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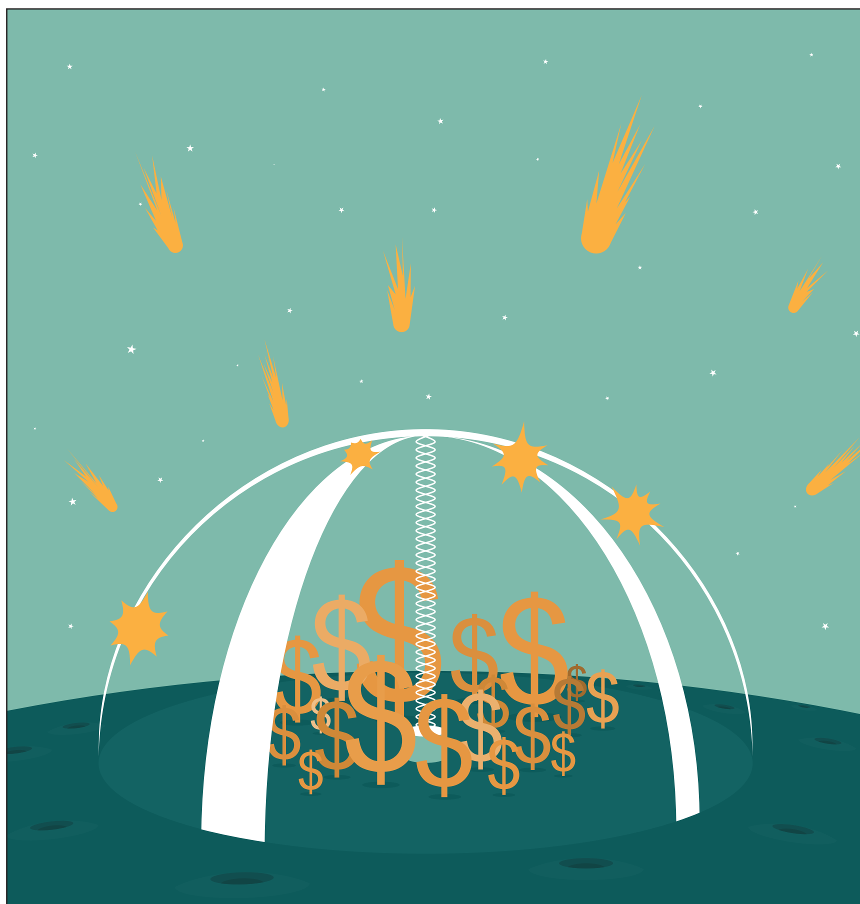
BY SCOTT G. WOLFE

PROTECTING YOUR COMPANY
from a Rebounding Economy



Welcome to 2014: The U.S. economy and construction market are staged for a rebound. In an October 2013 summit hosted by Reed Construction Data, a panel of construction economists discussed industry forecasts for 2014 and beyond. The news was positive: Although 2013 wasn't as great as many had hoped, it was a year of growth for the industry, with all signs pointing toward much stronger results in 2014 and 2015.[1]

Overall, a rebounding economy is great news. However, if contractors aren't careful, they may face more financial risk in the rebounding market than during the 2008 downturn. This article will explore why the construction industry isn't out of the woods just yet, and what must be done to protect against the market's new financial risks.

Why Is a Rebound Risky?

The economy's recovery is a process, and according to Thomas Schleifer, PhD, of the Del E. Webb School of Construction at Arizona State University, it's a process laced with peril.

In a recent *ENR.com* article, Schleifer explained that construction companies are *three times more likely to fail* in a recovery than in a downturn.[2] This is bad news for an industry already riddled by high business failure rates.[3]

While it's expected that a declining or flat economy carries financial risks, warning about an improving economy might come as a shock. Although it seems counterintuitive, a rebound economy creates a turbulent atmosphere that deserves a CFM's full attention.

Sudden Increased Cash Needs

It's been a long recession for a lot of companies, many of which significantly scaled down operations due to the decreased market demand and burned through cash reserves. The result is an excess of contractors that have been financially struggling during the downturn.

Sudden or rapid growth is a cash-eating affair. Negative cash flows are common during high growth periods and, depending on the circumstances, can persist for several years and require substantial financing.[4]

If 2014 is the year of the rebound, it could present a host of problems for the construction industry. Contractors will take on an increased workload and burn through cash they don't have. At the same time, private capital sources and financing institutions are still a bit gun-shy, especially with investments in the construction sector.

