BY NATHAN BUDDE

Technology's Role in Securing Projects & the Duty of CFMs

It's no secret that lower-tier contractors face ongoing payment obstacles from parties higher up on the contracting chain. To help overcome these obstacles, statutory security devices known as mechanics liens were developed to essentially guarantee payment (provided the work was done, materials were provided, and the proper procedural steps were taken).

These laws provide the same protection routinely used by banks to secure loans, and allow for the same ultimate remedy. Every state has passed laws that in essence allow parties to force the sale of somebody else's property in order to secure payment.

The laws are complex, strict, and occasionally demanding, but the protection to virtually guarantee payment is available. (For a more in-depth look, refer to "Is Everything You Know About Lien Waivers Wrong?" by Scott G. Wolfe in the March/April 2015 issue.)

With the availability of this payment protection, it seems like the burden of bearing the financial risks associated with construction projects should be placed on the parties at the top of the payment chain. But this is not the case. In fact, the failure of companies to properly use or implement available security instruments is exacerbating the historical payment problems plaguing the industry.

Challenges & Complexities of Liens & Payment Security

Unlike the nearly universal requirements for many other types of security (e.g., a UCC financing statement), the requirements to perfect a mechanics lien and bond claim vary among states as well as public vs. private projects.

For example, a CFM may be presented with a situation in which a large delivery of materials is to be provided on a jobsite in a state other than the one in which the company is located. In order to secure this furnishing of materials on credit, several steps may be required – all of which depend on the state to which the materials were delivered as well as the role of the party to whom the materials were delivered.

In order to remain in a secured position with the ability to file a valid mechanics lien, the CFM must:

1) Identify the applicable notice deadlines;

2) Provide the required notice, if any;

3) Identify and comply with the notice requirements vis-à-vis the parties mandated to receive the notice and the method by which the notice must be sent, and;

4) Comply with any mandatory follow-up notices.

If a lien becomes necessary, however, the CFM must take on an even more complex procedure than the initial notice process. The failure to meet these complex perfection requirements may result in the permanent loss of security on the project.

Since secured receivables are more likely to get paid than unsecured receivables (and a higher percentage of secured receivables results in higher company value), the failure to secure each furnishing of labor and/or material on credit directly impacts the financial health of a company. As such, it behooves CFMs to strive to always maintain a secured position.

Security rights directly and significantly impact both timing and likelihood of payment and, as such, they directly and significantly impact A/R data and cash flow. Because the expected write-off for secured extensions of credit is meaningfully reduced as compared to unsecured extensions of credit, the calculation of "bad debt" related to each differs in a corresponding amount.

U.S. GAAP allows companies to calculate outstanding bad debt (and therefore determine A/R worth) using different methods. However, "there is very little regulation around what methods may be used, except to require 'conservatism'."[1] Since secured receivables consistently outperform unsecured receivables, "segregating these two classes of receivables and applying a different allowance would be an acceptable multi-method calculation of bad debt, and likely would result in increasing and making more accurate the earnings reported by companies."[2]

As more information becomes available regarding the positive effect security rights may have on A/R, cash on hand, and even company value for contractors, the lax attitude toward the use of security rights is likely to change.

The tools available to contractors are as powerful (if not more) than the security devices available in other industries, but are not as frequently used. Since the *result* of securing debts is the same regardless of the industry, the difference must be in the *process*.

Technology's Role: Help or Hinder?

In the past, managing and tracking mechanics lien requirements was difficult to implement and required cumbersome in-house departments or inefficient third-party outsourcing, which made it impossible to leverage security on all projects. The biggest frustration and largest obstacle in the use of security has been the number and complexity of the laws and requirements that must be met, which makes it difficult for contractors to create smart and effective policies to use the security available.

Despite the improvements and advantages of adopting new technologies, the construction industry only spends 1% of revenue on technology; the cross-industry average spend is 3.3%.[3]

Still, cloud-based technology and emerging software offer a solution to automate security requirement compliance. As this type of technology gains traction in the construction industry, the days of CFMs being allowed to disregard security rights because of complexity and cost will rapidly disappear.

As stated in an article by Thomas W. Emison, Darwin D. Braunagel, and Timothy M. Gray, "[t]echnology is not a necessary evil, but rather a competitive differentiator."[4]

Emerging Software

Emerging software has the ability to decode and streamline security perfection requirements for parties up and down the payment chain. GCs, owners, and lenders are already using technology to determine which subcontractors and suppliers are considered potentially risky[5] – that is, to prioritize payment to parties that have secured their extensions of credit. Certain technology platforms can provide valuable information to top-tier parties and can be useful in streamlining payment.

Many technology platforms and software apps have been developed to help subcontractors with various specific aspects of their jobs (e.g., finding more projects, bidding, managing projects in the field), but inclusive cloud-based technological tools to manage security rights and other facets of the payment process are more difficult to find.

Some construction technology companies have started to reach out to subcontractors by presenting methods other than security rights in order to facilitate streamlined payment. These fee-based programs are designed and created to improve cash flow,[6] but rely on subcontractors to foot the bill for timely payment rather than providing a way to leverage the security and payment tools available by law.

Since these tools still have a long way to go in compatibility and fairness, CFMs lower on the contracting chain should be cognizant of any new technology designed to assist them with security rights, and consider what may be reasonably required to institute a thorough policy of remaining in a secured position on all projects.

Cloud-Based Technology & CRMs

Moving away from an over-reliance on Excel is one step. Embracing the power of cloud-based technology to reinvent business process, from customer relationship management (CRM) functions to security management to billing, is another. By emphasizing efficiency, cloud-based software platforms enable contractors to expend less effort and energy on tasks that can be successfully completed by software, and more effort and energy on expanding the business.

