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Construction Industry Loss Avoidance

I have been a surety broker for the past 28 years, and prior to that worked as a surety underwriter with Chubb for three years and as a CPA with S.J. Gallina & Co., (now known as Gallina, LLP), for over three years. That means I have been working with contractors for the last 34 years. I have to admit, I have very minimal skills when it comes to any form of construction....I have never built a bookshelf or a birdhouse. I also do not know how to read construction plans. Since I am not a construction attorney, my advice on contract language questions is usually to call your attorney. However, over the course of my career, I have witnessed many unfortunate, and in some cases predictable and avoidable, losses incurred by contractors, and I believe I have learned a few things about the risks contractors face and how to mitigate them. The following is a discussion of some common problems I have seen that led to serious losses, and some suggestions on what could have been done to avoid them.

GENERAL CONTRACTORS:

Since most of the bonds I issue are for clients who are general contractors, I have a lot of experience with them. Here are some pitfalls they would do well to avoid:

1. **Bad Owners / Construction Managers.** Many times a contractor will not know he has contracted with a bad owner until it is too late to do anything about it. I have seen owners who came close to bankrupting contractors because their own project managers were incompetent, and their default position was to blame the contractor. Bad owners usually deny all change order requests, grant zero time extensions and are quick to threaten the contractor with default, even though the contractor is doing the best job he can while knowing he is losing money daily. Construction Managers often seem like their purpose for being is to make sure the general contractor and the subcontractors do not make a profit on the job. This is perhaps the most common cause of contractor failure. On a few occasions, I have seen a single bad job/owner/CM nearly ruin very well-established general contractors, some with decades of experience.

What can a contractor do to prevent such situations from happening to them?

- a. **Keep a list of bad owners and construction managers and avoid their jobs at all costs.** Also ask around if you are unsure about a particular owner/CM before you get involved on a job with them. You should also determine if the project is properly funded. If you believe it is going to cost more than originally estimated, and money is going to be a problem, just walk away. **Avoidance is the best strategy.**

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- b. Accumulate a big stack of money to use to bring lawyers to bear if needed. This is not a particularly good choice, but, sometimes it is the only one left to you. Companies like Tudor/Saliba are strong enough to defeat a tough owner, like Caltrans, in court. But, they are reputed to have a floor full of attorneys on their payroll. **Construction litigation is very expensive**, so you need a lot of money in reserve if this is going to be an avenue you choose to pursue.
 - c. Document the job thoroughly. You should be doing this anyway, but, you need to be extra diligent when you know you are dealing with an owner/CM that is looking to get you to pay for a large percentage of the job. Video tape construction progress, or situations where no progress can be made due to the owner/CM. Also, get all change order requests in writing. Regardless of any oral assurances made, **if it is not in writing, it never happened**. If you document the job well enough, you may be able to get the owner to settle your dispute for a reasonable amount, rather than go to court. If you have to take a small haircut to do this, consider it money well spent to get out of the job intact and a little more experienced.
 - d. Consult a good attorney for advice on how to proceed in any adversarial situation. You may be within your rights to stop work on the project for lack of payment. It may be better to walk away from such a project than to keep digging the hole deeper.
 - e. Unless you are very familiar with a contract form, it is advisable that you **have your attorney review all contracts prior to your signing them**. The professional fees you pay in advance of a problem are always a fraction of what you will be paying if a dispute arises due to ambiguous or onerous contract language that might have been avoided.
2. Bad Plans. Often hand-in-hand with bad owners/CM situations, bad plans are usually a disaster for the contractor. If you are reviewing the plans prior to bid, and notice that there appears to be a number of errors, or perhaps that they are not meeting building code standards in some areas, you should consider not bidding the job. If you know the owner/CM commonly uses the contractor as a scapegoat for over budget jobs, run. Many years ago, contractors believed that bad plans could lead to high profits through lucrative change orders. The old joke was the contractor's dingy would be named "Low Bid" and his yacht would be named "Change Orders". That is not the case today. Many contracts with public owners limit the amount of profit that can be included on any change order work, and it is usually not enough to cover the general conditions increases and lost time that the change order situation caused. Also, architects and engineers do not like to admit they made a mistake, so a common response to requests for change orders is that it is already part of the contractor's scope and included in the original contract price. I have seen cases where the plans did not meet code, and the response was that the contractor should have known that was the case and made allowances for this in his initial bid. It is also very common for the owner to deny any time extensions that the change orders may

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require, with the hope of using the resulting liquidated damages to help avoid paying the additional costs incurred, at the end of the job.

What can a contractor do when he sees that he plans are not complete or up to code?

