

Growth of Modular Construction Raises New Legal Questions

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A growing number of developers, particularly in the multifamily and hospitality sectors, are using modular construction to reduce construction costs and build projects more quickly and efficiently, with less risk of weather-related delays. The sector received a visible boost in 2017 when Marriott International announced that 13 percent of its new hotel construction for the year would utilize modular construction.

While modular construction has its benefits, these projects also create legal questions not often associated with more traditional construction. As developers and general contractors explore these types of projects and begin to negotiate contracts, some of the questions they need to consider are:

- Will the company producing the modular units be considered a subcontractor or a manufacturer of goods?
- Who is at risk for the loss or damage of the units, both while under construction in the factory and while they are being transported to the site?
- How will the general contractor manage the unique scheduling and coordination issues presented by modular construction?
- Will the developer or other project representatives be entitled to inspect the modular goods prior to installation?
- Will the modular construction partner provide warranties for the modular goods?
- What are the contingency plans should the company building the units go out of business?

Subcontractor vs. Manufacturer of Goods

One legal question regarding modular construction is whether the company that produces the individual units is considered a manufacturer of goods, just like the maker of pipes or shingles, or if it should be viewed as a subcontractor. At this point, there is limited case law in this area, as few disputes have come to court, and even the legal decisions that have been made do not outline a clear path forward.

Each scenario creates its own legal risks and benefits. For instance, construction lenders may be uncomfortable with the idea that a modular construction partner is not considered a subcontractor because a performance bond provided by the general contractor may not extend to the modular construction partner. If the contract between the general contractor and the modular construction partner is unclear on this point, the lender may have concerns about what guarantees are in place that the modular construction partner will complete its part of the project on schedule. Contractually stipulating that the modular construction partner be treated as a subcontractor can provide some protections to both the developer and its lender that the work will be completed on time, and to the satisfaction of the general contractor.

In any event, the developer and the general contractor should work together on the front end of the negotiations with the modular construction partner to ensure that their role is clearly outlined in the contract. Simply titling the agreement as a “subcontractor agreement” may not be sufficient to satisfy the lender’s underwriting requirements.

Transportation Risk and Insurance

Another legal question that should be clarified early in the process is determining who owns the goods—and the associated financial and insurance liability—at each step of the construction process, particularly as the units are transported from the assembly factory to the real property where the final structure will be constructed.

Because modular construction for commercial projects is still relatively new, many lenders have limited experience with financing the projects, and some education may be needed to help lenders become comfortable with underwriting offsite construction. Construction lenders will want to ensure the role of the modular construction partner is clearly defined and that adequate insurance coverage is in place to cover any potential loss throughout the process before providing financing.

While most parties can probably agree the units are the responsibility of the manufacturer while the modules are being assembled and before transportation, there are still some risk and insurance questions the developer or general contractor should be sure to ask, including:

- Is there enough insurance coverage at the facility to cover a total loss of all units in the event of a fire, natural disaster or other unforeseen event?
- Does the manufacturer have the ability to separate the units from various jobs and identify which units and building parts belong to which project?

An often more disputed time of ownership is during the transportation of units—some of which can be as large as 16 feet wide, 75 feet long and 11 feet high—to the final project site. Transporting something this bulky—often for hundreds of miles—creates a lot of risk for damage to occur either to the unit or to other cargo and vehicles. Contracts need to clearly spell out who has ownership of the module while it is being shipped, including the responsibility for insurance during the process. Some modular construction providers have their own fleets that transport the units while others rely on third party carriers. It is important to inquire about the amount of transit insurance held by the provider as well as builder's risk insurance and whether that will apply during transit.

Determining at which point in the process the title of the units is transferred to the general contractor or developer may also decide when payment for the units is due.

Scheduling and Coordination Issues

Scheduling and coordinating the work of subcontractors with the delivery of materials is a challenge for every project. Incorporating modular components presents its own unique challenges. If the modular units are not delivered on time, the remainder of the work on the project likely will come to a halt, jeopardizing the entire schedule and resulting in delay costs. Conversely, if the modular construction is delivered before the project is ready to incorporate that work, additional costs will be incurred in storing the completed modular goods.

As such, it is important that developers select a general contractor experienced with modular construction who can manage delivery of the modular components so as not to delay or disrupt the overall project schedule. The contract between the developer and general contractor should make absolutely clear that the general contractor, rather than the developer, has the risk for any delay caused by constructing or transporting the modular components.

Inspection Rights

Typically, a project architect or owner's project representative conducts periodic inspections of the construction to ensure the contractor is following the plans and specifications. Modular construction presents a unique challenge in that the "construction" will take place offsite, and thus an architect or project representative will not be able to inspect the work during a visit to the project site. As a result, it will be important that the architect or owner's representative be afforded an opportunity to inspect the modular goods upon delivery and certainly before they are incorporated into the project. It also would be prudent to request a sample of the modular goods be delivered to the site for inspection before the remainder of the modular goods are constructed. This will help ensure that the modular construction partner is following the plans and specifications for the construction and allow the parties to address any issues with the modular units early.

Risk of Insolvency

One of the risks facing any construction project is the loss of a key subcontractor in the middle of the construction process. If a plumber or electrician goes out of business, there are usually other, high-quality subcontractors in the area to help fill the void. However, there may only be a few companies capable of creating the modular units that are needed for any specific project. That makes it particularly important for the developer or general contractor to fully vet the financial stability of any modular construction partner during the subcontractor prequalification process in order to ensure they have the materials and resources to get the job done well and on schedule.

Most construction financing agreements also require that a project be completed in a certain amount of time. When using modular construction, it may also be worth negotiating more time than is anticipated to actually complete the project in the event there are unforeseen circumstances and a new modular construction partner must be engaged.

Warranty

In addition to a general contractor's warranties of construction, a developer typically requires assignment of warranties of certain components of the project, such as the roof or HVAC equipment. Similarly, a developer should request that the modular construction partners warrant the modular goods against defects, and that those warranties be assigned to the developer by the general contractor upon completion of the project.

As the use of modular construction in the commercial sector continues to grow, it is important that developers and general contractors weigh the risks and rewards and then structure the contracts to provide themselves the greatest protection and to satisfy the lender's underwriting requirements. While there is no way to completely eliminate risk, contract stipulations around things such as the role of the modular provider as a subcontractor, clearly outlining ownership and financial liability throughout the process, and carefully vetting the stability of the provider can minimize some of the risk and make the project go more smoothly.

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