Project Buyout

Darin C. Zwick1 and Kevin R. Miller2

Abstract: Buyout is the transitional time between the preconstruction and the construction phases of a project. It is during buyout that purchase orders and subcontracts are issued. Most of the literature in construction addresses either estimating or project management but ignores the buyout time frame. This paper addresses how the buyout process attempts to reduce the ambiguities that occur during the transition from the preconstruction to the construction phase.

DOI: 10.1061/(ASCE)0733-9364(2004)130:2(245)

CE Database subject headings: Project management; Subcontracts; Owners; Financial factors; Estimation.

Introduction

Literature dealing with construction typically addresses estimating or project management. Many estimating texts start when a project owner approaches designers or contractors and end once the bid is submitted. Project management texts typically start at the period of time after the subcontracts have been signed. However, there is a period of time between the contract award to the general contractor and the subcontracts being awarded. In the construction industry, this time and process is commonly referred to as buyout. During the buyout period, the general contractor verifies the completeness of the subcontractor’s scope of work. At the end of the buyout period, the general contractor and subcontractor sign a contract that defines any ambiguities in the scope of work and set a negotiated price for the work to be performed. The intent of this paper is to investigate and report the state-of-the-art in project buyout. Because the literature is so scarce on the topic, many one-on-one unstructured interviews were performed with estimators, project managers, vice presidents and a former Director of Transportation for the state of Utah. The unstructured interview format was selected over the structured format to “provide greater breadth” in the interviews (Denzin and Lincoln 1998).

Why Buyout is Necessary

One of the most important elements of project control in the preconstruction stage is the “buying out” of subcontracts and purchase orders. Because of time constraints during the bidding stage of a project, complete, meticulous analyses of subcontractors’ bids may not have been made. Therefore, after the project has been awarded to the general contractor, each subcontractor’s bid is reanalyzed in relation to the entire scope of the project as defined in the drawings and specifications. Each bid is reanalyzed to ensure that the sum of all the scopes of work provides adequate coverage for the entire project as specified in the bid documents (Mincks and Johnston 1997). The buyout time allows the general contractor to be completely focused on the project and have ample time to analyze the subcontractors’ bids.

Each scope of work is reviewed for ambiguities during the preparation of the subcontracts for either incomplete “holes” in the scopes of work or double coverage in the scopes of work. These ambiguities may or may not affect the total cost of the job but need to be clarified and taken care of prior to entering into a subcontract. These ambiguities must be resolved during the buyout process, otherwise, disagreements will arise during the construction process and often cost more to be resolved. Removing the ambiguity early on will also reduce conflicts at the end of the project when punch list or callback issues arise (Daniel Burden, personal communication, 2002).

Occasionally, the general contractor will have two or three major subcontractors very close to each other on their price. This is the right time to make sure that the low bidder has everything well-covered, and it is also an opportunity to enhance the bottom line. For example, if the general contractor knows that the electrical subcontractor has a very competitive bid, then it might be in the general contractor’s best interest to include the temporary power set-up in his subcontract agreement. Often, the electrical subcontractor is willing to include it at no additional cost even though this is likely not in their scope of work. To avoid confusion and conflict during the job, it is critical to review every scope of work with every subcontractor, so when it comes time to execute an activity, everyone has a clear understanding of who is expected to cover each specific scope of work.

The initial profitability of the project is defined at buyout. Money is made during buyout when you agree on a price with a subcontractor that is lower than the budgeted amount. An in-depth review of every line item of the project is conducted. Special attention is given to the precise purchase agreements of materials that are to be purchased by the general contractor. The purchase agreement may also include owner-furnished items and contractor-installed items. While the buyout process starts once the contract is awarded to the general contractor, the buyout process does not end when construction commences on the job site. The buyout process may continue after construction has begun. However, when a number of project managers and estimators...
were interviewed during the course of this research, they stated that the job should be bought out as early as possible. By completing buyout early, future delays are avoided in the event that a given scope of work is difficult to buyout due to conflicts with subcontractors or suppliers. It also protects the project from price escalation.

Other tasks that occur during the buyout process by the general contractor include checking the following items to ensure that the subcontractor can perform the work for the project:
1. Insurance and liability coverage,
2. Evidence of state Workman’s Compensation coverage,
3. Evidence of proper local and state subcontractor licenses,
4. Evidence of proper bonding requirements if required.

The expiration dates of the previous items need to be verified to prevent lapses of coverage while the subcontractor is working on the project.

Another consideration that companies need to examine during the buyout process is the financial stability of the subcontractors and vendors. During economic downturns, companies may declare bankruptcy, leaving the general contractors in a precarious situation. In an example situation, a general contractor was involved in a $7 million project, but because of subcontractors declaring bankruptcy, the contractor had to spend $750,000 to have other subcontractors complete the remaining work. With situations like this occurring, general contractors cannot afford to ignore the financial stability of subcontractors and sub-subcontractors during the buyout process.

