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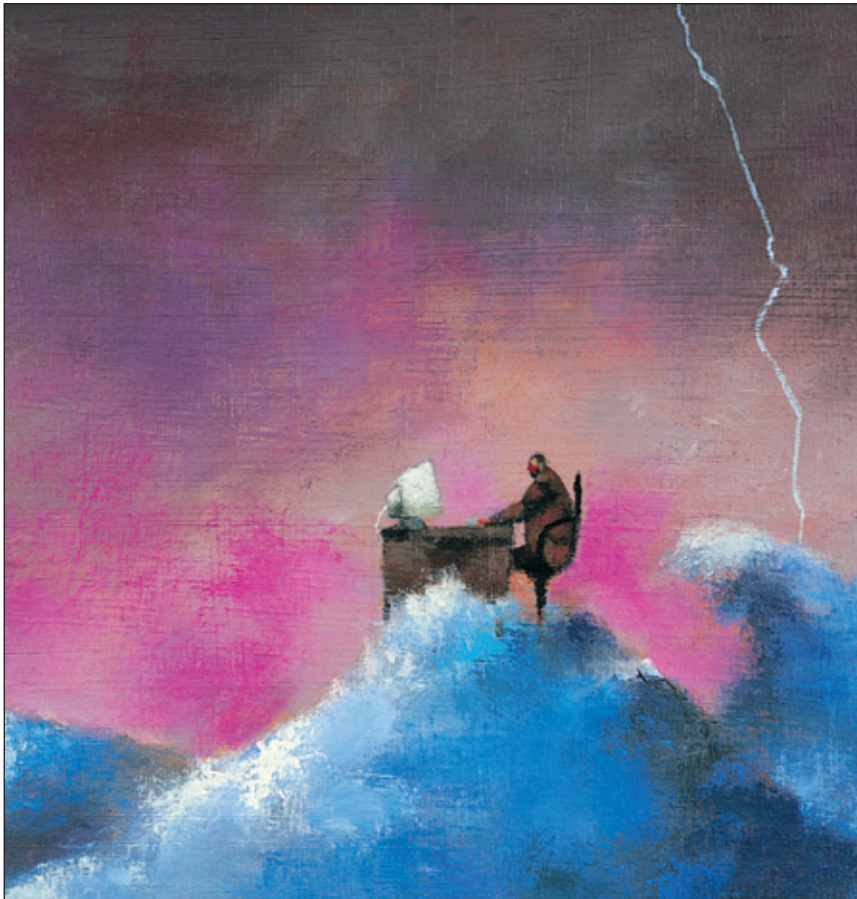
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**CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION**

*The Source & Resource for Construction Financial Professionals*

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# NEW TRENDS FOR *Weathering the Recession*



Sometimes it takes a traumatic experience to compel a company to sharpen its business plan, streamline costs, and increase efficiency.

This article will address new policies and strategies that some of the most successful contractors and subcontractors have implemented to stay afloat and, in some cases, even profitable.

These policies and procedures are not just temporary fixes during the Great Recession, but are rather the beginning of “the new way” of doing business in construction.

## **CHANGES AMONG OWNERS, GCs & SUBCONTRACTORS**

The increased ratio of public vs. private construction has a lot to do with most contract awards being driven by price more than any other factor. But, even on private jobs, owners are more price conscious than ever before.

For example, far fewer construction contracts provide contractor incentives for completing a job under budget. Also, in the past, many construction contracts provided financial incentives to contractors through shared cost savings plans; however, most owners are now keeping those savings.

Owners have also become more involved in helping or directing their contractors in subcontractor selection than before the recession. As a result, contractors are often required to hire the lowest bid subcontractors, irrespective of whether they may have underbid the project.

Due to the many inherent risks, contractors should establish their unfettered right to choose the subcontractors in their contracts with owners, subject only to legitimate objections (e.g., lack of license, reputation of faulty work, etc.). These objections should not be based on cost, especially if the contract price is lump sum (the subcontract price should be irrelevant).

