

TOOLS FOR TOUGH TIMES

Practical Tips for Contractors Who Want to Protect Themselves Financially and Better Manage Tight Economic Conditions

By:

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The current economic climate requires Construction Contractors to be even more vigilant than perhaps ever before in recognizing and managing financial risks. Cash flow has always been the lifeblood of any Contractor. Most Contractors (especially General Contractors) operate on very thin profit margins; so when the cash stops flowing, the Contractor may be unable to satisfy its financial obligations. Moreover, because the amount of money a Contractor places at risk each time it undertakes a Project, in comparison to the anticipated profit margin, a few bad jobs can, unfortunately, wipe out the profits earned from many years of good jobs.

Front-End Planning Issues

Protecting against financial risks should begin even before contract formation. Perhaps the most important thing any Contractor can do to protect itself against financial problems on a project is to carefully choose the companies it does business with, and to request evidence of those companies' financial strength. Some Owners "pre-qualify" prospective Contractors before allowing them to bid their projects. The prequalification process usually includes determining the bidders' financial strength. Similarly, Contractors should also consider "pre-qualifying" the Owners for whom they are considering working, with this pre-qualification process to include performing the due diligence investigation necessary to determine the Owner's ability to pay, as well as the Owner's reputation for making timely payments. Especially given recent developments in the financial world, a prudent Contractor should also consider "pre-qualifying" the construction lender. One thing that makes

construction so interesting is the fact that each construction project is unique. This characteristic is true with regard to financial risks too. Prudent Contractors must assess the financial risks inherent in each project. Contractors should also take appropriate steps to “secure” their position as much as possible. One vehicle for doing so is the construction contract.

Creating Contractual Protection

Most standard industry construction contract forms give the Contractor the right, at least in certain circumstances, to require the Owner to demonstrate its ability to satisfy its financial obligations. See, for example, ConsensusDOCS 200, Paragraph 4.2 and AIA Document A201-2007, § 2.2.1. One of the ways Owners protect themselves against the possible insolvency of a Contractor, and a Contractor can protect itself against the possibility of Subcontractor insolvency, is by requiring the Contractor, or Subcontractors, to be bonded – i.e., to furnish Payment and Performance Bonds. Some Owners require Contractors to provide alternative forms of security in lieu of bonds, such as a Letter of Credit, a Parent Company Guaranty, or a Personal Guaranty from the principal of the company. Contractors should consider these same options where Subcontractors are concerned. Rarely, if ever, do Contractors require the Owner to provide a Personal Guaranty or a Parent Company Guaranty. However, an argument can be made that the Contractor’s need for such protection is even greater than the Owner’s, especially if the Owner is a single-asset, or limited asset, limited liability company or corporation.

One of the main purposes of any contract should be to identify and allocate responsibility for various anticipated risks. Financial risk is one such risk. A common risk allocation tool used in subcontracts is the “pay-if-paid” or “pay-when-paid” clause. Depending upon which state’s law applies, the presence of such a provision may protect the General Contractor from being obligated to pay its Subcontractors if the Owner does not pay the General Contractor. Another example of a contract provision used to allocate risks is a contractual waiver of lien rights, which is enforceable in

some states, but not others. Other examples include the contract provisions relating to the amount and timing of payments, contract provisions relating to retainage (including the amount of retainage and the timing of its release), and contract provisions giving the Owner (or the General Contractor, in the case of a subcontract) the right to make payments by joint checks (to ensure that downstream parties are paid) or to condition payments on the receipt of sworn statements that downstream parties have been paid. Any contract provisions establishing remedies for nonpayment – such as the right to interest, the right to suspend work, and the right to terminate the contract – are also very important to note.

A less obvious, but potentially more deadly, contract provision allocating financial risk is the changes clause contained in virtually every construction contract. Many construction contracts require, for example, in the event there is a dispute between the Owner and the Contractor as to whether certain work constitutes extra work or as to the value of the extra work, allow the Owner to direct the Contractor to proceed with the work at the Contractor's expense, with the issue of entitlement to be determined later. See, for example, AIA Document A201-2007, Article 7 (and the provisions therein regarding Construction Change Directives). Compare, ConsensusDOCS 200, Article 8, which provides that the parties will split the estimated cost until a resolution is achieved.

Managing Financial Risks During Construction

Once construction commences, it becomes even more imperative for Contractors to proactively manage financial risks. A prudent Contractor should take affirmative steps to protect against the possibility of nonpayment by the Owner, as well as the downstream risk that a Subcontractor or supplier may fail to perform due to insolvency. A good financial risk management program should consist of a number of elements, including the following ten points.

1. ***Require Financial Assurance (i.e., “Show Me The Money”).*** The importance of contract provisions which entitle the Contractor to require the Owner to provide financial assurance is

discussed above. Exercising those rights whenever appropriate is potentially even more important. Many Contractors don't know what to ask or look for in this regard. The new ConsensusDOCS family of contract documents provides two useful tools for this:

ConsensusDOCS 290 (Guidelines for Obtaining Owner Financial Information) and 290.1 (Owner Financial Questionnaire).

