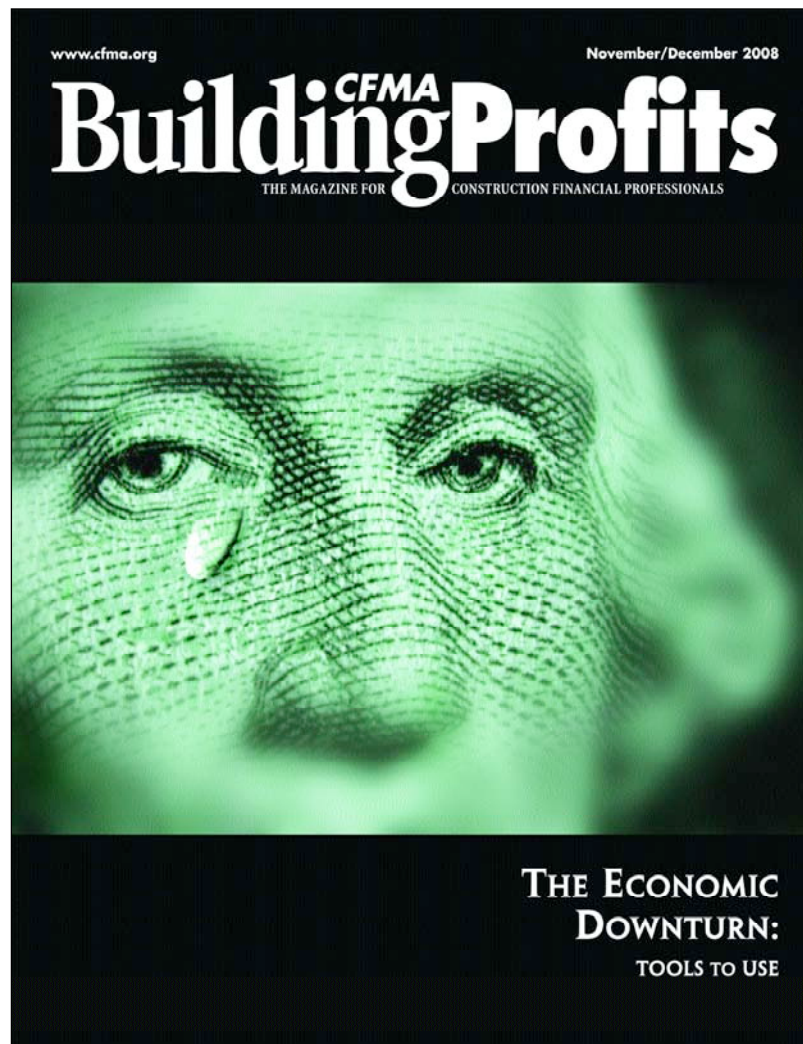


# CFMA Building Profits

THE MAGAZINE FOR CONSTRUCTION FINANCIAL PROFESSIONALS

R E P R I N T



NOVEMBER-DECEMBER 2008

**CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION**

*The Source & Resource for Construction Financial Professionals*

# Practical Steps To Help GCs Weather ECONOMIC HARD TIMES

BY LEE A. WEINTRAUB





---

---

Perhaps the most prevalent topic of discussion these days is America's deepening economic crisis. At least in Florida, the construction industry has already been hit hard. For example, 90% of all jobs lost in Florida have come from construction. Funding has dried up – not only stopping new construction, but also payments on projects already in progress.

Even worse, there aren't many signs indicating an upturn in the near future. On the contrary, all indicators are pointing toward a more accelerated downturn (or worse).

Unfortunately, the construction industry is no more immune to economic pressures than other industries. In fact, many contractors across the nation are feeling the effects of reduced capital, coupled with more difficult relationships with owners and lenders, slower payments and reduced cash flow on projects, and businesses that are facing bankruptcy or dissolution.