## **Subcontractor Prequalification**

Gone are the days of being hired solely on prior experience, reputation, or low bids.<sup>1</sup> Over the past couple years, seemingly stable contractors and subcontractors



have surprisingly and suddenly gone out of business. Therefore, contractors have implemented practices to help ensure that selected subcontractors have the financial wherewithal to complete their jobs.

Contractors now require complete financial statement disclosures from subcontractors before awarding contracts. In addition, they review potential subcontractors' debt positions to determine if they are more leveraged than they should be. Unfortunately, few sureties issue bonds solely based on credit and personal guarantees; more are now requiring collateral to secure the bonds.

Therefore, even if subcontractors appear to have good liquidity, contractors carefully review the assets pledged as collateral to sureties and lenders. A subcontractor that seems perfectly solvent could quickly become insolvent if its surety has to call the security interest for those assets on which you relied if something goes wrong on another bonded job.

### Subcontractor Default

More contractors are also carefully planning for subcontractor default in their construction contracts. Consider subcontractor payment and performance bonds (where available). Alternatively, consider purchasing a subguard insurance policy with a 10-year tail for latent defects (or matching your state's applicable statute of repose). Similar to a subcontractor's performance bond, subguard policies insure against subcontractor failure.

### Pay-if-Paid

Planning during the contract phase also entails carefully drafting subcontracts. Pay-if-paid clauses (whereby a contractor doesn't have to pay a subcontractor unless the owner pays the contractor for that subcontractor's work) are becoming more popular in those states in which they are permitted. Armed with experience and guided by case law, contractors and subcontractors (in their subsubcontracts) are carefully wording these clauses to ensure their enforceability.

### Claim Submission Requirements

You can also include clauses in subcontracts and subsubcontracts to ensure that claims for change orders or delays are submitted appropriately and timely. In order for a claim to be addressed as procedurally valid, specify how to submit a claim, set deadlines for submission (shortly after discovery), and insist that substantiating documents be timely submitted. These types of clauses will help prevent subcontractors and subsubcontractors from submitting claims at the end of a job.

### On the Bright Side

Not everything is gloom and doom, however. Subcontractors that have previously been in high demand are now more readily available for work. Further, as a cost-cutting measure, many have released a number of employees and have likely retained their top-notch employees. Finally, subcontractors are paying more attention to their current jobs and less on competing work. Therefore, construction defects and job delays have decreased.

### BEFORE YOU SIGN

Contractors and subcontractors should resist the temptation to take any job they can find. Projects with unrealistically low margins (as a result of overly competitive bidding) should be avoided. If, however, you need the job to keep your key employees working and equipment utilized, then great care should be taken to separate the worthwhile jobs from the dangerous ones.

Begin by researching your prospective clients and their principals. Review court records to determine if they are litigious and bankruptcy court records to see if they've had prior financial problems. Talk to people who may know them. Google them. Find out anything you can to help detect warning signs before you sign a contract.

### Adequate Assurances

Draft your contracts with tight financial leashes to enable your company to get out of a problematic job quickly and with as little financial risk as possible. For instance, include the right to demand adequate assurances from the owner that it has the funding to complete the job. A201-2007, General Conditions of the Contract for Construction, only permits a contractor to demand adequate assurances under specifically delineated circumstances after work has begun.

A better-drafted clause would give contractors and subcontractors an unfettered right to demand assurances before and after construction begins. Also in your clauses, identify the form in which the adequate assurances should take. Require the owner to specify where the money is coming from and in what amount. Don't rely on a statement like "the money is available" without additional supporting information.

Demanding adequate assurances is only half the battle. What happens if the owner does not provide them? Your contract must allow you to immediately suspend work until adequate assurances have been provided. Upon assurance of payment according to your contract, you would remobilize construction,

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but should also have a contract clause entitling you to payment of costs incurred for demobilization and remobilization.

If an owner agrees to provide adequate assurances in response to a contractor's request, then the owner may require reciprocal disclosures from the contractor. In that event, ensure that your contract details what type of financial disclosure you will have to make.

Unlike most owners, contractors are vulnerable to their competitors if their financial information is circulated around the industry. Instead, agree to provide only top line revenue figures on financial statements, excuse your company from having to disclose the project profit margin, and include confidentiality provisions in your contract.

