

## **Preventing and Managing the Risk of a Subcontractor Default... A Best Practices Checklist**

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Tough times have depleted balance sheets and left working capital levels dangerously low for many subcontractors. Defaults are on the rise and expected to increase; a trend that has somewhat been masked by the number of subcontractors that have chosen orderly liquidation over continuing operations given the challenging market conditions of the last four to five years. Current evidence would suggest that general contractors experiencing subcontractor defaults have been able to weather the storm thus far because they have been able to find qualified subcontractors to step into the breach and perform the work in question for the same, or at least similar, prices. This trend will likely dissipate as the market continues to improve as subcontractors will likely not need, or want, to take on these types of thin-margin projects. History has also shown that default risk tends to increase as the market rebounds due to the cash requirements of funding a growing backlog.

So what does all this mean? Simply put, subcontractor default has become a top management agenda item and should remain that way for the foreseeable future. As the market slowly improves, general contractors will need to sharpen their risk management practices to ensure they don't get burned. Unfortunately, defaults happen and must be managed; however, a risk management approach that focuses on the end game alone (claims, litigation, etc.) is a bit like shutting the barn door after the horse got out. As the saying goes, "an ounce of prevention is worth a pound of cure."

The following list of best practices is intended to inform your risk management strategy. It is not, however, a substitute for a carefully crafted strategy that your risk management, pre-construction and operations leaders, as well as your business partners (brokers, attorneys, consultants, etc.), have all had an opportunity to review. The list includes a great many of the practices that have helped contractors in the past, and all merit your consideration, but do not all apply to every situation. It would be a mistake to rigidly implement all of these practices without regard to other facts or circumstances. Each contractor must make an independent determination of what is relevant to and appropriate for its particular situation.

### **Prequalifying subcontractors**

- Create a fair, objective system that generates a short list of firms that are qualified to bid on a project to:
  - Mitigate the risk of subcontractor default
  - Increase the chance of on-time, on-budget delivery of the project that meets the expectations of the owner
- Review financial condition (statement preparation, cash flow, over/under-billings, liquidity ratios).
- Review insurance coverage.
- Review and understand their bonding capacity. Is their surety financially sound?
- Visit the subcontractor's office and meet key management personnel.
- Conduct reference checks.
- Request notification of a change in executive team or ownership of the company.
- Know how many years the firm has been in business. What is their history?

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- Assess their litigation experience (claims, conflict resolution).
- Know their project history (market segment, geography, project size, project scope, etc.).
- Review references (contractors, suppliers, bank, surety).
- Review current projects under contract or in the pipeline to understand capacity.
- Analyze volume for the last three years to understand capacity.
- Understand workforce size and any recent appreciable changes.
- Assess the availability of resources (labor, equipment).
- Verify EMR for the past three years.
- Review history of OSHA incidents.
- Assess safety-training programs.
- Be diligent. Don't assume that once a subcontractor has been prequalified all is well. Continually insist on updated financials (Income Statement, Balance Sheet, Work-in-Process, backlog, etc.)
- Update prequalification before contract award if significant time has passed since original pre-qualification.
- Conduct a risk-benefit analysis to determine whether best price equals best value and acceptable risk.
- Asking for personal guarantees does not absolve you from doing the necessary due diligence to ensure the subcontractor can pay.

### **Using contracts to manage and reduce the risk of subcontractor default**

- Require identification/listing of 2<sup>nd</sup> tier (or lower) subcontractors and suppliers.
- Create and enforce the right to approve (or reject) 2<sup>nd</sup> tier subcontractors and suppliers.
- Create and enforce the right to see (and approve) 2<sup>nd</sup> tier subcontracts.
- Require that key contract requirements be flowed down.
- Require that payments be promptly flowed down.
- Require lien/bond waivers and certification of downstream payments at all levels; and specify forms to be used.
- Ensure lien waivers are valid in the states in which you operate.
- Consider bonding subcontractors, or requiring subcontractor default insurance.
- If bonds are used, prequalify surety and specify form of bonds.
- Consider procuring major, long lead-time, and/or critical materials and equipment directly.
- Control stored materials (payment, ownership, security and insurance).
- Establish the right to withhold payments in appropriate circumstances, with emphasis on appropriate circumstances. This does not advocate that the General Contractor has the right to unilaterally and arbitrarily withhold money that is due. The subcontract should clearly establish the circumstances under which the General Contractor can withhold money and when the General Contractor cannot.
- Authorize joint payments when necessary.
- Be clear about retainage.
- Require appropriate insurance coverage and ISO forms (may include design E&O insurance).