Until the economy rebounds, only those contractors adept at predicting and preparing themselves for reduced cash flow, credit problems, and distressed projects will survive. Contractors should recognize these warning signs when:

- 1) Payments on a project become consistently delinquent or, even worse, are missed entirely;
- 2) Progress on a project slows as a result of unresponsive/undercapitalized contractors or subcontractors who can no longer fund the appropriate crews needed to meet the project's schedule;
- 3) Loan funds (either from a project lender or your company's lender) dry up, and authorizations for disbursement and/or extensions of credit become more difficult to obtain; and
- 4) The number of foreclosures increases.

These are only some of the signs that manifest during economic hard times, signaling the need for significant foresight, planning, and creativity. Only those contractors successful in this endeavor will survive a prolonged or worsened recession.

This article discusses what GCs can do to protect their businesses until the good times return. (Subcontractors should consider implementing some of these suggestions as well – both in their client contracts with GCs and their downstream contracts with their sub-subcontractors.)

Three phases of economic planning will be reviewed: 1) planning at the time of bid and contract; 2) addressing financial problems once a project has begun; and 3) long-term corporate planning.

### **Planning at the Time of Bid & Contract**

---

In order to stay in business, contractors must know which projects to reject as questionable. Contractors who indiscriminately accept all business opportunities often accept problematic and underbid projects, ignoring the warning bells foretelling financial loss.

Trusting one's instincts and recognizing that a client or project may be problematic are skills developed through experience. However, contractors who heed the warnings and reject questionable projects end up accepting solid and stable work with fewer complications. For those contractors who have yet to hone these skills, there are a number of ways to decrease the chances of financial loss on a project.

### **RESEARCH**

First, someone in your company must research each prospective client's financial and payment history on past projects. Court records are public documents that can easily be searched to determine a client's litigation history. Has the client been sued multiple times for non-payment? Even worse, is the client litigious, as gleaned from a pattern of frequent lawsuits?

Also, be sure to find out if the client has previously filed for bankruptcy, and talk to people in the industry who may know about the client's ability to fund the project. If these searches reveal warning signs about the client's financial wherewithal, then the project should be declined.

Until the **ECONOMY REBOUNDS**, only those **CONTRACTORS ADEPT** at **PREDICTING** and **PREPARING** themselves for reduced cash flow, credit problems, and distressed projects **WILL SURVIVE.**

#### **NEGOTIATE FAVORABLE CONTRACT TERMS**

Second, carefully negotiate a favorable contract with each client. In today's economy, litigation is increasing and smaller contractors are being forced out of business. Many lawsuits can be avoided with clearly worded and advantageous contracts. There are a number of important provisions contractors should include in their agreements with owners.

#### **Pricing Mechanisms**

Begin with the pricing mechanism of the project. As the cost of materials continues to increase, many contractors are moving away from fixed-fee contracts and gravitating toward more flexible cost-plus arrangements.

If your company uses a fixed fee for its pricing arrangement, then add a price escalation provision, providing entitlement to increase the fixed fee if the cost of materials or labor increases more than a specified percentage during the project. That way, your company will not have to absorb significant cost increases while on the job.

#### **Adequate Assurance**

A contractor's agreement with the owner should also contain a provision entitling the contractor, at appropriate intervals, to demand adequate assurances of the owner's financial capacity to complete the project, including all approved change orders. The contract should require the owner to disclose the source and amount of available funding.

#### **A201-2007 General Conditions**

The AIA Document A201, General Conditions of the Contract For Construction, previously entitled the contractor to demand adequate assurances before commencing the work and at any time thereafter.

However, under the A201-2007 General Conditions, the contractor may request adequate assurances from the owner before commencing the work and thereafter only if:

- 1) The owner fails to pay the contractor in accordance with the contract requirements;
- 2) A change order materially changes the contract sum; or
- 3) The contractor identifies in writing a reasonable concern regarding the owner's ability to pay.