Sources of Ambiguities

Materials

Subcontractors that furnish and/or install items such as glass products, exterior systems, elevators, lighting supplies, mechanical equipment and controls, or certain roofing products may be specified either as preapproved or exclusive manufacturers/installers of the specified products. If the specifications also contain a phrase such as “like products,” further investigation may be needed to determine if a subcontractor’s product is truly a suitable “like product.” If the owner wants the general contractor to examine ways to decrease the cost of the project, the contractors may need to attempt to find even more “like products,” thereby cutting costs by substituting generic products for expensive, name-brand products.

One point to remember with materials during the buyout process is to lock-in the material prices for the duration of the project and not just for 30 days as stated in many bids. If the vendors are unwilling to lock-in the prices for the duration of the project, an escalation factor should be included, or other vendors should be examined to see if they will lock-in their prices for the duration of the project (Derek Bowen, personal communication, 2002).

Natural Workflow

Some scopes of work lend themselves more to one subcontractor performing the work even though another subcontractor may offer the scope of work at a lower price. Road base is one example where this may be the case. Earthwork and asphalt subcontractors may bid on this scope of work; however, it may be imperative to have the road base depth to within 1/100 of a foot for the asphalt. It therefore becomes more practical to allow the asphalt subcontractor to perform this scope of work and avoid conflicts between the earthwork and asphalt subcontractors (Derek Bowen, personal communication, 2002). By allowing trades to be responsible for scopes of work that directly affect their own respective scope of work, finger pointing and litigation can be eradicated from the construction process.

Management Team

The person responsible for the buyout of the project should carefully review all subcontractor bids. It is very important that the reviewer understand the actual bid tabulation to be well acquainted with each scope of work. Most owners have a system for prequalifying general contractors (Glen Kubricky, personal communication, 2001). Prequalification typically includes an evaluation of prior work and the precise project management team that will be used for the project. At project buyout, the general contractor should review the subcontractors in a similar manner. If a subcontractor’s management team for a project was difficult to work with on a past project, the general contractor may want to consider not using that subcontractor on future projects. This same scenario may also work in a reverse situation. A subcontractor may provide a discount to the general contractor once they know who is on the management team for the general contractor. Often, the exact teams for both general contractor and subcontractor are not known until after the bid, unless this information has been required by the owner as part of the bid documents.

Questionable Bids

A former director to the Utah Department of Transportation stated, “At bid time, there will occasionally be an unusually low subcontractor who is confident that his bid is accurate and insists that he has given the right number. It then becomes the general contractor’s responsibility to determine whether he has an error in his bid or not” (Craig Zwick, personal communication, 2001). When considering using a questionable bid, it may be wise to add a contingency to the low bid. At project buyout, the general contractor should then use the subcontractor’s written proposal as the basis of their contract and then “hold his feet to the fire” to remain responsible to this original bid. However, during buyout and the duration of the project, the contingency can then be used to cover the “unexpected” costs that will arise from that low bid subcontractor (Alan Collier, personal communication, 2001).

During buyout, the general contractor is able to assess whether a subcontractor who was the apparent low bidder in their specific scope of work is a risk. If it is determined that this subcontractor is a risk, it may be wise to include a payment and performance bond for this particular subcontractor. The general contractor should make this judgment call unless the owner has made it clear in the bid documents that payment and performance bonds are required on certain major trades (Glen Kubricky, personal communication, 2001). The owner will normally not reimburse the general contractor for the bond premium for a subcontractor who was not prescribed to be bonded in the construction documents.

Economies of Scale

After the entire bid has been clearly reviewed following bidding and after the award is made to the general contractor, it may be advantageous to package some parts of the job to gain an economy of scale or “bundling of services” with a certain supplier or subcontractor (Ben Nilsen and John Alley, personal communication, 2001). The project may have been bid initially in separate scopes of work; however, it may be cost-beneficial to combine several scopes of work with a single subcontractor. An example of this might be exterior lighting, which was bid separately from electrical. By packaging exterior lighting and electri-
cal together, there may be cost savings and fewer subcontractors to manage. “Frequently it is wise to package ... specialty equipment items or architectural accessories and give them to someone who will also install them, even though the general might not have had an installation price at bid time” (Kip Walter, personal communication, 2001).

Some material suppliers are very interested in payment arrangements and are willing to give unit prices or total price discounts based on no retention or timely payments. When making purchase orders during buyout, it is wise to take advantage of all cash discounts or early payment discounts. This affects how the general contractor must bill the owner in order to take advantage of these early payment programs. Normally it is a 2% discount if paid in full by the 10th day of each month following delivery of the materials. This billing might not coincide with the general contractor’s billing to the owner, so it must be properly coordinated with the general contractor’s own accounts payable department in order not to lose the advantage of this discount (Craig Zwick, personal communication, 2001).