In other words, contractors are starving, and they're about to walk into an all-you-can-eat buffet. Many are going to get over-stuffed. But cash is just one problem with scaling up a previously depressed market – the task presents some practical challenges as well.

Delays & Challenges in Homebuilding

The 2013 homebuilding industry gave a sneak peak at the challenges in scaling a market from depressed to rebounding. Long the scapegoat for the economic crisis, the homebuilding market took an aggressive and surprising uptick in 2013.[5]

The New York Times published an article suggesting that the "sudden rise in home demand" was taking government and builders by surprise.[6] But getting taken by surprise has its downsides.

Since government agencies have downsized, the sudden increase in building permit filings has greatly increased the volume of paperwork. This, of course, results in construction delays and adds to the cash strain.

Likewise, many laborers have moved on to other jobs or other territories. *The New York Times* article reported that "builders are scrambling to ramp up production but face delays because of the difficulty [in] finding construction workers."

Everyday Credit Risks

The rebounding economy will present unique problems for contractors, and clearly, it may be challenging to keep up with a sudden demand for cash and output when the economy depleted most companies' reserves and capacities. Nevertheless, it is important to recognize that these problems are simply compounding the risk in an already risky market.

Through the recession, many companies have built stronger credit policies and practices out of necessity, and it may be tempting to sacrifice some of these practices when blinded by the allure of a marketplace full of new profitable opportunities. This, too, however, is another reason why the rebounding economy presents financial risks. Sound credit practices are important in every shade of economy, especially so in rebounding ones.

How Can Contractors Manage Financial Risk?

CFMs are very familiar with the industry's financial risk factors. Accordingly, preparing for the heightened risks of a rebounding economy won't require foreign efforts. The risk management practices are the same, which makes understanding the nature and scope of the risk half the battle in succeeding against it.

The rebounding economy's financial risks require contractors to prepare on two fronts:

1) Ensuring their own houses are clean to avoid becoming a statistic; and

2) Taking precautions when contracting with others in the industry.

Don't Become a Statistic

Keeping one's own house clean requires discipline and preparation.

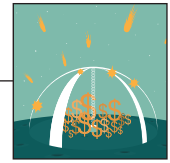
On one hand, a contractor must resist the urge to accept new business unless it has the cash to perform. Over the past few years, many companies have gotten into the habit of saying "yes" more often than "no." Taking on too much work may suffocate a company faster than the 2008 downturn ever could.

On the other hand, understanding what a company can and cannot financially handle requires the company to have a solid understanding of its finances. Accordingly, CFMs must make reliable cash flow projections and prepare for their companies' capital needs. Allocate cash or secure financing for a best-case scenario negative cash flow run.

Take Precautions When Contracting with Others

It will be extremely difficult to distinguish between those companies growing at a sustainable pace and those that are stretching themselves too thin.

Guessing about or depending on a company's previous track record is not reliable. Instead, risk-shifting or risk-insulating practices can offset the risks posed by the other parties on a



construction project. The remainder of this article discusses many of these practices, including:

- risk-shifting contractual terms;
- contractor default preparations;
- preservation of security rights; and
- making smart credit decisions.

Shift the Financial Risk Around in the Construction Contract

During presentations at the 2013 AGC/CFMA Construction Financial Management Conference, the consensus was that "cash-strapped public and private owners are shifting greater risk onto contractors through onerous deal terms."[7] This is just a spoke in the wheel of the constant financial risk-shifting battle among owners, GCs, subcontractors, and suppliers.

Naturally, the financial risk associated with a construction project rests with the owner, and works its way down the contracting chain. Shifting the risk away from one party to another begins with the contract, but the risk-shifting tug of war gets very complicated.

Current law straddles two public policy choices when interpreting any risk-shifting provision. Our country believes in the parties' freedom to contract, empowering parties to agree to anything they want (provided it's not against the law). However, the U.S. also has a public policy interest in protecting those at the bottom of the contracting chain from those at the top.

Mechanics lien and bond claim laws, prompt payment penalties, misappropriation of funds criminal statutes, and retainage restrictions are all examples of state governments stepping between contracting parties, determining that the financial risk of a project should be shouldered at the top of the chain, and taking steps to facilitate that result.