Therefore, if using the 2007 AIA documents, be sure to modify the General Conditions to restore your company's right to freely demand adequate assurances of the owner's finances at any time before or during a project, without preconditions.

Also ensure that the contract entitles your company to terminate the contract or suspend work if the owner fails to comply with requests for assurances or if the owner's response reveals insufficient funds to complete the job.

#### **It Works Both Ways**

A demand for adequate assurances may work both ways, since owners may require contractors to provide financial statements at various times during the project. After all, it would be hard to require a contract clause entitling contractors to adequate financial assurances from the owner without reciprocating this right.

If your company includes such reciprocal provisions in its contracts, then require confidentiality agreements from the owners to prevent them from disclosing your company's financial information to your competitors.

Additionally, limit your company's disclosures to a balance sheet and the top line revenue figure on financial statements.

And, be careful not to disclose the project's estimated profit margin, since an "excessive" profit margin (from the owner's viewpoint) may become an issue in the event of subsequent litigation.



Further, a reciprocal disclosure requirement should specify the detailed circumstances under which the owner may request disclosures, similar to those imposed upon a contractor in the A201-2007 General Conditions.

### **Contract Default**

Regardless of how these provisions are drafted in a contract, requests for adequate assurances of funding, coupled with a provision entitling your company to terminate a contract in the absence of adequate assurances, may allow your company to stop problematic projects before they get out of control.

Many contracts between owners and contractors provide for assignments of contracts and subcontracts to the lender if the owner defaults (or assignments of subcontracts to the owner if the contractor defaults).

If your company's contract with an owner contains such a provision, ensure that all of your subcontracts require your subcontractors and suppliers to accept the assignment in favor of the owner or lender. Otherwise, your company may be in breach of its contract once the owner or lender seeks to accept assignments of the subcontracts.

Also, consider a reduction in the retainage amount as the job progresses. A common provision reduces the standard 10% retainage to 5% when the project reaches 50% complete, then down to 2% at the punch list phase.

### **Payment & Performance Bonds**

Another necessary consideration at the time of bidding and contracting is whether to provide payment and performance bonds. These bonds are becoming harder and more expensive to obtain, and are more frequently available only to those contractors with good pre-existing surety relationships, good credit and collateral, and a good history without claims against prior bonds.

The bond underwriting process is in a state of flux right now, making a relationship with a surety underwriter a critical prerequisite to obtaining payment and performance bonds.

One way to avoid the hassle and expense of obtaining bonds is to convince the project owner that obtaining bonds from your subcontractors, or at least your primary subcontractors, will be adequate bond protection for the

project in lieu of your own bond. (This will be a tough sell for sophisticated owners, but it's still worth trying.)

The cost of these bonds can be passed along to the owner, much as the cost of your company's bonds would have been – and, as long as the owner is a beneficiary on each bond, he or she may be convinced to accept this arrangement in lieu of your company's bonds.

If your company has limited bonding capacity, it's worth considering this alternative before walking away from a job it cannot bond.

### **Subcontractor Issues**

Finally, your company should minimize its exposure to subcontractors (or to sub-subcontractors if your company is a subcontractor) should your client stop paying. A number of subcontract provisions will assist in this regard.

#### **Pay if Paid**

These clauses (statutorily prohibited in many states, but not all) make payment from your company's client a strict condition precedent to your company's obligation to pay its subcontractors the corresponding sums.

Where such clauses are enforceable, case law may dictate specific wording to ensure enforceability. When properly worded, enforceable "pay-if-paid" clauses may excuse your company from paying its subcontractors when your clients fail to pay.

Of course, from a subcontractor's point of view, fiscal protection may require refusing any attempt by a GC to include "pay if paid" clauses in the contract. Alternatively, subcontractors could mitigate the burden from these clauses by including similar clauses in their downstream contracts with sub-subcontractors.