2. ***Preserve Lien and Bond Rights (“Use Them or Lose Them”)***. The statutory lien rights which exist in every state of the United States – but which vary from state-to-state and often do not exist outside the United States – are examples of the government actually helping Contractors and, in most states, Subcontractors and suppliers. A Contractor's right to place a lien on the real property the Contractor helped improve provides a form of security against nonpayment. Usually, however, the Contractor must timely exercise its lien rights or risk losing them. On public works projects, the General Contractor is usually required to post a Payment Bond, which essentially serves as a substitute for Subcontractors' and suppliers' lien rights, since public property generally cannot be liened. Again, however, these rights must be timely exercised or they may be lost.
3. ***Pace Payments and Progress***. In simplest terms, a construction contract is nothing more than an agreement by the Contractor to perform construction work in exchange for the Owner's agreement to pay money. Viewed in these simple terms, it is obvious that one way a party to a construction contract maintains optimal leverage over the other party is to tilt the balance of payments and construction progress in its favor. In other words, generally speaking, one way the Owner can help ensure that the project will be completed within budget is by withholding a contract balance which exceeds the value of the remaining work. Conversely, one way the Contractor can help ensure that the Owner will allow the Contractor to complete the project and will pay the Contractor for its work is for the cost of the remaining work to exceed the contract

balance. This article does not advocate that either side unfairly or unreasonably tilt this balance in their favor; but *both parties should* be careful to guard against the other party doing so by making sure that construction progress and payments proceed at approximately the same pace.

4. ***Ask for Money Owed.*** Most Contractors and Owners like to avoid conflict and confrontation whenever possible. Some Contractors make the mistake of failing to insist upon timely payments for fear of offending the Owner. Generally speaking, a Contractor will be better served in the long run by professionally and courteously, but promptly and firmly, asking the Owner to honor its payment obligations as they accrue. This is even more important in the current economy, in which companies are holding onto money as long as they can, out of fear of what the future may hold.
5. ***Consider Alternative Payment Sources.*** If a party with whom the Contractor has contracted becomes insolvent or unable to satisfy its financial or other contractual obligations, there may be alternative payment sources available. These may include guarantors, sureties, construction lenders, and insurance carriers, as well as remedies created by statute, licensing laws, and manufacturer or other warranties.
6. ***Protect Your Backside.*** Both the Owner and the Contractor must remain mindful that it is not just one another they need to worry about. The Owner needs to make sure it satisfies the requirements of its construction loan so that loan funds remain available to satisfy the Owner's payment obligations to the Contractor. In the current economic climate, the Owner may also need to guard against lender insolvency. The Contractor, on the other hand, must take affirmative steps to protect against Subcontractor and supplier insolvency.
7. ***Know Your Rights, Obligations, and Deadlines.*** Implicit in the admonition to enforce and honor your contractual and legal rights and obligations is the need to know what they are. A

prudent Contractor must read and understand its contracts, seeking legal and/or other professional assistance as required.

8. *Act Timely.* While construction is not always an exact science (e.g., even a two-by-four does not measure 2" x 4"), if the contract requires that some notice be given or some step be taken within seven calendar days, the Contractor who takes seven work days to do so is also taking an unnecessary risk. Contracting parties should act within the deadlines established by the contract and by law if at all possible, or they may risk losing their rights. This is particularly important when it comes to statutory rights such as lien rights, which are often strictly enforced, or if the other party may be prejudiced by a failure to act timely.
9. *Exercise Contractual Remedies.* Some key contract provisions used to allocate financial risks were discussed above. Having included such protections in their contracts, Contractors should not be afraid to use them. For the Contractor, this may mean suspending work if the Owner is not satisfying its contractual payment obligations and if the construction contract gives the Contractor that right. Again, withholding work is perhaps the Contractor's ultimate way of exercising its leverage. If a Contractor is dealing with a nonperforming Subcontractor or a Subcontractor experiencing financial difficulty, this may include taking whatever measures the contract allows (such as payment by joint checks, conditioning payments on the submission of appropriate lien waivers and/or sworn statements, etc.) to ensure that the payments continue flowing downstream to second and third tier Subcontractors and suppliers. It may also even include termination of the contract in extreme circumstances. In this regard, parties should keep in mind that under the United States Bankruptcy Code, a contract cannot be terminated because the party has filed bankruptcy (even though many subcontract forms include such language); thus, if termination proves necessary and is justified on other grounds (which it

usually is if the Subcontractor is insolvent), the contract should be terminated prior to the filing of bankruptcy.

10. *Be Attentive.* The last point above is an appropriate segue to this final point: Contractors must remain alert, vigilant, and attentive at all times. If a company is on the brink of insolvency, there are usually a number of early warning signals. If, however, a Contractor is not being careful to monitor the project and surrounding circumstances, they may miss the red flags and fail to react in time to protect themselves.

Conclusion

The famous explorer Ferdinand Magellan reportedly said “*The fishermen know that the sea is dangerous and the storm is terrible, but they have never found these dangers sufficient reason for remaining ashore.*” Today’s Construction Contractors find themselves in rough economic seas. Hopefully this article has provided a few useful tips to help them navigate through the storm.