply no reason for new construction projects to begin without cost certainties built into the contract. Owners are still taking risky shortcuts in order to unnecessarily begin construction as quickly as possible, while their lenders are not aware of or simply ignore the potential consequences. As a result, many construction projects come in 20, 30 or even 50 percent over budget. What owners, developers and lenders must know is that now there are proven methods that will protect their investments.

To help them avoid commonplace, yet unnecessary construction problems, we can offer these Four Golden Rules of Construction Cost Certainty, all time-tested, all proven to control costs:

- 1 **Rule number one requires developers to "Demand Complete Drawings."** Owners and lenders typically do not recognize the direct relationship between an incomplete set of construction documents and cost overruns. They should therefore strongly consider allowing the design team the additional time — and fees — needed to produce a fully complete and coordinated set of construction documents for bidding on a project.
- 2 **The second Rule is to "End Fast-Track Projects."** Despite the proliferation of "fast-track" projects — where construction starts "early" while design documents are still being finalized — they rarely finish earlier than if construction had commenced after the design had been given the time to be fully developed. In fact, "fast-track" always extends construction schedules and increases construction costs.

Rule #1 and Rule #2 go hand in hand. But owners rarely understand the consequences of letting the contractors' work go forward without completed design documents. Contractors readily acknowledge that these documents are incomplete and prevent anyone from pricing them fully. This sets in motion a disastrous scenario that ensures additional costs that, when schedule delays are included, can often exceed 50 percent or more of the signed contract budget.

QUOTE OF THE QUARTER

"Press on. Nothing in the world can take the place of persistence."

Ray Kroc

Four Golden Rules... *cont.*

- ▶ Surprisingly, architects and engineers go along with this situation time and time again and do nothing to warn their clients of the pending financial costs of a fast-track project.

3 **Next on the list? “Say ‘No’ to Low Bids and Say ‘Yes’ to True Fixed-Price Contracts.”** Owners and lenders should insist upon a fixed-price contract for all construction projects. Meaning, what you agree to pay contractually is what you end up paying.

Much to its own detriment, the construction industry has long accepted a process of low ball bidding, in which the lowest bid offered by a contractor is often awarded the project. Under this system, construction managers, who typically bid on incomplete drawings, often reap their greatest profits by submitting costly claims and change orders after construction has begun. This leaves the owner with little recourse but to agree to the changes and absorb the added expense. True fixed-price contracts will protect owners and lenders from these often drastic price escalations.

4 **Rule Four is “Demand On Time and On Budget Project Completion.”** As part of the construction contract, insist that projects be delivered on time and on budget. Contractors would be awarded extra compensation for doing so, or take a penalty for failing to meet those obligations. A contractor with “skin in the game” will be far more motivated to deliver the project they promised. Contractors need to assume risk in return for a fair profit.

Owners and lenders can either continue to allow the accepted, flawed industry practices to bust their budgets and jeopardize their investments, or they can insist upon a rational process that will keep them in the black.

As the financial crisis abates and credit availability enables construction projects to move forward, construction overruns will no longer be affordable, nor should they be tolerated by owners.

The impacts of construction cost management run wide. Our nation is at a critical inflection point where funds for construction — which totals nearly a trillion dollars a year — are scarce both in the private as well as the public sector.

Indeed, the need to generate a more robust economy will come from spurs in the construction industry, which generates more jobs than many other sectors of our economy. Construction helped to push us out of the doldrums of the Great Depression. And it will be the driving force once again if we do not find ourselves lapsing into the damaging and self-defeating practices of the past — practices that make delays and cost overruns virtually inevitable.

That’s why, now more than ever, it is imperative for owners, developers and lenders to recognize the critical importance of adhering to these Four Golden Rules as a means of keeping construction projects on time and on budget. ■

Deficient Health

What Are the

by Henry H. Korn, Esq.

Hospital executives throughout the country face serious consequences if hospital internal control over construction projects is deficient. The author, an expert in construction law and corporate internal investigations, has found widespread practices of irregularities and deficiencies exposing hospitals and their senior executives to significant risks in growing State claw-back programs that are intended to catch wasteful and illegal construction practices.

The intensely regulated environment in which hospitals operate magnifies the adverse consequences facing a hospital that permits deficient construction practices.

This article uses the New York regulatory environment as an example, but the fact remains no matter which state hospitals operate in, the intense regulatory and enforcement environment can be found nationwide. The concern is nationwide. In speaking of wasteful hospital practices that deplete tax dollars, especially relating to Medicaid, former Attorney General of Florida William McCollum has made clear “every single dollar we recover benefits ... the Florida taxpayers who have funded the Medicaid program”. Pennsylvania, California and Texas attorney generals have made similar pledges to taxpayers. (See article.)

Counsel and specially retained forensic auditors play a critical role in protecting hospitals from adverse state investigations concerning deficient construction practices.