#### **No Damage for Delay & Notice Requirements**

Your company's subcontracts should also contain a "no damage for delay" clause. This clause provides that, in the event of delays, your subcontractors will waive any claims they may have against your company for delay damages. Instead, an appropriate time extension would be the sole and exclusive remedy.

The enforceability of these clauses also differs from state to state, as do the circumstances in which courts will



enforce these provisions. Nevertheless, a properly worded clause may insulate your company from liability for delay claims by its subcontractors.

Again, from a subcontractor's point of view, fiscal protection may require refusing any attempt by a GC to include "no damage for delay" clauses in the contract.

And, as previously described, subcontractors could mitigate the burden from these clauses by including similar clauses in their downstream contracts with sub-subcontractors.

Finally, subcontracts should require strict notice requirements of any claim a subcontractor may make for additional compensation or time extensions, whether delay-related or otherwise.

If your contract (as a condition precedent to relief) requires written notice within a specified number of days after the event that gave rise to the claim has occurred,

then a subcontractor's failure to make the written claim in a timely manner may waive its entitlement to damages or a time extension.

### **A201-2007 General Conditions Example**

The A201-2007 General Conditions contain a great example of such a clause, requiring all notices of claims to be made in writing within 21 days of occurrence of the event giving rise to the claim.

In a tight economy, many subcontractors bring claims for additional compensation later in their jobs when they realize they are facing financial losses. Many of these claims are afterthoughts and are submitted late, rather than promptly after an event occurs.

With a strongly worded contractual deadline for written claim submissions as a condition precedent to relief, these late (and possibly spurious) claims may be forever barred. And, such a requirement works equally well for subcontractors in their downstream contracts with sub-subcontractors.

### **Abandonment**


Finally, consider the possibility of subcontractors/suppliers becoming insolvent, undercapitalized, or otherwise abandoning one of your company's projects.

Contrary to popular belief, a subcontractor's abandonment of construction is not an excuse for your company's non-performance, but rather may support a delay claim the project owner may bring against your company.

So, here are a few options that, under the right circumstances, may help your company mitigate its exposure:

- 1) Require payment and performance bonds from your subcontractors so that your company can make bond claims for non-performing subcontractors.
- 2) Consider insurance that protects your company against subcontractor non-performance.
- 3) Include a provision in client contracts stating that abandonment by your subcontractors or suppliers (other than as a result of your non-payment to them) is agreed to be outside the scope of your company's control and, therefore, the client waives any such claim it may have against your company.





Such a provision should also address your company's entitlement to a reasonable time extension and an increase in the contract price, as necessary, to reflect the cost and time of replacing the subcontractors.

### **Addressing Financial Problems Once a Project Has Begun**

These days, a large number of projects are becoming distressed as owners, contractors, or subcontractors run out of money. Therefore, various debt workouts or arrangements to defer payments are often required to keep the job going.

Here are several factors to consider when deciding how to address project cash flow issues:

- Status of the job when financing runs out,
- History and relationship of the contracting parties,
- Proposed restructuring and timing of payments,
- Amount of retainage held by the owner, and
- Existence or non-existence of lenders, sureties, insurance companies, etc.

#### **PRESERVE ALL LIEN OR BOND RIGHTS**

It is always critical that your company preserve its lien or bond rights until all sums due are paid. In your eagerness to assist the client and the project, don't forget to fully perfect all lien and bond claims. Once they are perfected, do not release them until your company has been paid in full, except to the extent of the payments already received.

As you work through a payment plan with your client, your subcontractors and suppliers will likely continue requesting prompt payments despite your client's slower payments. Written pass-through agreements (whereby your company assigns to its subcontractors the appropriate payments you will be receiving from your client) may be a way to stave off litigation or claims by your subcontractors.

Encourage your subcontractors to perfect their own lien and/or bond rights (except against your company's bonds) so they remain fully secured and are more willing to accept deferred payments as your company receives them from its client. Of course, if your company's subcontractors contain a "pay if paid" clause, then subcontractors

may have little choice but to accept the same deferred payment plan.