It's important that your contract be a vehicle to detect early signs of a job's financial failure, coupled with the ability to get out quickly if you're not being paid.

### **LENDERS' IMPACT ON JOBS & COLLECTABILITY**

Construction lenders and first mortgage holders are having a more profound impact on the ability of contractors and subcontractors to get paid than ever before. With property values low, cash flow tight, and mortgage defaults on the rise, lenders are foreclosing on projects and wiping out unpaid construction liens in the process.

In the past, contractors would take on more risks in choosing their jobs because cash flow was positive and properties had enough equity to secure construction liens. Now, once a lender takes back the property, competing lien holders are usually wiped out.

Before agreeing to perform work on a project, research the apparent available equity on the job. A title search on the property will reveal the existence of a mortgage and the initial dollar amounts involved, as well as all subsequent advances or modifications of the loan. It will also reveal the existence of other liens, which will give you an idea of how encumbered the property is and how much available equity there may be to secure your lien, should you not be paid. It will also provide insight as to how often the owner has been liened or sued, and therefore how financially problematic the owner may be.

If a job appears to have enough equity to secure your lien rights, then you may be more willing to take it. If not, then you should either walk away or negotiate stringent contract terms. If your lien rights have no value, then include strict payment requirements in your contract, along with clauses that allow you to suspend or terminate work if you remain unpaid for a specified period of time (which should be shorter for jobs with low-value lien rights than for those offering better protection).

If a project lender took back the property and wiped out the liens, then find out if you have any rights against the construction lender. Some states make lenders liable if the loan was not fully funded, payments were improperly made, or the lender misrepresented to or misled the contractor about the availability of funds. Consider your rights against the lender as a possible source of compensation for work performed.

### **NEW GEOGRAPHICAL AREAS & DIFFERENT TYPES OF CONSTRUCTION**

Many contractors that ventured beyond their state lines early in the recession are returning to their home states due to increased out-of-state construction costs. The travel and housing expenses of sending project management crews to other states, combined with the inefficiencies inherent in the learning curves about construction in a new venue, are not always justified given the low profit margins currently available on most jobs. As a result, many contractors have kept their geographical reach to cities within their home states where they may not have worked before.

Contractors have also migrated toward public construction jobs; however, this work has become far less profitable since larger contractors (capable of working on lower margins) have begun to bid on public projects.

These large contractors underbid smaller ones that have been working in the public arena for years, but cannot meet the lower costs achieved by their larger competitors. They also reduce costs by self-performing some of the work, calling on loyal subcontractors and suppliers for favorable terms, and employing more sophisticated estimating departments.

The intense competitive bidding environment means most public jobs are being performed at or near breaking even. Contractors entering public construction for the first time must also become educated on the sometimes drastically different rules than those in other construction sectors. These include legal, accounting, and practical differences. Some states also have prompt payment laws in public construction, which changes the manner and timing of payments to subcontractors and reporting requirements to the public owner.

Further, the *Federal False Claims Act* (and any corresponding state acts) imposes significant potential liability on contractors and subcontractors on public jobs for misrepresentations, even of the most seemingly innocent nature. For example:

- Misstating the quantity of materials supplied to the job, which results from a failure to properly count upon receipt as opposed to intent to defraud, may create liability.



- Invalid change order claims or contests of a back charge may be grounds for exposure.
- Front-end loaded progress payment requests, overstatements concerning the status of work performed, and inaccurate representations about the status of payments to subcontractors and suppliers (including representing all subcontractors have been paid when in fact you're withholding contractually authorized retainage) are all potential false claims.
- Defective or substandard work not justifying a requested payment may be a violation.

Therefore, the decision to move into public construction merely due to the availability of work should not be taken lightly.

### CONCLUSION

Contractors and subcontractors continue to try to reinvent themselves and tweak the way in which they do business as the recession continues, with no apparent end in sight. Although the process is tedious, thoughtful contractors are instituting wise procedures that minimize their financial exposure, which will better equip them for a long future. ■

### Endnote:

1. This also applies to subcontractors that hire subcontractors.

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