



Contractor Surety Losses: Lessons Learned

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Agenda

- 👷 **Introduction**
- 👷 **Top Ten things your surety doesn't want to hear**
- 👷 **Why do contractors fail?**
 - Strategic business decisions that put contractors at risk
 - Unrecognized impacts of business practices
 - Financial issues
 - Business and succession planning
 - Assumption of inappropriate risks
- 👷 **Questions you can expect from your surety in these challenging market conditions**
- 👷 **Q&A**

Top Ten things your surety doesn't want to hear:

- 10. Yes, we've built schools for 50 years, but doesn't nuclear power plant construction sound exciting?**
- 9. Our new general counsel says he's pretty sure that doing business in Venezuela won't be much different than doing business in Topeka.**
- 8. We doubled our work program again this year, and Todd has no problem at all managing eight projects at once. He's very efficient. Really.**

Top Ten things your surety doesn't want to hear:

- 7. We are uncompromising, litigate frequently, and have great confidence that we will be vindicated by our fair and impartial court system.**
- 6. Allow me to introduce my son-in-law. He's taking over in June.**



Intentionally Blank

Top Ten things your surety doesn't want to hear:

- 5. Sure my cash flow has dried up and my line is exhausted, but my underbillings are through the roof!**
- 4. There were fourteen bidders, so we had to submit a bid with no profit or overhead in it, but we got the job! Isn't that great?**
- 3. I agree with you that those contract terms are one-sided contractor killers. How about we sign, but carve the liability out of the bond?**

Top Ten things your surety doesn't want to hear:

- 2. Yes, my backlog is down to one convenience store project in Milwaukee, but if I reduce my overhead, I won't be ready when the really big jobs get let. I'm sure there will be some ... soon.**
- 1. Hey! How would you like to bond a Newco?**

Why Do Contractors Fail?

The Challenge:

**Maintaining
business
discipline in the
midst of adverse
market conditions**



Strategic Business Decisions That Put Contractors at Risk

Strategic Business Decisions That Put Contractors at Risk

- 🛑 Geographic “Stretch”
- 🛑 Increase in Project Size and Complexity
- 🛑 Entry into New Market Segments
- 🛑 Rapid Expansion of Work Program
- 🛑 Restructuring/M&A/Unfamiliar Business Partners

Morrison Knudsen – Lessons Learned

- 🛑 Entry into New Market Segment – Design and Construction of Railcars
- 🛑 Rapid Expansion – Transportation Sector projects became 40% of total revenues
- 🛑 Inadequate pricing and experience to perform the contracts
- 🛑 **Result: Bankruptcy**

Acme Construction - Lessons Learned

- 👷 Senior employees of 50-year-old, successful company seek to buy the business
- 👷 They partner with New York equity firms to finance a leveraged buyout and company reorganization
- 👷 In order to satisfy the ROI expectations of the equity firms, Acme expands into three new markets and doubles its payroll
- 👷 Acme secures ample work in the new markets, the equity firms provide ample funding and convert debt to additional equity to support the expansion

Acme Construction – Lessons Learned

Three years later . . .

- 🛑 Untested new personnel underbid projects by underestimating costs and overestimating productivity in the new markets
- 🛑 New personnel not properly supervised, leading to widespread quality control issues and substantial rework costs
- 🛑 New business partners' unrealistic ROI expectations led to a breakdown of previous management discipline in order to secure new work
- 🛑 **Result: Acme files for bankruptcy protection and is liquidated**

Acme Construction – Lessons Learned

- 🛡️ A successful work program expansion requires careful planning and consideration of the financial, staffing and systems requirements of the company as it enters new markets.
- 🛡️ Avoid overleveraging the company. Adequate working capital and cash flow management are essential.
- 🛡️ Know who you are hiring. Postpone significant expansion until new personnel have proven their expertise and ability.
- 🛡️ Invest the time and resources required to fully understand the risk profile presented by new types of work and new markets. Risks that are not known or understood cannot be mitigated.
- 🛡️ Don't bite off more than you can chew. As staffing and work programs increase, make sure you have the systems and management controls in place that will enable you to spot problems early and correct them.