#### **IF ALL ELSE FAILS...**

If your subcontractors are going to sue for non-payment, request that your company be omitted as a defendant in the lawsuit, at least initially, and let them proceed directly against the owner on a lien claim or other equitable action. In exchange, offer to give evidentiary and other logistical support for their claims.

You may even want to consider assigning part or all of your claim against the owner to your subcontractors to facilitate their right to proceed directly against the owner. Of course, such an assignment may deprive your company of the opportunity to pursue the owner in the event of non-payment, so legal advice should be obtained in crafting the appropriate language of the assignment.

Keep in mind that your company's contract balance against the owner would likely be reduced by the amount of any payments against the principal the owner pays your subcontractors.

You should also review whether your contract contains a covenant to pay your subcontractors and suppliers and/or an indemnity or hold harmless provision. If so, then the owner may bring your company into the suit with an indemnity claim if your subcontractors sue the owner directly.

There are benefits to structuring and facilitating direct claims by subcontractors against owners as a way of keeping your company out of subcontractor litigation, but great care should be taken to consider the consequences of such an action to your company. (For example, support of your subcontractors' claims against the owner may translate into an admission of indebtedness should your subcontractors subsequently amend their suits to add your company.)

This course of action should be taken only if the alternative is to be sued by subcontractors who are no longer willing to wait for payment.

As previously mentioned, agree at the time of contract negotiations to pay your subcontractors and suppliers only to the extent that your company receives payment.

With this clause in your client contracts, combined with a “pay if paid” clause in your subcontracts, you can stop paying your subcontractors if your clients stop paying you.

## **BANKRUPTCY**

Developers and other owners of construction projects are increasingly filing for bankruptcy while construction is ongoing. This raises a number of issues, not the least of which is your company’s right to payment and obligation to complete construction.

### **Terminating Construction**

Many construction contracts provide that a client’s filing of bankruptcy is a default entitling the contractor to terminate construction.

However, these provisions are unenforceable as they violate public policy in favor of permitting bankruptcy for those in need of its protections. Therefore, your company cannot rely upon such a provision as grounds for terminating construction.

Additionally, the automatic stay imposed when an owner files for bankruptcy prevents your company from pursuing claims against the bankrupt owner other than in bankruptcy court. Therefore, when an owner files for bankruptcy, you should first contact him or her to agree to a cessation of work pending the appointment of a bankruptcy trustee who may undertake the owner’s obligations under your contract.

Your company should also perfect any available construction lien rights if allowed in the state where the project is located without violating the automatic stay. Then, your company would become a secured creditor, most likely holding a better position against the owner than the unsecured creditors.

However, perfecting a lien after an owner files for bankruptcy can be tricky because it must be done in a manner that does not violate the automatic stay of all claims against the owner’s interests. Your company should seek immediate legal advice on this issue.

### **Perfecting Your Company’s Lien**

A bankruptcy trustee may abandon the property on which construction has been performed if construction liens dilute the property’s equity, making it a valueless asset to the estate. An abandonment may pave the way

for your company’s entitlement to foreclose upon its lien and get paid.

It is critical that your company fully perfect its bond rights without violating the bankruptcy stay. Also, consider alternative avenues of relief other than a direct claim against the bankrupt entity.

For instance, some states may permit claims for restitution against a license holder of a bankrupt construction company. Pursuit of such claims may not violate the bankruptcy stay, provided your company is not proceeding against the bankrupt company itself or its assets. Be sure to obtain legal advice before taking action.

Similar considerations should be made if the bankruptcy debtor is a principal on a payment or performance bond against which your company may have a claim.

## **FORECLOSURES**

Finally, our economy has led to increased numbers of mortgage foreclosures and condominium association liens, which may compete with your company’s construction lien for priority.

