<u>Effective Risk Management in Challenging Times</u>

Lowell H. Patterson, III

Long time veterans in the construction industry recognize that market cycles follow the laws of gravity and will return to earth despite protracted prosperity. America's current economic boom, which commenced during the Reagan Administration, produced incredible demand for commercial and industrial space. Incredibly aggressive, indeed speculative, credit underwriting by insurance companies and commercial banks, coupled with the effects of changes to the tax code, triggered a series of events in the late 1980s and early 1990s that resulted in widespread loan defaults, tightening credit, and declining commercial real estate values in several major regions of the country.

The pressure on owners and developers produced a myriad of bankruptcies, and the pain and pressure from these events had far reaching consequences in the construction industry. As project financing dried up, planned projects were aborted. Numerous contractors and subcontractors felt real financial pain. Many businesses suffered financial reversals and a number of them failed. With the passage of time, many owners and contractors, like most people, tend to forget the painful lessons and focus on the present good times.

History does not always repeat itself. Nevertheless, it would be foolish to conclude that the current prosperity will last forever without some correction. The present prosperity will, in all likelihood, abate for some reason — a reason that is perhaps just beyond the horizon. Accordingly, contractors should consider adapting or refining some basic prudential steps.

As a preliminary matter, an understanding of the financial strength of the prospective contracting parties is fundamental. Contractors would be well served by understanding the financial strength of owners with whom they are considering working. To the extent possible, contractors should attempt to gauge the depth of an owner's pockets. For owners which are publicly traded companies, this analysis is straightforward and should be achievable with relative ease. For a major project, obtaining and analyzing recent financial information is preferable. If obtaining internal financial reports is not possible, credit reports from a reputable agency can be helpful. At a minimum, attempting to ascertain an owner’s reputation for prompt payment and litigiousness makes sense.

If a private owner intends to finance a project, the contractor will likely be asked to subordinate their lien rights and those of their subcontractors. Institutional project lenders often require subordination to protect the priority of their liens. Appreciating the viability of the owner allows the contractor to assess the attendant risks associated with subordinating lien rights at the outset.

Assessing the viability of subcontractors is likewise important. If a subcontractor does not have the financial recourse to fund its internal operations smoothly, its performance will likely suffer.

A contractor's ability to realize a recovery against an insolvent or weak subcontractor for damages to complete work after the subcontractor's termination presents a myriad of problems. Quite simply, if the subcontractor is not viable, the contractor will likely eat the loss.

Allocating risks during contracting represents a critical opportunity to favorably shift risks. Several basic contract provisions merit particular discussion. Contractors face obvious problems when owners, for whatever reason, stop paying. Subcontractors understandably want and need to be paid. The inclusion of a "pay if paid" provision in subcontracts curtails some problems. This provision, enforceable in many states, provides that the contractor is not required to pay the subcontractor until <u>and unless</u> the contractor receives payment from the owner. Some contracts include "pay when paid" provisions, and contractors sometimes subsequently learn that this similar sounding provision does not afford the same level of protection. Courts in a number of jurisdictions have taken the position that a “pay when paid” provision really means that subcontractors must be paid within a reasonable time whether or not the contractor has been paid by the owner. An enforceable “pay if paid” provision can save a contractor a lot of grief if an owner is rendered insolvent during the course of a project and stops paying.

Contractors should also review indemnity provisions with special care. Contractual indemnity provisions represent a pitfall for the unwary. First, persons considering indemnification should carefully review proposed indemnity obligations. These provisions come in many forms ranging from relatively reasonable to onerous. Obtaining insurance, which covers indemnity obligations is a good idea. There are possibilities, such as naming the indemnified party as an additional insured, which merit consideration. Also, consider whether indemnity obligations continue after completion of work and obtain appropriate insurance. Contractors should approach indemnity provisions with care prior to assuming such obligations.

When the economy experiences a decline, the effect typically ripples through the construction industry. Financially weak contractors and subcontractors tend to grow weaker. This affects their ability to pay suppliers, employees and taxing authorities. Often, the most skilled and savvy workers depart for greener and safer pastures. As loan defaults in the construction sector rise, institutional lenders raise their loan underwriting standards as do sureties. No failsafe prescription exists to avoid the attendant problems. Nevertheless, understanding and managing risks will help minimize losses.