

Department of Legislative Services
Maryland General Assembly
2015 Session

FISCAL AND POLICY NOTE

House Bill 119 (Delegate Morhaim, *et al.*)
Health and Government Operations

Construction Contract Clauses - Change Orders (State Procurement Change Order Fairness Act)

This bill requires each State construction contract to include a clause related to the execution of change orders. The requirement extends to procurement units that are otherwise exempt from State procurement law, including the State's public institutions of higher education and public-private partnerships (P3s).

The bill takes effect July 1, 2015.

Fiscal Summary

State Effect: Significant increase in State construction costs (all funds) due to likely delays in construction project schedules and increased costs associated with change orders. The net cost to the State is potentially in the millions of dollars. No effect on revenues.

Local Effect: None. The bill applies only to State construction contracts.

Small Business Effect: Meaningful.

Analysis

Bill Summary: The required contract clause must:

- prohibit the State, a prime contractor, or a private entity under a P3 agreement from requiring a prime contractor or subcontractor to start work under a State-issued change order (or for a P3, a change order issued by the private entity) or to start any other work directed and acknowledged by the State, a prime contractor, or a private

entity that is determined to be beyond the original scope of the contract, except that the clause must:

- allow the State, a prime contractor, or a private entity under a P3 agreement to require a prime contractor or subcontractor to start work if (1) the State or private entity has agreed with the prime contractor and, if applicable, the subcontractor, on a price for the work; (2) the appropriate fiscal authority has set aside funds for the work and made a written and binding commitment to pay for the work within 30 days after the submission of an invoice; and (3) given written notice of the set-aside and binding commitment to the prime contractor;
- allow the prime contractor or subcontractor to stop work without incurring any penalty if the State or private entity under a P3 agreement fails to pay for the change order or additional work within 30 days after submission of an invoice;
- require a prime contractor to include in its subcontracts a clause that requires the prime contractor to (1) notify subcontractors within five business days of receiving written notice to begin work on a change order as described above, including the approved amount to be paid to the subcontractor; (2) pay the subcontractor an undisputed amount (as defined in statute) within 10 days of receiving payment from the State or private entity; and (3) notify the subcontractor in writing if the prime contractor is withholding payment, state the reason why payment is withheld, and provide a copy of the notice to the unit or private entity;
- prohibit any party to a contract from declaring it in default or assessing, claiming, or pursuing damages for delays due to the inability of the parties to agree on a price for a change order or additional work.

Contractors must pay subcontractors any undisputed amount for a change order within 10 days of receiving payment for the change order or additional work performed under a contract.

Current Law:

Procurement Exemptions

The University System of Maryland, Morgan State University, and St. Mary's College of Maryland are exempt from most provisions of State procurement law. Likewise, P3s authorized by State law are exempted from most State procurement law. State law also exempts other agencies, in whole or in part, from State procurement law, including:

- Blind Industries and Services of Maryland;
- Maryland State Arts Council;
- Maryland Health and Higher Educational Facilities Authority;
- Department of Business and Economic Development;
- Maryland Food Center Authority;
- Maryland Public Broadcasting Commission;
- Maryland State Planning Council on Developmental Disabilities;
- Maryland Historical Trust;
- Rural Maryland Council;
- Maryland Health Insurance Plan;
- Maryland Energy Administration;
- Maryland Developmental Disabilities Administration;
- Maryland Stadium Authority;
- Maryland State Lottery and Gaming Control Agency;
- State Retirement and Pension System;
- the Department of General Services, for renovation of historical structures;
- the Department of Natural Resources, for negotiating with nonprofit entities for projects related to conservation service opportunities;
- College Savings Plan of Maryland; and
- Chesapeake Bay Trust.

However, each exempt entity is subject to specified provisions of State procurement law; the bill makes them all (but the State Retirement and Pension System, College Savings Plan of Maryland, and Chesapeake Bay Trust) subject to the mandated change order clause.

Change Orders

A “change order” is defined as a written order signed by a State procurement officer that directs a contractor to make changes that the contract authorizes the procurement officer to make without the consent of the contractor. The Code of Maryland Regulations requires construction contracts to contain a provision giving the State the unilateral right to order in writing changes in the work within the scope of the contract. A change order differs from a “contract modification,” which changes the terms of a contract and requires mutual agreement by the parties.