- a. Keep track of bad architects and engineers and avoid projects in which they are involved. If you hear another contractor is having trouble on a job, try to determine the reasons. If it is the architect, put him on your “watch” list.
 - b. Check to see if the owner has the money to pay for the increase in contract amount. This actually should be done to the extent possible for every job. A tight budget usually means that there is going to be a fight over paying for change orders, even if the building would collapse without the change order work being done.
 - c. Document everything, just as in the case of a bad owner. As I said, bad owners and bad plans just seem to find each other. Perhaps it is because the owner hired an architect that was not qualified to design the project to code.
 - d. Consult with your attorney to determine your legal options. Again, you might be able to legally be excused from the job if the situation is bad enough.
3. Subcontractor issues. After bad owners and bad plans, the biggest problems I have seen for general contractors is with subcontractors, who often do all of the actual construction work on a project. Subcontractors can hurt you by pulling their bid after you have been awarded a job, leaving you with a gap to fill if you can. They can be uncooperative and not help you meet your critical path by understaffing the job at critical junctures. They can run out of money and need advances to cover their payroll and other costs. They can also declare bankruptcy in the middle of a job, which is perhaps your worst case scenario, especially if they are working on more than one of your jobs at the time. The cost to replace a subcontractor in the middle of a job is often exacerbated by the fact that the sub has not paid all of its own subcontractors and suppliers for which he has already been paid by the general contractor. Also, any new subcontractor will have a learning curve to get up to speed on the job, and may find that the previous sub’s work needs to be replaced to some extent. It is unlikely that the GC will be able to find a replacement subcontractor that will do the work for the same cost to which the original sub agreed.

What can a general contractor do to mitigate this risk?

- a. Know your subcontractors. Keep a list of the subs you have used in the past and be sure you keep notes on how well they performed. At bid time, if you have two sub bids that are close and one of the subs has worked well with you in the past, list that subcontractor. If you do not have that option, you may try running credit reports or asking your surety broker or underwriter to check on a sub and get back to you. A

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sub's ability to bond the job is a good indicator of his ability to do the work in a competent manner.

- b. Bond the subcontractor. For any subs that are critical to the job, and cannot be easily replaced, consider requiring a performance and payment bond from them. The subcontract bond gives you more than just protection against the subcontractor failing or not paying suppliers, it gives you leverage you can use to persuade him to keep with the job schedule and properly staff the job. A claim on a bond gets everyone's attention, and can result in the subcontractor trying harder to meet the demands of the job. When a surety provides a bond for a contractor, it means they have examined that contractor's financial statements, checked with references, run credit reports and done other underwriting to determine that the contractor is qualified to do the work in question. If the surety is doing its job properly, bond claims should be very rare.
 - c. SubGuard Insurance. For large general contractors, usually those doing well in excess of \$100 million in revenues a year, there is an insurance product available known as Subguard. Zurich underwrites such a policy, and perhaps one or two other companies do as well. These programs can provide a number of advantages to large GCs over bonding of subcontractors. Broader coverage is provided, and there are creative methods for payment which can result in additional revenue for a GC that is able to keep subcontractors from defaulting. These programs require that a GC prequalify its subcontractors before enrolling them in it, thus making the GC very cognizant of the financial strength and capabilities of the subcontractors it hires, usually resulting in a better job for everyone concerned. These programs are used extensively on large private projects, where performance and payment bonds are not necessarily required by the owner. Of course, the cost of this insurance is usually added to the GC's bid, which might be an issue, especially with an owner that is already paying for a performance and payment bond from the GC, and feels that the subcontractor risk should be borne by the GC. For more information regarding Subguard and its pros/cons, you can find several articles on the internet by searching for Subguard Insurance.
 - d. Joint-check the subcontractor. This technique can help you to avoid having to pay for a supplier's billing twice. It also causes the GC to very carefully examine all subcontractor billings and make sure that second-tier subs and suppliers and even unions and payroll taxes are properly paid by the subcontractor. It is more of a burden for a GC's staff, but, usually worth the cost to have someone assigned to this task. Requiring unconditional lien releases is another method employed by GCs to help make sure everyone on the job has been paid.
4. Cash Flow Problems. General contractors have the advantage of being the first to be paid on a project, and usually do not have problems with their cash-flow as a result. However,

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if the GC does a lot of the work with its own forces, then they may find themselves using their bank line of credit on a more regular basis in order to meet payroll and pay suppliers early for a discount. If they find that the bank line cannot be repaid through their normal operations, there is a potential problem. The bank can put a company out of business by calling their loans, if the bank feels that is the most prudent way to limit their losses in this situation. Usually, a GC would have to be in non-compliance with bank loan covenants prior to such an action being taken by the bank, so it should not be a surprise when something like that happens. However, in my experience, I have seen banks' attitudes toward their clients change dramatically in a short time, making the foreclosure a shock to the GC. In the instances where I have seen this happen, the GC was forced to close its doors after decades of operations. How can this be avoided?