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- Include appropriate termination for default provisions (without an overly long “waiting period”).
- Include termination for convenience provision.
- Consider post-completion warranty obligations.

### **Managing the risks of subcontractor default during contract performance**

- Honor and enforce your contracts.
- Pace payments and progress.
- Be careful about “helping out.”
- Ensure that penal sums of bonds are increased if contract value increases.
- Obtain surety consent to payments and change orders.
- Be vigilant: watch for early warning signals of financial distress.
- Ask questions/communicate.
- Beware of “robbing Peter to pay Paul.”
- If a parting of ways is necessary, consider “kinder and gentler” options, e.g., negotiated resolution, deductive change order or termination for convenience.
- If must terminate, act promptly, following the letter of the contract and the law (be aware, e.g., that filing of bankruptcy cannot be a reason for termination, even if the contract says it is).
- Know your rights, obligations and deadlines.
- Act timely – problems do not usually improve with time.
- Exercise contractual remedies.
- Communicate! Develop a continuous feedback loop between pre-qualification, pre-construction and operations resources. If one link in the chain sees early warning signals of distress, alert everyone else in the chain and manage accordingly.
- Be attentive.

*This paper was developed by the Executive Committee of AGC’s Service & Supply Council, whose objectives are to:*

- *Be a resource for training and knowledge sharing to all elements within the construction industry*
- *Be a resource for cutting-edge business practices in the construction industry*
- *Be the resource and the implementation for new technology*
- *Be a major supporter of AGC PAC*
- *Serve as a conduit among other industry-related associations*
- *Serve as a conduit by creating a better relationship between AGC’s general contractors and the supplier/service providers members who serve them*



## **Additional AGC OF AMERICA CONSTRUCTION RISK MANAGEMENT RESOURCES**

AGC is committed to helping its members deal with the myriad risks facing contractors in today's marketplace. These challenges include the risks of construction litigation, subcontractor default and insolvency, exposures resulting from unintended gaps in insurance coverage, environmental compliance and more.

AGC has helped to develop the following resources and tools to help members better manage contractor risks and increase project success and profitability.

**Surety Bonding & Construction Risk Management Conference** – Held annually, this important meeting provides a unique opportunity for the thought leaders in the construction, surety and insurance industries to share information on the latest developments in all three industries.

**ConsensusDocs** - ConsensusDocs contracts are developed by a coalition of 38 leading industry associations representing owners, contractors, subcontractors, designers and sureties, including AGC of America. ConsensusDocs contracts protect the best interests of the project rather than a singular party, yielding better project results and fewer disputes.

**Subcontractor Prequalification Data Management** - Using subcontractor prequalification to improve subcontractor selection can help mitigate the risk of subcontractor default. AGC has partnered with iSqFt, a leading construction technology firm, to offer members free access to iSqFt's prequalification data management solution.

**Insurance Checklist & Risk Profiler** – Use the AGC Insurance Checklist to determine the precise scope of your current insurance coverage. AGC's Risk Profiler is an electronic form that construction contractors and their insurance brokers can use to create, save and continuously update a profile of the business activities that expose such contractors to significant risks of either loss or liability.

**Federal Government Contractor Ethics and Compliance Programs Toolkit** – Use the sample document including the two Sample Codes of Ethics, a Compliance Program Checklist, a Compliance Risk Matrix and Sample Questions for In-house Training to develop and maintain a compliance program on a cost effective basis.

**Surety Bonding & Risk Management Presentation Archive**

**State-by-State Construction Defect Case Law Map**

**AGC State Law Matrix**

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**Managing the Risk of Mold in the Construction of Buildings – Whitepaper**

**Contractor’s Guide To Owner Controlled Insurance Programs – Whitepaper**

**Additional Insured Endorsements – Whitepaper**