Property owner hard hit by the recession have a tougher time paying their bills, causing mortgage holders and condominium associations to lien and foreclose upon their properties.

Remember: Any time a competing lienor forecloses upon property upon which your company has a lien, the security for your unpaid debt is jeopardized.


If one of your company’s projects has excessive mortgages or the potential for competing encumbrances, then you should rely less on the protection afforded by lien rights and more on keeping your company’s A/R under control.

Unfortunately, you may need to consider terminating the contract and mitigating the losses if your company’s bills are not being paid. The assurances of payment commonly provided by liens are diminished in a recession, requiring that you monitor your company’s unpaid bills more prudently.

## **Long-Term Corporate Planning**

Nobody likes to consider the current recession as a





long-term condition, but it would be foolhardy not to plan appropriately in the event the economy does not improve in the near future. There are a number of ways that your company can prepare to weather the downturn over the long run.

### DEVELOP NEW MARKETS

First, some contractors must reinvent themselves if their markets are drying up. Many contractors are looking for new niches because their current markets no longer have enough buyers to develop new projects.

For example, many condominium and residential developers are now turning to commercial and public construction projects, where there is slightly more stability. (And, in fact, if President-Elect Obama implements his plan of increased government construction spending, then the public construction sector may offer lucrative opportunities for contractors.)

However, in addition to considering your company's qualifications to shift market focus, the legal and practical differences between public and private (or residential and commercial) construction should also be considered.

Sometimes, only a slight shift in the types of projects your company undertakes is all that is necessary to maintain business continuity – and a more drastic shift, such as from residential to commercial or private to public, may yield costly surprises. So, be sure to review the different legal and accounting principles applicable to your new line of work before your company commits to such a change.

### IMPROVE COMMUNICATION

Second, tight economic times require better and more frequent communication with your company's financial professionals. Accountants, surety representatives, insurance underwriters, and bankers can assist with invaluable long-range planning and help predict financial problems before they occur. Until the economy stabilizes, you should meet with these professionals as a group at least quarterly.

### REINVEST YOUR COMPANY'S PROFITS

Third, how your company reinvests its profits becomes more important. Whereas good times afford the opportunity for profit distributions among the company's principals, in a tight economy, more profits should be invested

back into the company. This will create a revenue stream for when cash flow dries up or increased financing or bonding capacity is needed.

### BENCHMARK

Finally, benchmarking is a vital exercise that measures your company's successes against those of its competitors. CFMA's *2008 Construction Industry Annual Financial Survey* is one of the best benchmarking tools available. It provides, at minimal cost, the specific information needed to gauge how well your company is positioned compared to its competitors.

### Conclusions

---

The stress everybody feels these days over the economy can prevent clear-headed fiscal planning. But, now more than ever, you must review your company's financial condition and long-range business plan.

Recheck and adjust, as necessary, your company's contracts, A/R management practices, and bonding and insurance plans to increase both stability and flexibility.

Increase consultations with your company's accountants, insurers, sureties, and attorneys to ensure that your company is as protected as possible. Then, hold on tight because it looks like it's going to be a bumpy ride!

**BP**

---

LEE A. WEINTRAUB is a Board Certified Construction Attorney for Becker & Poliakoff in Ft. Lauderdale, FL, specializing in construction law and commercial litigation. He represents owners, contractors, subcontractors, design professionals, bond sureties, and many others in the construction industry.

Lee is a frequent presenter and author (including *CFMA Building Profits*) on construction-related issues. Lee earned a BSBA and JD from the University of Florida, Gainesville, FL, and is board certified as an expert in construction law by The Florida Bar.

He is on the Board of Directors of CFMA's South Florida Chapter, and has chaired numerous construction law committees in Florida.

Phone: 954-985-4147

E-Mail: [lweintraub@becker-poliakoff.com](mailto:lweintraub@becker-poliakoff.com)

Web Site: [www.becker-poliakoff.com](http://www.becker-poliakoff.com)