Unrecognized Impacts of Business Practices

Unrecognized Impacts of Business Practices

- 🛑 Inadequate job cost accounting leading to underbidding and impaired financial and strategic planning
- 🛑 Project management issues – failure to administer and collect change orders, forfeitures of claims due to failure to comply with critical notice provisions, late completion of projects, failure to maintain accurate schedules
- 🛑 Frequent or protracted involvement in litigation
- 🛑 Staffing issues – inadequate or inappropriate staffing, high turnover, inexperienced or unfamiliar new hires in critical positions
- 🛑 Failure to implement risk mitigation measures – contract review, bonding of critical subcontractors, etc.

Project Management Errors Cost Money – Lessons Learned

Dan Nelson Const. Inc.

- 🟡 Nelson was a site work contractor working for DEP. Its contract had a 15 day written notice provision with a reasonable differing site conditions clause.
- 🟡 Nelson encountered unexpected water and rock. DEP personnel *helped* Nelson prepare his draft claim. Nelson sent written notice four months later.

Mike M. Johnson, Inc.

- 🟡 Sewer contract required Johnson to provide 15 day written notice of protest of a proposed change order ("PCO").
- 🟡 Working under PCO, Johnson encounters buried phone lines. *County instructs* Johnson to stand down while they relocate lines.
- 🟡 Johnson fails to provide notice that protests the amount and time granted in the PCO, thinking County had actual knowledge of issue.
- 🟡 **RESULT - Both Nelson and Johnson were denied relief in court due to their failure to meet the notice provisions of the contracts.**

Dan Nelson Const. Inc. v. Nodland, 608 N.W.2d 267 (N.D. 2000); Mike M. Johnson, Inc. v. County of Spokane, 78 P.3d 161 (Wash. 2003)

What's Not in the Contract Can Hurt You – Lessons Learned

- CM at Risk contract with \$600,000 fee for renovations of operating casino in Atlantic City, NJ.
- Work required scaffolding covering facade of casino and disruption of public areas which impacted normal operations.
- Disputes over materials and specifications escalated and led to delays and the termination of Contractor.
- ***The contract contained no CD waiver or cap, and no liquidated damage provision.*** Contractor's field managers didn't recognize the consequences of not having CD waiver clause and/or LD clause during their pre-bid review and during the course of construction.

What's Not in the Contract Can Hurt You – Lessons Learned

- 🛑 The casino claimed significantly diminished foot traffic, lost profit and revenue as a result of the construction delay.
- 🛑 An arbitration panel awarded the casino ***\$14.5 Million in consequential damages.***
- 🛑 Contractor sought to set aside the award, claiming the damages were not foreseeable.
- 🛑 **Result: The Supreme Court of NJ upheld the award, even though the damages awarded dwarfed the contractor's fee.**

Business Practices – Lessons Learned

- 🛑 Timely and accurate job cost accounting is essential to effective strategic decision making and company profitability
- 🛑 Thorough and disciplined contract review is an essential component of pre and post-bid risk mitigation and cost control
- 🛑 Frequent cost/benefit analyses of matters in dispute keep your resources and attention focused on critical business concerns rather than protracted, potentially financially draining litigation
- 🛑 Time and resources invested in ensuring that staffing is adequate, appropriately skilled and provided with essential systems and support saves money in the long run and provides the quality information and expertise needed for success

Financial Issues

Financial Issues

- 🚨 Inadequate working capital
- 🚨 Accounting practices that distort management information – held checks, booking disputed claims, inaccurate job cost tracking, inadequate accounting systems
- 🚨 Inability to forecast and manage cash flow
- 🚨 Credit crunch – lines reduced or at limits, lines not renewed, all credit fully secured
- 🚨 Inadequate pricing models – inadequate cost accounting, heavy reliance on change order revenue to support overhead costs, etc.
- 🚨 Failure to proactively manage overhead in the face of declining revenue

