

Coronavirus-Related Subcontractor Default Risks

What you should know and how you can mitigate the risk



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The coronavirus has posed a tremendous threat to the construction industry. Companies are being impacted and projects are experiencing challenges. It is important to be aware of these challenges and take action so you can mitigate the default risks you may face in the coming months.

The immediate challenge comes from work shutdowns in certain jurisdictions as a government directive. In these locations, projects have been completely shut down. Some project owners have also directed work to be shut down. However, construction operations have been deemed as “essential” in many locations, allowing for work to continue.

While work may be able to continue, there will still be challenges in getting your projects completed on time and on budget. Additionally, there is still ambiguity around essential vs. nonessential work. For example, a general contractor may interpret the order that their work is essential, but a trade partner may not view it the same way.

Be aware of the default risks:

Delays, insolvency, project funding and quality issues

Contractors are experiencing schedule delays due to labor shortages and supply chain issues.

Insolvency concerns are heightened as revenue and cash flow is disrupted. As contractors experience challenges meeting payroll obligations, labor shortages could result from layoffs. Labor shortages are also being reported due to illness, employees balancing child care needs with work, employees staying home due to concerns about spreading the virus to loved ones, and localized shelter-in-place orders.

Working on a project when workers aren't supposed to be within 6-feet of one another, and trying to coordinate various trade subcontractors, becomes very difficult.

It will stretch the project out significantly, even if no work stoppage occurs. Additionally, many contractors have instituted required procedures for job site cleaning/disinfecting, which takes time/manpower that pulls from typical efficiencies, and either shortens the workday, or increases the wages paid for workers on-site.

Many contractors have operations in locations that may be impacted by local shelter-in-place orders and this could impact your ability to receive critical project materials and labor.

Some contractors have even had challenges getting labor to a project site as workers are required to drive through areas that are under shelter-in-place orders and are being stopped by local police.

Because trade partners may be experiencing labor shortages and supply chain issues, the quality of their work may suffer.

One of the challenges with quality comes as the inability of third-party inspectors to review work if their firm is not considered "essential." Building inspectors may be unable to review and approve work so that progress can continue. Lack of critical project inspections, whether it be a local building inspector or a third-party quality review, can cause serious delays and/or quality issues.

As this crisis continues, we continue to see a tightening of available credit which is impacting owners' ability to finance projects.

General contractors and their trade partners should not be performing any work on the promise that funding is near. Confirm your project financing is in place and do not take any unnecessary credit risk.



What can you do to mitigate your risk?

Stay close to your trade partners through increasing the frequency of regularly scheduled meetings.

It is important you are aware of which of projects and staff may be affected due to employee contagion and/or project shutdowns. These meetings do not need to be in person, so use technology to stay connected with your trade partners. Regular communication will allow you to take a proactive approach in working with your trade partners to resolve the issues.

Review the following items during your trade partner meetings:

- Project staffing.
- Performance.
- Financial health.
- Payments to suppliers.
- Schedule.
- Any other challenges trade partners are facing.

Consider requiring more frequent financial statements from subcontractors and monitor payments to suppliers.

Monitor the following:

- Any WIP changes (timing of this will depend on how long we face this issue).
- Manpower changes.
- Bank line of credit changes.
- Surety capacity and relationship.
- Liquidity and leverage ratios.

With the inherent lag of financial statements, there might even be cases where specific balance sheet items should be confirmed as of a certain day such as cash balances, loan balances, payables, receivables, etc.

Do not award new work to trade partners that are not financially strong and emphasize the importance of prequalifying trade partners before you award new work.

If the economic situation worsens, even in sectors outside of construction, it may play a big part in a tightening of available credit. Corporate loan/bond defaults are rising, the Federal Reserve's ability to support the mortgage-backed security market through purchasing those assets is unknown. The end result is a tightening credit market, which could affect subcontractors that rely on their banks and credit lines to cash flow their business as they await payment of receivables/retainage.

- i. Beyond just a "strong" financial position, there needs to be added focus on liquidity and lack of leverage. Subcontractors that are heavily reliant on their revolving credit line are at an increased risk.
- ii. General contractors should consider negotiating with owners to get better cash flow terms for trade partners during this difficult time.

If your company does not have the internal resources to perform this level of review, there are third-party firms that can perform this service for you, including Lockton's SCORE system.

Identify, discuss and plan for materials with long lead times.

Directly purchasing materials, using joint checks, and monitoring lien releases is strongly recommended to help mitigate default risk. Ensure the work and materials meet your specifications before you pay your trade partners.

Now is the time to review your own crisis management and business continuity plans.

If you don't already have one, it is not too late to create one. Use your trade partner meetings to review business continuity and contingency plans and provide any valuable insight you can offer to support your partners. If needed, consider establishing a risk mitigation plan to help your trade partners manage through the crisis.

If projects are suspended, maintain frequent contact with the subcontractors to discuss your project with your trade partners to ensure that it receives priority when work commences.

Consider formally notifying your trade partners about their contractual obligations following a force majeure delay.

Review your contracts and subcontracts with your attorney and pay attention to force majeure and termination clauses to determine if pandemic events are applicable.

There is optimism that courts will take a broad interpretation of force majeure to include pandemic events. However, this will solve the contract schedule impacts, but it will not affect the contract price. If your existing contracts are silent on pandemics, consider adding it for future projects.

Establish a higher level of scrutiny around new project awards.

Include C-suite review of all owner contracts to ensure it is a project that your firm should pursue.

Proactively work with your owner to develop a contingency plan if construction is suspended and be sure to discuss the impacts on project financing.

Consult your attorney to determine whether you should provide written notice to the project owner for potential delays resulting from the coronavirus. You may want to consider opening a change order in their project management tracking system in order to track time and cost associated with any potential delay.

This is an unprecedented event that is causing disruption in the contracting community. Every contractor and project are unique and so is the risk associated with the coronavirus.

Now is the time to lean on your business partners to help you develop your business continuity plan. Consult your trusted surety, insurance, financial and legal advisors to discuss your business operations, financials and risk profile. These partners can help you navigate contract negotiations, insurance and surety needs, and financial considerations.

Finally, be vocal and stay in tune with how you can help the industry by communicating with your peer groups, trade associations, local business leaders and legislators.



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