Material Deliveries
There are times when materials could be delivered to the jobsite earlier than they are needed, enabling the general contractor to get some cost advantage over what was initially bid. If a cost would be incurred by storing the materials on-site, the general contractor can also search for inexpensive off-site storage, which could increase the cost savings of bringing the material to the jobsite early.

When generating purchase orders, it is very important to clarify whether the materials are to be delivered and unloaded on-site or whether they are only “F.O.B. trucks jobsite.” An example of this is concrete reinforcing steel or hollow metal frames. This must be clarified at job buyout in order to avoid an expensive surprise later. It is easier to negotiate the payment of unloading prior to entering into the contract rather than when the materials have been delivered to the site and the trucks are waiting to be unloaded.

During buyout, the general contractor may discover some items that were not included in their initial bid but were included in the bid documents. Buyout is the time to determine if the missed items can be included in the scopes of work of the apparent low bidder subcontractors. For example, if a specialty carpet was not included in the initial bid during buyout, an inquiry should be made of the carpet subcontractor to determine if they would be willing to include it in their scope of work for the initial bid price in their subcontract agreement. If they are not, maybe the second low bidder would be willing to include the specialty carpet, which would then make them the low bidder. There may also be items that should have been better detailed in the bid documents, and the general contractor may want to provide the better detailed scope of work in the subcontractors contract. Buyout is the time to tie up loose ends and to clarify contract scopes of work.

Completing Buyout Process
The issuing of a subcontract and/or purchase order marks the end of the buyout process for each scope of work. Prior to issuing the subcontract and/or purchase order, “it is wise to have someone other than the original writer proofread for names, spelling, punctuation and numbers. Ensure that this person pays particular attention to dollar amounts” (Cook 1985). When the buyout process is completed for the project, several of the people interviewed stated that, typically, the buyout process can add from 1 to 10% to the profitability of the project.

Sometimes the end result of the buyout process is that the profitability of a project decreases. This is often due to the following reasons:
1. A subcontractors’ bid used in the submitted bid contained an incomplete scope of work.
2. The subcontractor or vendor ceases to operate as a business.
3. The estimator was too aggressive to obtain the project.
4. The estimator did not understand the scope of the project.

Ethics
Project buyout is not a time to engage in any form of unethical practices such as bid shopping subcontractors or suppliers into lower prices. Tim Cotton, an estimator with the Church of Jesus Christ of Latter-Day Saints stated the following in an interview in 2001:

General contractors should honor responsible subcontractor bids and award the contracts for the bid amounts wherever possible. It is not ethical to open the job to the street for bid shopping after bid closing. In other words, the general contractor should ride with who got him there in the first place. If the conditions change or if the general contractor is not satisfied with the ability of a subcontractor to perform, the job buyout time is the ideal time to make a change. Changing a subcontractor at this stage may result in ‘burning a bridge’ with the subcontractor or supplier in question, but may save the project from failure.

A few subcontractors who are not the apparent low bidders, may try to become the low bidder by telling the estimator that they included items in their bid that the estimator might not have understood were in their proposal at bid time. It is important to be wary of this form of bid peddling. Also, it is imperative not to make overtures to anyone saying that they are the low bidder but carefully evaluate all bids and then move ahead with issuing the subcontract and purchase orders. If the contractor makes overtures to a subcontractor that they are the low bidder before the buyout of the project is complete and after the buyout process is complete a different subcontractor is selected, the original subcontractor may question the ethics of this because the contractor inferred that they were going to be the subcontractor for the project, and now, they are not. Treat all parties involved in the bidding and buyout processes equitably. The purpose of the buyout process is not to renegotiate bids but rather to ensure a smoothly run project, with complete scopes or work by subcontractors and vendors.

Another unethical practice that occasionally occurs during the buyout process is throwing out the original bids and rebidding selected scopes of work without any real change in the project’s scope of work. This is nothing more than the general contractor or owner attempting to engage in another form of bid shopping. The reason this is another form of bid shopping is now many of the subcontractors will know their competitors’ previous bids and know the number to beat.

Summary
Project buyout is a critical part of any construction project. During buyout, the general contractor has more time to analyze all the
scopes of work at a greater level than was possible during the bidding stage of the project. The goal of buyout is to assemble the best team possible to deliver a building to the owner on time and within budget. During buyout, high ethical standards should be adhered to; however, this does not always mean that a different subcontractor will not be selected during the buyout process. Several factors may warrant selecting a different subcontractor than the one selected when the bid was submitted. These factors could include the following: natural workflows, existing working relationships, incomplete scopes of work, and economies of scale. Project buyout requires a deep understanding of the project and being able to communicate well with subcontractors, architects, and the owner. If the buyout process is done correctly, the project will have fewer disputes and be more profitable for everyone involved on the project.

References