Take a Chance Construction

– Lessons Learned

- Newly formed company managed by experienced former general contractor.
- Chance's owner adequately funded the company and utilized personal guarantees to secure an ample bank line to support its capital needs.
- Chance secured several substantial projects and decided to self perform the concrete, masonry and carpentry scopes of work.
- Chance disregarded its surety's advice to bond its major subcontractors.
- Chance believed it had identified all risks and was positioned to successfully complete its projects.

Take a Chance Construction

– Lessons Learned

- 👷 Critical subcontractors defaulted on two projects. Because they were un-bonded, Chance had to absorb the costs of re-letting the work.
- 👷 Inadequate historical cost data caused Chance to underestimate the cost of its self performed work and underbid the projects.
- 👷 Chance's failure to track its job costs hid the problem from management until it had exhausted its cash.
- 👷 After reviewing the deteriorating financials, the bank reduced Chance's line of credit.
- 👷 **Result: Although there were no issues with the quality or timeliness of its work, Chance ran out of cash and defaulted on its contracts.**

Financial Issues – Lessons Learned

- 🛡️ Adequate working capital and liquidity is critical.
- 🛡️ Frequent and accurate cash flow projections enable proactive and strategic management of company resources.
- 🛡️ Disciplined accounting practices are more important than ever as credit tightens and competition for new work intensifies. Insist on timely and accurate financial information.
- 🛡️ Act decisively and proactively to keep overhead costs in line with company revenues.
- 🛡️ Seek out your surety's advice. Your surety wants you to succeed.

Business and Succession Planning

Business and Succession Planning

- 🛑 Unclear business plan lacking a “road map” to achieve objectives
- 🛑 Expansion into new business environments with inadequate consideration given to the financial, staffing and legal implications
- 🛑 Insufficient or incapable personnel in key positions
- 🛑 Inadequate management structure
- 🛑 Unclear chain of command

Family Owned Business, LLC

– Lessons Learned

- Family Owned Business (FOB) was established by Patriarch.
- For over 40 years Patriarch grew the company, staffing it primarily with family members and long time trusted employees and keeping a tight rein on expenses.
- Patriarch brought his three children into the business but retained 100% ownership of FOB. Decision making authority remained with Patriarch.
- Upon Patriarch's death, his shares were distributed to the children equally.

Family Owned Business, LLC

– Lessons Learned

- 🛑 Children adopted an informal management structure, with all decisions made by consensus
- 🛑 Incapable CFO hired who was unable to produce accurate financial reports.
- 🛑 Considerable company resources were invested in new equipment and expansion into new markets. Previously ample cash flow tightened.
- 🛑 Unforeseen problems on several projects further stressed FOB.
- 🛑 **Result: FOB's management was unable to timely respond to the challenges facing the company and it was forced to close its doors.**

Family Owned Business, LLC – Lessons Learned

- 🛡️ It's never too early to begin planning and implementing a business continuity/succession plan.
- 🛡️ Identify, retain and develop the skills of key personnel.
- 🛡️ Establish company practices and values that yield consistent success and work actively to instill the company culture into management and staff members.
- 🛡️ Create a management structure with defined areas of responsibility, accountability and clear chains of command.
- 🛡️ Create mechanisms for the transmission of ownership and management control that retain effective management structure and preserve the culture of the organization.

Assumption of Inappropriate Risk

Assumption of Inappropriate Risks

Risk is inherent in business, but risk becomes inappropriate when it is has not been identified, negotiated, priced, and/or mitigated.

