APRIL 1, 2020
WEBINAR RECAP

How to Manage and Mitigate Subcontractor Default Risks During the COVID-19 Crisis (Part 1)

Peckar & Abramson, P.C.
COUNSEL TO THE CONSTRUCTION INDUSTRY

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Rethinking Subcontractor Default of Performance: Legal and Practical Implications

- In the normal pre-COVID world, there was a process to follow for defaults, and the remedy to correct was clear. Today's issues are far more challenging and fraught with Catch-22s.
  - GCs or CMs bear the responsibility of dealing with obligations to the owner. If a sub defaults, the GC or CM must fix it. If it doesn't, then it may be in default upstream with the owner.
  - **Do not knee-jerk a default** with a nonperforming sub in this environment; there is a potential whipsaw effect upstream of what you do downstream.
- **Seek owner directives through collaborative dialogue: Minimize points of argument.**
  - Many owners are agreeing to suspend projects voluntarily, out of safety concerns for the workforce or because they agreed to a government directive requiring the project to be shut down. **The reason for shutdown gives you clearer direction.**
    - **Follow the suspension procedures and reserve your rights (as appropriate).**
    - Once you get agreement, **document it.**
  - If an owner doesn't agree to a shutdown and directs activity to proceed, be mindful of the context for nonperforming subs. **Slow down and be very deliberate.**
    - This is very case-sensitive; due to the Catch-22 whipsaw potential, you want to stay **neutral**.
    - **Using general notices, acknowledge the time and money impact** with your owners and establish your reservations of rights.
- Be collaborative with subs by indicating what you can do to work with them and mitigate work slippage. However, **document nonperformance and reserve your rights.**
- Contractual Clauses: force majeure, suspension, termination, emergency measures/obligations.
  - **Force majeure clauses often give a limited right of relief** to reschedule but often do not compensate for these delays. If the force majeure clause would entitle the subcontractor to excuse its lack of performance, then there's no legitimate basis to declare default or declare termination.
  - **Suspension clauses, emergency measure clauses and changed conditions clauses may offer broader rights to time and money.**
  - **Consult with counsel and know what your contract says;** then tailor your strategy and your notices upstream to cover all bases.

Monitor Your Subcontractors; Initial Prequalification Is No Longer Sufficient

- Request updated financial information, including interim statements:
  - **Consider engaging a third party** to assist with collection and analysis.
  - Specifically, look at measures related to **liquidity and leverage** such as working capital, current ratio, quick ratios and debt-to-equity ratios.
  - **Analyze accounts receivable.** During an economic crisis, timely payments may become less likely.
  - **Assess each subcontractor's ability to survive** a two- to three-month disruption in revenue and cash flows.
  - Determine if their line of credit has been accessed or if their banking relationship changed; **ask questions to understand.**

- Assess manpower issues:
  - Determine if absences are occurring due to illness, quarantine or other barriers to getting to work.
  - **Ensure that your projects continue to receive priority** if there are competing projects.
- Be prepared to respond if financial deteriorations are detected:
  - Consider how to **help with cash flow issues.** Release some retainage; make more frequent payments or even consider advance payments in conjunction with an advance payment bond.
  - Assess and **strengthen your relationships** and **keep lines of communication open.**
  - **Encourage access to the small business loans** that were made available through the COVID-19 Relief Bill.
- Monitor supply chains for possible disruptions, since the ability to obtain materials is becoming more difficult as this event evolves:
  - Identify items with long lead times and **confirm sources and locations.**
  - Make sure you have an effective process to **confirm that what's delivered to the project site is in conformance with specifications**–do it now rather than after installation.
- Tighten controls on payment processes
  - **Verify not just quantity but also the quality of what's installed** prior to approving subcontract payments.
  - Increase **utilization of joint checks** for payments to sub-tiers and suppliers.
  - **Expand requirements for lien releases** to include all sub-tiers and suppliers.

Capacity and Underwriting Considerations

- No significant or industrywide restrictions in capacity at the immediate moment, but there will be additional oversight (e.g., **supplemental underwriting questionnaires**).
- Bigger risk is the likelihood of a recession and the impact on the financial health of GCs and subcontractors. Start implementing lessons from past recessions and **stepping up prequalification and even requalification processes.**
- **Contractual Updates:** Engage legal and risk management staff and advisors to **conduct a thorough review of your contracts.** Focus on force majeure and project suspension clauses and the language around an unforeseen event and use of terms like pandemic.

- Update your prequalification and subcontractor management practices. **Step up credit monitoring and risk assessment processes.**
- **Consider new tools and technology** to assist in this process, and think about asking for assistance from third-party prequalification providers.

Subcontractor Risk Management Program

- **The model really hasn't changed,** and the components that make up a strong subcontractor risk management program remain the same.
- Firms that bought in and **built a strong foundation around their programs will be in the best position** to manage distressed and defaulting subs. Cash ratios and the ability to deliver labor will be key.
- **Reflect on the lessons from the Great Recession;** the real impact to the SDI market came after the restart. Contractors are three times more likely to fail in a rapidly growing market than a rapidly declining market.
- **Plan for the future** and consider the state of each project before, during and after this event.
  - **Projects that continued through the crisis** have likely slowed down or been otherwise impacted. Make sure there's a clear plan for ramping those projects back up.
  - **Some projects halted altogether.** Think through how to restart those projects for which there will likely be new subcontractors or maybe new mitigation plans in place.
  - The third group is **new projects,** some of which got pushed or delayed. How will these projects be brought online? There may also be projects in this group that were started by someone else and now you are stepping in to finish.
- **Communicate up and down** both with your internal teams and your external partners. Have the uncomfortable conversation today rather than a difficult conversation tomorrow. The best approach is to engage in those discussions before they become necessary or before they get uncomfortable.

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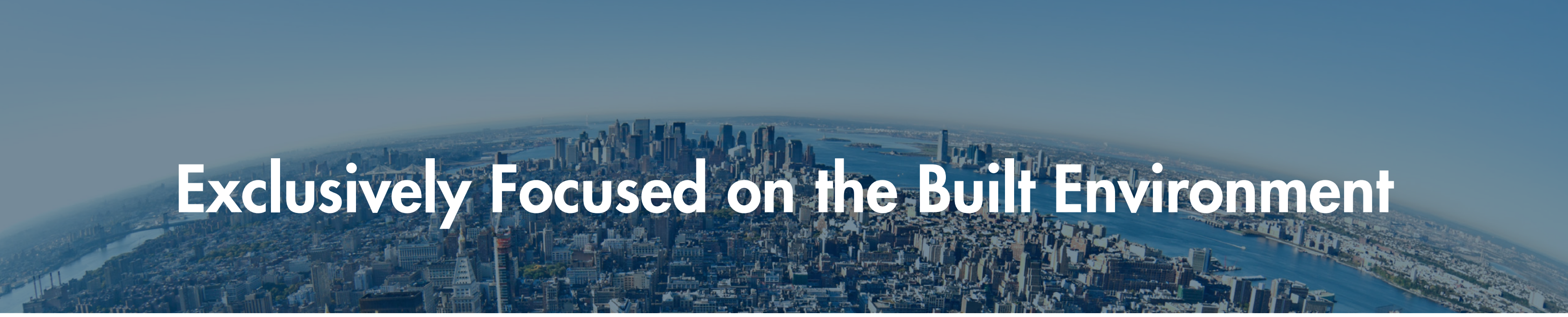

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