To start with, it is clear that a number of reoccurring deficiencies typically arise when a hospital’s facilities management department controls construction. Letting good business practice slide for the sake of “maintaining special arrangements” with contractors that inure to the benefit of the facilities department and its senior personnel, simply will not work in today’s heavily regulated environment.

These deficiencies affect virtually all institutions that task in-house facilities personnel with oversight of construction projects. Typically in these instances, hospital construction policies are not followed in a number of critical respects, including: (a) failure to adopt lists of approved trade contractors; (b) absence of fair bidding processes; (c) lack of credible bids; (d) absence of required documentation for the project, including failure to have signed contracts; (e) failure to follow adequate procedures for invoice payment, authorization to pay for additional work beyond the originally contracted for scope of work (known as “change orders”), signoffs, and lien waivers; and (f) absence of insurance certificates and proof of insurance.

Coincident with lack of internal controls, construction deficiencies arise from the lack of clear lines of executive authority. Alarming, illegal practices, such as kickbacks, become more prevalent when hospital facilities personnel oversee construction projects. An informal and incomplete flow of information also hampers hospital construction projects. Moreover, facilities personnel fail consistently to effectively utilize expert advice.

Deficiencies result from the organizational structure of the hospital, which does not adequately address the challenges

of construction projects. Deficiencies result from costly change orders, which are paid without proper approval and documentation. Projects are also regularly completed well beyond the contract period resulting in substantial claims against the hospital for delays. Senior hospital construction personnel often fail to adequately address state and federal regulatory requirements with respect to adherence to regulations and law.

In New York, for example, Hospital facilities managers oftentimes disregard filing Certificates of Need (“CON”) and amending them when aware, or when the managers should be aware, of cost overruns and related construction problems impacting the cost of construction. See N.Y. Comp. Codes R. & Regs. Title 10, § 710.1 (c)(2) through (5)(2010).

State laws and regulations cover medical facility rates for reimbursements for hospitals. Pursuant to the New York statute regulating reimbursement rates (*Ibid*), each medical facility must submit a proposed reimbursement formula conforming to the statute, no later than 90 days prior to the effective date of rates of payment for approval by the State Commissioner of Health.

Under the Department of Health policies, at least 10% of projects must be supported by an equity contribution. The remaining 90% can be financed. A CON application will state the funding structure and will address how the remaining costs will be paid (i.e. leases, fundraising, financing). Most major construction projects (over \$25 million) will be funded through some form of government financing.

A hospital’s Medicaid Reimbursement Rate (“MRR”) may fluctuate from a base year and trend forward, with adjustments made based upon construction costs, amongst other things. Capital costs, including construction costs, when approved, are built into the hospital’s MRR.

Thus, hospital construction undertaken in the manner described in this article poses for the hospital the real prospect that the cost overruns will reduce the MRR amount, adversely impacting the MRR for future construction projects and at the same time exposing the hospital to huge claims by the State’s Attorney General for the cost overruns involved in the projects.

New York joined the Federal/State partnership to reform and restructure hospital expense practices, commonly identified as the State Health Reform Partnership (F-SHRP). See New York Federal-State Health Reform Partnership Section 1115 Demonstration Fact Sheet (last updated Oct. 1, 2006).

In 2008, New York’s Office of the Medicaid Inspector General (“OMIG”) released a comprehensive and ambitious Medicaid work plan that reviewed OMIG’s efforts to investigate Medicaid Fraud. See SFY 2008-2009 OMIG Medicaid Work Plan (released April 18, 2008) available here.

Through OMIG, the Bureau of Investigations and Enforcement (“BIE”) investigates individuals, facilities, or entities that bill or are alleged to have billed Medicaid for services not rendered, claims that manipulate payment codes in an effort to inflate reimbursement amounts, and other false claims submitted to obtain program funds. It also investigates business arrangements that allegedly violate the federal health care anti-kickback statute. *Id.*

OMIG is tasked by law to uncover fraud in the healthcare system and has statutory authority to audit hospitals. N.Y. Pub. Health Law § 32(6) (McKinney 2010); see also 10 N.Y. Comp. Codes. Rules and Regulations, Title 10, § 86-1.8 (2010). Additionally, OMIG may seek recoupment of overpayments to hospitals and other medical facilities if audits uncover evidence that the facility is operated in a manner inconsistent with its approved CON. See *Dokmecian v. ABN Amro N. Am., Inc.*, 304 A.D.2d 445, (N.Y. App. Div. 2003). OMIG is also empowered to impose penalties on non-compliant health care providers, and is empowered to, “in conjunction with the commissioner, develop protocols

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to facilitate the efficient self-disclosure and collection of overpayments and monitor such collections, including those that are self-disclosed by providers.”

The OMIG or Attorney General may consider a provider’s good faith self-disclosure of overpayments as a mitigating factor in the determination of any administrative enforcement action. As a result, once a hospital discovers the construction practice irregularities identified in this article, it behooves the hospital to prove its good faith by addressing the subject of effective internal controls in the manner discussed above.