- a. Increase the company's equity. If you are relying on your bank line to continue your operations, your company is undercapitalized. Your best course of action is to retain more earnings in your company, even if it means paying taxes to do so. If that is not an option, you may need to find an investor willing to put money into the company, so it can manage its affairs without the bank loans. Bank loans should really be used during unusually heavy cash-flow situations, like a large job beginning and you were not able to negotiate any advances for start-up costs. The bank borrowings should be repaid as soon as the situation stabilizes, and if you cannot do that, you may have a problem.
 - b. Negotiate better contract terms. If you have jobs with large retention, you need to get that amount reduced. Usually, that is possible after the job is 50% completed. Sometimes, you can negotiate to be paid twice a month, which can be a great help. "Front end loading" is another way to get your cash from a job faster. If you include your profit in the first 1/3 of the job, you can bill it earlier, though you must be careful to spread the profit over several areas of the job, so it can't be eliminated by a deductive change order.
 - c. Maintain good relations with your banker. You should be using a bank that has many contractors as clients and understands the construction industry well. There are some smaller banks that do an excellent job in this area, where some of the large national banks simply do not care and will drop a long-term client with no warning if they decide that such clients are now too risky for their tastes.
5. Bad Estimates / Project Management. Sometimes a GC goes out of business through his own failures. Bad estimates, usually caused by omitting part of the scope of the work, can be a disaster if not caught before contracts are signed and bonds provided. If you find the error early enough, you can usually pull you bid due to the error without penalty. Another reason for bad estimates is the GC takes jobs too cheaply just to keep his people busy. That is a very dangerous practice, because it leaves no room for error on the jobs,

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and there are usually errors to some degree. It is understandable that a GC does not want to lay off good people, but, if he takes on losing work, he won't have the bonding capacity to get the profitable work when it becomes available. Then everyone gets laid off! Another common cause of failure is bad management on one or more projects, perhaps combined with a very tight bid. The ability to run a job is a talent that not every person brings to the table. Sometimes the Peter Principle applies...a person rises to their level of incompetence. So, good people, both estimators and project managers, are usually the cure for these issues. How can a GC make sure he has the right people?

- a. Hire talented people and keep them happy. Incentives of ownership are a good way to keep such key individuals from leaving to start their own companies. Good profit sharing programs can also be helpful in this regard.
 - b. Ownership should keep actively involved in all key facets of the company. One way to do this is to allow key employees the opportunity to own a percentage of the company.
 - c. Establish a business continuity plan that will work. I had a client die tragically recently, but, because he had made arrangements to have others run the company, the contractor is still viable and profitable today.
 - d. Cost accounting systems should properly allocate all job costs to the correct job. Job estimates should be reviewed and updated at least monthly to reflect the current expectations for each job. Management should review these reports to determine the progress of the jobs, and take corrective action if problems are apparent.
 - e. Maintain a system of internal controls to protect company assets from being misappropriated. It is very common in the construction industry for this to happen.
 - f. Consider hiring the services of a management consulting firm to help you with all of the above. There are firms that specialize in the construction industry, and some of the largest, best organized contractors still employ their services regularly. A good CPA can also be very helpful in this regard.
6. Using company assets for development and other investment schemes. It is very common for a general contractor to think he can make a killing in real estate investment. After all, he is capable of building the project with his own company, thus controlling that cost, and he has seen others do very well without nearly the same level of expertise he brings to the table. What the contractor is not able to control, however, is the cyclical nature of the economy, and that is what either makes or breaks him if he chooses to invest in real estate development. One of the largest GCs in the Valley lost everything when they decided to buy a golf course and build houses on it for sale. Surety companies have seen such scenarios happen numerous times, and is a big reason most surety companies will not bond a contractor that is using his company assets to finance development

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projects. What can a contractor do to keep its surety happy and still scratch his itch to try his hand at real estate development?