The construction industry is all about relationships, and CRM products designed to give users control over and insight into customer records are uniquely suited for cloud-based software platforms.

The unique nature of customer relationships in construction presents an interesting challenge for CRM products. In construction, the same party may be both extending and credit and having labor and/or materials furnished on credit to it – buyers are sellers, and sellers are buyers. This means that CRM-type needs are present at both the jobsite – by connecting PMs and collecting, collating, and organizing all of a project's communications – and in the back office.

In fact, a recent development in the creation of construction CRM technologies is that business process and workflow software applications are the platforms developing CRM-type products for the back office.

Platforms designed to provide control over and manage the complex security device requirements not only provide help

with lien requirements, but they can also view data differently as well as assess the customer relationship to gauge risk and act accordingly.

By understanding the relationship between security status and risk, and how that specifically relates to customer relationships and payment, the entire relationship can be managed in a more efficient and informative way. However, to do so requires the knowledge of whether or not one is secure on every project, and the awareness and tracking of deadlines and requirements. When this is accomplished, though, bad debt is virtually eliminated and company value increases.

Duties of Corporate Directors & Officers: Why They Matter

A duty signifies a thing due, or designates an obligation of performance, care, or observance.[7] These obligations are often imposed on a person in some fiduciary capacity (e.g., a director, officer, or manager). Company leaders have two specific duties, both to the corporation and to shareholders: the duty of care and the duty of loyalty.[8] (The duty of loyalty is beyond the scope of this article.)

While these particular "duties" are obligations of the directors and officers of corporations, the ideas behind the obligations are applicable both to CFMs and other nondirector/officer parties. The duty of care requires prudent oversight of the company's business and decisions made on its behalf, in light of all reasonably available information.

Specifically, the following steps should be taken when determining a company's course of action: consider all relevant information, consider the advice of experts, and understand the terms of transactions.

Given the industry's failure rates and profit margins, in addition to the duties owed to the corporation itself, the directors and officers of a financially distressed corporation are also likely to have some similar duties to the company's creditors.[9]

Decisions to not follow or disregard what would be considered an industry's "best practices" generally does not result in a breach of the duty of care. A director or officer does not breach his or her duty of care to the corporation/shareholders if the decision was made: 1) in good faith, 2) with the care a prudent person would use, and 3) with the reasonable belief he or she acted in the best interests of the corporation.[10]

Though it's unlikely to see a court case in which a CFM faces allegations for failure to properly use mechanics liens further resulting in a breach of the duty of care, it presents an interesting thought experiment. As contractors looking to reduce payment problems become more aware of the benefits of mechanics lien rights and new technologies are developed to assist in that process, they may consider more in-depth examinations of their policies in securing payments, and such cases may become a reality.

Payment Challenges **Inherent in Construction**

For many parties, it's not just the structural framework of the construction payment process that causes problems (at least in terms of waiting for other parties to be paid). Parties higher up on the contracting chain are often able to exert more leverage over the payment process, which can cause frustration and lead to less working capital. The further down the chain a project participant is, the more opportunities there are to experience hiccups in the payment process.

Unfortunately for many project participants, the ability of top-of-the-chain parties to exert more control over the payment process has led to many contractual risk-shifting mechanisms designed to pass the burden of financial risk onto the lower-tiered parties. Chief among these risk-shifting clauses are the pay-if-paid/pay-when-paid clauses.

Pay-if-paid/pay-when-paid clauses are generally expected in contracts, and it can be hard for a CFM to see how odd that practice is. Since this type of contractual risk-shifting is common and accepted in the construction industry, the unbalanced spectrum of leverage on a project that gives rise to these mechanisms is taken for granted. Because the parties closer to the money are able to exert more control over how and when it gets distributed, lower-tiered parties often must accept unfair risk-shifting clauses and potentially bear a project's financial risk.

It's no wonder that the construction industry is volatile and subject to significantly higher failure rates.[11] Even companies that do succeed are restricted by enormous cash flow concerns and razor-thin profit margins.

Using security rights when available would be the best practice for companies in an industry in which these rights are provided to them by law. As noted, failure to follow industry best practices, however, is not a breach of duty on its own. But consider the following: What happens if the failure to use mechanics lien security was the result of the following facts?

1) No information regarding the payment rates for secured extensions of credit vs. unsecured extensions of credit was examined.

2) No experts in security and/or financial receivables management were consulted.

3) No examination of the availability of newly developed software to assist with this process was undertaken.

In all likelihood, a decision to not use mechanics lien security pursuant to the previous information would not violate any duty. But, this may be more of a function of the historical treatment given to mechanics liens by construction industry participants rather than an actual examination of the facts.

Conclusion

Given how drastically security rights impact a business, CFMs should strongly consider implementing security for all extensions of credit (including mechanics liens) now, and integrate it into their companies' policies.

Technology allows for security to be used by construction industry participants on every project; setting up such a methodology before it's mandated by the industry will not only protect CFMs, but will have a positive effect on the company's bottom line, cash flow, A/R, and value. ■

Endnotes

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NATHAN BUDDE is Editorial Director of The Construction Payment Blog and Chief Legal & Product Officer at *zlien* in New Orleans, LA. The company produces a software platform that reduces credit risk and default receivables for contractors and suppliers by giving them control over mechanics lien and bond claim compliance.

Nate is a licensed attorney in Louisiana and earned a BA from Stanford University and JD from Tulane Law School.

Phone: 866-720-5436, ext. 708
E-Mail: nate@zlien.com
Twitter Handle: @nathanbudde