Owners and GCs continue to craft contractual provisions in an attempt to circumvent this public policy. Pay-when-paid and pay-if-paid clauses are key examples of these provisions, and the split in courts across the country about whether these provisions are valid risk-shifting clauses or mere "timing mechanisms" highlights the friction between these two competing interests.

In any event, the risk-shifting approach to utilize will depend on where a company falls in the contracting chain. When possible, those at the bottom should resist such risk-shifting provisions as pay-when-paid clauses, pay-if-paid clauses, and even notice claim provisions. Those at the top of the chain should employ their attorneys to insert the risk-shifting clauses with the best chance of surviving scrutiny (i.e., don't get too greedy).

(To learn more about these clauses, read Susan L. McGreevy's article in the May/June 2013 issue of *CFMA Building Profits*.)

Mitigate Contractor Default Risks

The report from ENR's first Risk & Compliance Summit in September 2013 is obvious: "The perception of risk depends on where you live on the payment chain."[8] Perhaps obvious as well is that those at the top of the chain worry most about subcontractor defaults.[9]

Owners and GCs worry about subcontractor defaults, and even subcontractors live in fear over sub-subcontractor defaults. The risks associated with a rebounding economy only increase the importance of this threat.[10]

The tools available to mitigate this risk are the same regardless of the economic climate: prequalify subcontractors, require performance and payment bonds, and attempt to "stay ahead" of the contractor.

Secure Your Contribution to the Project & Receivables

Security should always be a key component of a company's financial risk plan. In the construction industry, every extension of credit should be secured by either a mechanics lien or bond claim right. While the economic downturn had a negative impact on these rights by draining real estate equity and making sureties pinch pennies, the rebound will have the reverse effect. In the rebounding economy, security rights should be a fitting antidote to individual business failures and cash misappropriations.

Contractors and suppliers, regardless of tier, can benefit from security instruments like mechanics liens and bond claims.

Mechanics lien claims are perhaps the original risk-insulating devices in the American construction industry.[11] Despite being more than 200 years old, these claims stand tall even today as the most effective weapon against a project's financial risk.

It's a sobering reality that every time a contractor or supplier steps onto a construction project, they are stepping onto a financial battlefield. The terms of the contract wrestle to shift the project's risks. Payment and performance bonds are requested to insulate parties. Retainage is withheld on every payment down the chain, and parties manipulate pay applications to "stay ahead" of the other parties. All the while, millions of dollars flow through numerous sets of hands, each hoping that this orchestra of financial chaos ends well.

Mechanics lien and related security rights provide the arsenal needed in this financial risk battle. Companies are apt to utilize these rights, which almost always require proactive action at the beginning of a contract and ongoing monitoring of each state's specific requirements. Nevertheless, the difficulties are a small price to pay for the protections afforded by compliance.

Make Smart Credit Decisions

Avoiding financial challenges requires assessing risk, which almost always boils down to making intelligent credit decisions. Signing a contract to furnish labor or materials to a project can impose a significant obligation upon a company, and the company owes that obligation to a customer. In construction, more than in any other industry, the quality and reliability of the customer is crucial.

While the quality and reliability of a customer may sometimes be unpredictable, it need not be secret. Many tools exist to help contractors and suppliers alike assess the risk of doing business with a potential customer, including credit checking and monitoring services, asset searches, and other services that perform business reviews and monitoring. There's no silver bullet method to evaluating businesses. What's important is that companies evaluate a potential customer at the onset.

Making smart credit decisions doesn't stop with a pre-contract review. If it did, most business transactions wouldn't take place, because it's rare to get spotless and complete credit information on a potential customer.

Instead, making a smart credit decision means evaluating the risk of a customer, and then filling in the gaps of exposure with some risk-offsetting tools, including personal guarantees, joint check agreements, credit insurance, and Uniform Commercial Code (UCC) filings. Again, there is no silver bullet here, but companies should understand and have at their disposal as many of these tools as possible.

At the end of the day, smart decisions about taking and securing business is what will separate the companies that thrive from the companies that fail.

Conclusion

Everyone is excited about the rebounding economy, and overall, it's great news. While getting through the rebound may be fraught with danger, it's unanimous that the light on the other side is bright.

Clearly, however, the rebound process carries unique financial risks for those in the construction industry. Understanding and preparing for these risks will help contractors avoid becoming a fatal statistic in the recovering marketplace. ■

Endnotes

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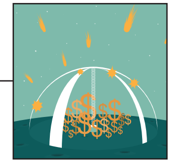

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