OMIG audits could trigger federal review under the Federal-State Health Reform Partnership (“F-SHRP”). New York’s Governors in recent years have made clear the commitment that OMIG investigate hospital mismanagement across New York state to claw back huge sums paid to hospitals that fail to control waste in Medicaid and related spending. In a December 12, 2008 press release, then Governor Paterson announced \$551 million in Medicaid recoveries under the F-SHRP program, under the auspices of New York State’s Medicaid Inspector General, James G. Sheehan. ▶

Construction Cost Certainty with Internal Controls Deters Investigations

There is an alternative available to hospitals in this regulatory environment – an effective system of internal controls and cost certainty. The objective of good internal controls is to withstand Federal and State scrutiny. Crafting a system that fits an institution’s unique needs is often an arduous and difficult task. However, regardless of a hospital’s specific needs, below are six key principles that are the hallmarks of effective and proactive control system design.

First, deterrence and eradication of fraud should be the foremost concern when designing an internal control system. The first step involves ranking fraud risks based on their likelihood and impact. It is critical to establish formal guidance and directives regarding authorization, approval, and review of change orders and increases in a project’s scope. Similarly, the development of formal processes to investigate overhead costs, reimbursable expenses, and other budget deviations will aid in preventing and stopping fraudulent activities.

Second, to maintain and foster transparency, formal lines of communication must be developed between senior hospital management and project managers. This facilitates the flow of important project-related information and decreases the likelihood of cost overruns related to misunderstandings between hospital management and project staff.

Third, establishing formal processes to evaluate the effectiveness of a control system is an integral part of establishing an internal control system. The evaluation process should include detailed and regular project risk assessments designed to identify actionable weaknesses in the control system, as well as recommendations for improving transparency in the actions of both hospital management and project coordinators.

Fourth, internal controls should be enacted that ensure proper disclosure and presentation of a project’s impact on the financial condition of the hospital and are achieved by enacting procedures that constantly monitor whether or not the construction team has maintained appropriate insurance coverage and the hospital is protected as an additional insured.

Fifth, the creation of controls that require strict regulatory compliance is an indispensable aspect of a sound control system. An important first step in improving compliance may involve defining the roles and responsibilities of project managers and third-party advisers and consultants. Additionally, establishing procedures that ensure that project employees possess the proper experience and training will aid in eliminating a variety of regulatory issues.

Finally, it is critical to establish controls related to claims for change order work and associated payments (the effect of which typically increases the cost of the project). Enacting controls related to identifying who has the authority to approve change order work is required to justify such increases to the project budget and are vital to managing costs. Controls must be designed to effectively ensure that every requisition payment reflects work actually completed, that payments are made in full to subcontractors, and that funds are not diverted from the project to pay for the expenses of other projects involving the general contractor or other project staff. Cost-related control must include monitoring whether lien waivers for the subcontractors and general contractor/construction manager are properly prepared and executed to protect the hospital, and utilized as a condition to payment. Finally, procedures must be instituted that require the hospital to secure all required sign-offs and other closing out documentation for the project.

Enlightened hospital executives in today’s electrified regulatory and enforcement environment nationwide would be well advised to tap into resources of specially trained professionals and their forensic team to avoid the huge financial and other risks identified in this article. ■

+ Partner Henry Korn and co-author Greg Korn, AIA with James Gillette published “Ensuring Projects Are Completed On-time and On-Budget” in the May issue of **Healthcare Development Magazine**. With health care construction notorious for its complexity and cost overruns, the article looks at how a single-source design-build solution could deliver true cost certainty to the owner/developer of the clinic, provided that key contractual provisions are agreed to and followed.

+ The firm is pleased to welcome Katherine Hofmann as our newest associate. Kate joined the firm in December and was recently sworn in to the Second Department, State of New York. Congratulations!

+ Congratulations also to Barry LePatner, who tied the knot on May 20 with the lovely Marla Tomazin. We wish them every happiness and good fortune in their new life together.

+ LePatner was a guest in early February on WUSB 90.1FM Stonybrook, NY talking about **Too Big To Fall** and how true fixed price contracts must be adopted if politicians are going to feel comfortable funding future infrastructure projects

+ We were gratified to note the significant contribution made by the Tiffany & Co. Foundation to advancing the third and final section of the High Line Park on Manhattan’s West Side. This announcement was made as the Mayor Bloomberg and others opened the second section of the High Line to the public. LePatner was honored to serve as pro bono counsel to the Friends of the High Line in connection with the Park’s construction activities for the past several years. The project has always been viewed as one that most significantly recaptures some of NYC’s lost history. Restoration of the High Line has served as a magnet for over \$2 billion in new real estate and commercial investment in the area.

We are pleased to be working closely with Tiffany & Co. on its worldwide building program and excited that in our respective ways, we share a commitment to making the High Line the special place it has become in the hearts of New Yorkers and the those from around the nation and the world who enjoy its unique offerings.

LEPATNER REPORT

IS A PUBLICATION
OF THE LAW OFFICES OF
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