- a. Do not use any company assets for such investments. If you can afford to invest your own money in such projects, the surety will not object, as long as you do not involve your company in any capacity. If you are going to have the company build the project, say a large commercial office building, you need to establish financing for the project that does not require the company's guarantee. It is my understanding that the owner of a well-known engineering construction company invested heavily in a golf course development that caused him to declare personal bankruptcy. However, he was smart enough to keep his company out of the deal, and that company continues to perform large bonded projects to this day.
 - b. Don't do it.....
7. GC owners' overspending and reduced involvement in the company's operations. I have seen a few occasions where the owner of a successful GC let that success go to his head, and it cost him his company. Buying expensive homes, planes, boats and cars is not an uncommon reaction to waking up one day to find you have done very well, and you want to show the world just how well. This is often accompanied by the owner allowing an employee to assume more responsibility for the company's operations. Soon, the combination of the owner taking more from the company than he should and the reduction in the company's efficiency because the owner is not keeping his eye on the ball can result in a lot of red ink. What can be done to avoid this?
- a. See b. above.....just don't do it. **Keep your ego in check!**
 - b. Plan for the finish line. If you are running a company and you are personally guaranteeing their contracts with the surety company, how are you going to close the company one day? Are you going to sell to a competitor? Are you going to let your employees buy you out? Do you have family that will take over for you? You should have a solid plan that considers all of these options. The help of a good consultant can be money well spent to establish such a plan.

SUBCONTRACTORS:

Just about **everything listed above concerning general contractors can also apply to subcontractors**. Probably the biggest difference between the two is cash flow. Because the GC gets paid first, and also does not usually employ a big staff of workers for the job, or have to buy supplies in advance for the job, the GC's cash flow is usually much better than their subcontractors'. I have seen GCs with no analyzed working capital from a surety's perspective maintain cash balances over \$100 million. It is just a completely different world for them.

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Subcontractors need to be much more heavily capitalized in order to avoid falling into the bank line of credit usage crutch, that is so often the case. What should subcontractors do?

1. Invest more money in the company. If the sub has to maintain a fabricating plant, as well as employ construction workers and purchase materials, it is going to need a lot of money to operate. Undercapitalizing the company initially is a very common mistake, because the owner either does not have the means to invest more, or is not willing to have partners in the business who could also invest to bring them to the capitalization level needed. What can be done in such cases?
 - a. Increase your company's net worth through earnings. That is by far the best way to get the capitalization you need, from the surety's perspective. The owner may have to live a frugal life style to keep overhead down, but, if he can get his company to a point where he is not reliant on the bank for his working capital, he can then increase his personal pay.
 - b. Use a banker that specializes in contractors. This is very important for a subcontractor, who is much more likely to need to use his bank line fairly often. Bankers who specialize in construction are not going to pull their support of a client because a similar client recently cost his bank a lot of money. Banks that do not specialize in contractor accounts can be very reactive when losses occur, because they do not understand the business as well as those that specialize in it.
 - c. If the owner feels the need to take a bonus for avoid income taxes, in the case of a C Corporation, he should loan the bonus back to the company, to keep the cash levels adequate to maintain operations.

Cash flow is not the only difference a subcontractor has with general contractors, it is just the most significant. Subs also have to be much more careful on their bids to be sure they did not miss anything, because their estimates of labor and materials have to be correct or they lose money. Because of the increased risk and the need for positive cash flow, subs need to earn more than 10% on their jobs. Otherwise, the retention will cause them to have to borrow to complete the job. A successful subcontractor typically earns more than 15% gross profit on average...sometimes significantly higher.

Bonding is often not as crucial to subcontractors because they are often not required to bond their work by the general contractor, especially if they are known to be a successful company. The subs that do need bonds usually are doing some bidding directly to owners, and so are acting as the GC in such cases. There are also some large GCs, like Hathaway-Dinwiddie, who do require bonds from virtually all of their subcontractors. Just as GCs need to do with owners/CMs, subs need to keep a list of the GCs that they should avoid, either from past experience, or from information they have learned from other subcontractors. When bidding to

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GCs that are on such a “list”, the sub would be well advised to add a significant surcharge to his bid, to cover potential legal fees and other issues he will likely encounter during the job. If the plans are bad on the job, the sub should pass at any price.

Though surety bonding may not be required from a subcontractor on many jobs, the sub still needs to have a good surety relationship established, because GCs these days are going to ask them about it during the prequalification process. Prequal letters from the surety are a standard request these days, so not having bonding is really not an option for most subcontractors doing commercial and public work projects. Perhaps the most positive aspect of this for a sub is that the process of establishing a surety bond relationship forces the sub to make decisions and take actions that usually improve his company. For instance, the sub may have to hire a CPA that the surety company recommends, because his current CPA really does not understand the construction industry that well. I have seen such moves result in tax savings that the new CPA was able to find due to his specialized expertise. The sub may also need to decrease its dependency on its bank line and establish a business continuity plan. Generally speaking, the surety’s interest in the subs success coincides with the sub’s, so any suggestions made by the surety should be seriously considered, as they usually result in a stronger company.

I hope you found the preceding information useful. If you wish to discuss any of this more in depth, please contact me.

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