- 🛑 Inadequately understood or mitigated design/build risks
- 🛑 Performance specification risks
- 🛑 Acceptance of onerous, one-sided contract provisions
- 🛑 Contractual waiver of critical contractor rights
- 🛑 Excessive amounts of acceptable risk taken at the same time over multiple projects can become dangerous

Invincible Company, Inc. – Lessons Learned

- Invincible was a large and successful general contractor.
- Invincible was confident that it had the resources & expertise to handle its diverse work program which included:
 - Design & Construction of underground nuclear storage tanks.
 - Design & Construction of a Candy Manufacturing Plant.
 - EPC Contract for an Electrical Co-Generation Plant.
 - Design & Construction of acoustical enclosures for testing Navy jet engines.

Invincible Company, Inc. - Lessons Learned

- 🛑 Invincible's decision to enter into multiple, complex and diverse design build projects located throughout the country stressed its engineering and management staffs.
- 🛑 Invincible encountered costly and time consuming delays on projects as it attempted to meet performance specifications and address impact of unforeseen site conditions.
- 🛑 Two owners withheld payments due to performance issues; litigation ensued.
- 🛑 Overlooked onerous contract provisions shifted financial risk for differing site conditions to Invincible and waiver of right to contract balances if terminated on EPC project.
- 🛑 **Result: Invincible being financially unable to discharge its obligations, filed for bankruptcy and was liquidated.**

Invincible, Inc. – Lessons Learned

- 🛑 Design/Build projects and performance specifications greatly increase your risk.
- 🛑 Review your contracts. Risks that are not identified cannot be negotiated, avoided, priced or mitigated.
- 🛑 Negotiate contract provisions that quantify and limit damages.
- 🛑 Choose design subcontractors carefully and require them to provide substantial insurance coverage.
- 🛑 Be aware of the risks inherent in each project and be conscious of their cumulative effect.

**What questions can you expect
from your surety in today's
challenging construction
environment?**

Financial Questions

- 🛡️ **Liquidity/Bank Line.** How is the relationship with your banking partner? How dependent is your company on the bank line to support operations? If the company is reliant on bank borrowing to support operations, what steps has the company taken to improve cash flow? Has the banker renewed the line?
- 🛡️ **Receivables.** How quickly are the receivables turning over? Are there any slow receivables which concern you? If you do private work, do you verify financing?
- 🛡️ **Investments.** If the company has an investment portfolio, expect the surety to ask about the make-up of the investments. Expect the surety to be seriously concerned with utilization of company funds to finance outside business ventures.
- 🛡️ **Real Estate.** Expect the surety to want to know what real estate is owned both by the corporation and by the owners of the company. If the real estate is income producing, are the buildings leased out? What are the lease terms? Are you able to carry the mortgage through the leases? What is the loan-to-value ratio on the real estate held? Are their balloon payments that are close to maturity which will hinder cash flow of the corporation?

Operations Questions

- 🛑 **Overhead/Operations.** What measures have you taken to reduce / eliminate discretionary overhead expenses? How many months of overhead can you cover with the profit in your backlog? What is your plan of action if your company can't secure work?
- 🛑 **Personnel.** Quality of people in the company. Quality of superintendents / project managers. Be prepared to provide resumes.
- 🛑 **Internal Cost Controls.** Who handles the internal accounting? Are you able to produce quality monthly Work in Progress Schedules? Are you able to produce interim statements that are accurate?
- 🛑 **CPA.** Is your CPA construction oriented?

Project Specific Questions

- 🛡️ **Subcontractors.** How does your company manage subcontractor risk?
- 🛡️ **Profit margins.** What is an adequate mark-up for work? Are you bidding the job or bidding the competition?
- 🛡️ **Geographic spread.** Are you considering looking at work outside your normal area?
- 🛡️ **Scope of work.** Is this work that your company has done before? What is your experience with the complexity of the work, the type of work, and the size of the project + backlog you will be managing?
- 🛡️ **Contracts.** Are you reviewing contracts?

**Remember, it's not meant to be an
interrogation . . .**

The Surety is your business partner and wants you to succeed.

Q & A

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