The New Rules of Risk

The unprecedented market downturn from which we are emerging has weakened some construction organizations to the extent that they may have difficulty financing the growth that will come with even a slow market recovery. That, in turn, may increase the potential for defaults. But some of the common ways of dealing with the risks may be self-defeating. Here's what I mean: General contractors and subcontractors have the same exposure—if either type of contractor fails, the entire project is disrupted, and all involved are exposed to disruption and loss.

In my experience, many defaults are not a total surprise, with project owners, CMs, designers, GCs or subs expressing some variation of "I had a bad feeling about this for months" or "All the signs were there, but I was hoping for the best."


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Some of the signs of trouble include complaints from suppliers or subs about unpaid invoices or partial or late payment; contractors asking for advance payment or help making payroll; unexplained cuts in crew size; declining work quality; overbilling of quantities or percentage of work completed; requests for payment of materials ordered or supposedly stored off-site.

Another sign is a change in foremen, supervisors or mid-managers. Long-term employees of an organization suffering financial difficulties often learn of, or sense trouble, early on and leave for other opportunities.

Protecting your organization against default is much easier said than done because many commonly recommended protections can cause as many problems as they are intended to prevent. For example, there is the adage "Don't take a low-ball price." Yet if a number in this market is on the street, someone else is going to use it, and you might not get the job. Even after a contractor has the job, if a low-ball price comes in, there is pressure to consider and possibly accept it—even knowing the risk. In good times, this is obviously less of an issue because aggressive pricing is not as prevalent, and if you don't get the job in question, there are others.

Surety Bonds, Costs and Prices

Bonding unfamiliar contractors is often the best advice, especially if their price is much lower than any of the others you have received. However, when a prime contractor tries to pass along the cost of a bond not required by specification, they risk outpricing themselves and not getting the job.

Prime contractors may also find that many low-ball offers are not bondable. I have experienced numerous cases when it was said "We tried to bond the contractor, but they could not get a bond" or "We were promised a bond, so we issued the contract," and then, after the work started, the contractor could not get a bond, and it seemed too late to change horses. There is also an unsettling increase in contractors having financial difficulties between pricing and negotiation—but before the award of contract. In these uncertain times, even the ability of a contractor to be bonded may be a diminishing indicator of a contractor's reliability.

Holding back payments is a common solution; however, it often compounds the contractor's cash-flow issues and accelerates the potential for default. Joint checks have the same impact.

In the past, the cost of a contractor default was primarily the payment of unpaid vendors and subcontractors. However, in these difficult times, that is changing with an increasing loss exposure from defective work. Organizations with serious quality-control processes and those that foster a culture of quality control may see earlier signs of contractor default that could assist in mitigating losses.

The common wisdom has been that contractors' financing deteriorates from poor management. The reality today is that the failure of one or more contractors on a project can have a significant impact on the financial condition of the other contractors on the job. Your contractor is, literally, only as good as their last job.

Even prequalification isn't an absolute guarantee against default. If the trend continues, contractors may need to learn a whole new skill set: how to manage defaults to minimize exposure. ■

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