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How contractors can avoid landmines during a construction market recovery

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Construction companies fail three times more frequently during a recovery than during a downturn. Schleifer, Beware the Recovery: What History Teaches Contractors and Sureties, Engineering News-Record-January 14, 2013. The reasons are simple: contractors are still bidding at recession level profit margins, but are now landing more jobs. However, many contractors do not have the working capital to manage those jobs because lenders are still very reluctant to lend to an industry pummeled by the recession. Lenders drastically reduced credit lines during the downturn and have been painfully slow to restore the same. To make matters worse, material costs are escalating and labor costs are projected to jump significantly as well. The end result: some construction companies are likely to run out of money before completing their projects.

Hopeless? Far from it! Every construction environment (from robust to recessionary) presents challenges and opportunities. Success hinges on understanding the environment and setting forth a strategy to maximize those opportunities. The current environment requires consideration of the following steps. First, owners should insist on inserting a contract provision requiring contractors to prove sufficient capitalization to complete their projects. Many of these provisions are limited to the period preceding commencement of the work. However, the better provisions require contractors to submit this information before and during construction.

Second, owners should consider payment and performance bonds. Although owners will ultimately bear the costs of the bonds, bonds serve two crucial functions. Payment bonds protect owners from non-payment claims including, without limitation, mechanic's liens and attachments. Performance bonds protect owners from contractors who fail to complete projects.

Additionally, bonds serve as a kind of "Good Housekeeping" seal of approval. Contractors must achieve a level of fiscal responsibility to be bonded. Surety underwriters scrutinize contractors' financial information to ascertain whether they are "bondable" and, if so, to what extent. In short, the mere fact that a contractor is bondable should give the owner some degree of confidence the contractor has the fiscal resources to pay its debts and to complete its projects. As noted by Brian Rossi, executive vice president, GenCorp Insurance Group:

"As we exit the Great Recession, albeit slowly, surety credit should be viewed as a precious commodity and an instrument of competitive advantage. While somewhat counter-intuitive, the frequency of contractor defaults is actually escalating as construction economic conditions improve. This phenomenon will encourage the continuation of cautious surety underwriting, thereby creating opportunities for best-of-class contractors to use surety credit to their advantage."

Owners can achieve additional layers of protection through contract terms relating to subcontractors. Specifically, the owner/contractor contract should require the contractor to identify all key subcontractors and material suppliers and to notify the owner immediately of any changes among that group. In conjunction therewith, the contract should include a provision allowing the owner to contact each such subcontractor and material supplier in advance of payment to ensure each has been paid in full. The contract should also give the owner the ability to issue joint checks whenever it has any reason to believe the contractor has not paid a subcontractor or material supplier.

One of the most important contract terms, however, is the requirement that the contractor, subcontractors, and material suppliers sign Lien Waivers and Indemnity Agreements. The owner should ensure its proposed Lien Waiver not only contain the basic Lien Waiver language (e.g., acknowledgement of payment and assurance it paid its creditors), but also an indemnity obligation triggered by any failure of the contractor, subcontractor or material supplier to fulfill a requirement within the Lien Waiver (e.g., failure to pay creditors). Lien Waivers often fail to include indemnity language so owners need to ensure it is included in all Lien Waivers.

In short, all construction environments contain risks and rewards. The present "recovery" phase environment presents the risk of contractor failure. Owners should use properly drafted contracts that include the terms most likely to mitigate the risk of contractor failures so owners can reap the rewards of successful projects.

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