Each State construction contract must include a clause that makes each contract modification or change order that affects the price of the contract subject to (1) prior written approval from the procurement unit and any other responsible party and (2) prior certification by the responsible fiscal authority regarding the availability of funds and the

effect of the change order or modification on the contract's costs. The clause must also prohibit the execution of any contract modification or change order if the fiscal authority discloses that it will increase the cost beyond the amount budgeted, unless additional funds are made available or the scope of the project is adjusted to allow it to be completed within the budgeted amount.

An "undisputed amount" means an amount owed by a contractor to a subcontractor for which there is no good faith dispute, including any retainage held. Contractors on State contracts must pay their subcontractors any undisputed amounts to which the subcontractor is entitled within 10 days of receiving a progress or final payment from the State. If a contractor withholds payment from a subcontractor, the subcontractor must provide a written notice and explanation to the subcontractor and relevant State procurement officer.

Public-private Partnerships (P3s)

Chapter 5 of 2013 defined a "public-private partnership" as a method for delivering public infrastructure assets using a long-term, performance-based agreement between specified State "reporting" agencies and a private entity where appropriate risks and benefits can be allocated in a cost-effective manner between the contract partners, in which:

- a private entity performs functions normally undertaken by the government, but the reporting agency remains ultimately accountable for the public infrastructure asset and its public function; and
- the State may retain ownership of the public infrastructure asset and the private entity may be given additional decision making rights in determining how the asset is financed, developed, constructed, operated, and maintained over its life cycle.

A "public infrastructure asset" is a capital facility or structure, including systems and equipment related to the facility or structure intended for public use.

Only reporting agencies identified by Chapter 5 may establish a P3. Reporting agencies include the Department of General Services which oversees building purchases and leases for most of State government, the Maryland Department of Transportation, the Maryland Transportation Authority, and specified State higher education institutions. However, P3s do not include agreements entered into by the University System of Maryland, St. Mary's College of Maryland, Morgan State University, and Baltimore City Community College in which State funds are not used to fund or finance any portion of the project. Specified revenue-producing transportation facilities are also not considered P3s.

Background: Although terminologies differ, the concept of a unilateral change order as specified in State law and regulations is common in the construction industry. Many

change orders have no effect on project cost, but others can involve additional cost to the contractor or subcontractor. If the change being sought is within the scope of the original contract, the State can issue a change order unilaterally. If it affects cost, the State procurement unit must follow the process and meet the conditions established in statute, as described above. Settlement on cost with the contractor is typically done after the fact, subject to legal challenge if agreement cannot be reached. For instance, both the Maryland Transit Administration and the Maryland Transportation Authority include “force account” provisions in their construction contracts, which allow payment for time and materials plus a profit markup once work related to a change order has been completed and billed.

State Fiscal Effect: The bill’s main effect is to prohibit the State from issuing a change order, even one within the scope of the contract, unless agreement on cost is reached with the contractor prior to the contractor making the change being requested. This has the potential to delay construction projects and to increase the cost of change orders by giving contractors and subcontractors more leverage. The fiscal effect of such delays and change order costs cannot be reliably quantified, but given that the State awarded \$1.8 billion in construction contracts in fiscal 2013, the effect may be significant.

The bill does not specify any enforcement role for State agencies or additional legal remedies available to the State or to contractors, so additional costs related to enforcement of the bill’s provisions or increased caseloads for the Judiciary are not anticipated. To the extent that the bill reduces legal disputes between contractors and the State that occur after the execution of change orders, caseloads for the District Court and/or circuit courts may decrease, but any reduction is expected to be minimal and have no material effect on staffing or revenues for the courts.

Small Business Effect: The bill gives added protection to small construction companies involved on State construction contracts so that they will not have to incur unanticipated costs from unilateral change orders issued by the State. It also gives them added leverage in negotiating compensation for work performed under change orders by barring projects from proceeding if agreement on cost cannot be reached and by prohibiting the State from collecting damages due to work stoppages that result from those disagreements.

Additional Information

Prior Introductions: None.

Cross File: SB 708 (Senator Conway) – Education, Health, and Environmental Affairs.

Information Source(s): Board of Public Works, Department of Budget and Management, Department of General Services, American Institute of Architects, Maryland Department of Transportation, Department of Legislative Services

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