July/August 2020

CE CONSTRUCTION EXECUTIVE

BUILDING SPACE

Adapting to a New Way of Life in the Post-Pandemic Construction Industry

PLUS

THE TOP 50 CONSTRUCTION ACCOUNTING FIRMS

SOLAR INSTALLATIONS

SPECIAL SECTION:
CONSTRUCTION ACCOUNTING

Contractors as Bankers: The Good, the Bad and the Ugly

BY NITIN GULATI

Big-budget construction projects require general contractors that are capable of handling large-scale work with not only an effective project management team, but also a strong financial foundation.

That financial footing is required because general contractors often bankroll a project until there is a positive cash flow. This cash flow helps keep the construction ongoing and the contractual requirements fulfilled.

As projects get underway, however, problems can arise. Issuances of bulletins, unforeseen field conditions and scope changes are some of the key factors that might affect a contractor's budget in one straight shot. In other words, they are some of the factors that take the project from good to bad—and even ugly.

The "Good"

The ability to support a project financially is considered a benefit to the client and a "positive" to the contractor. It's one of the critical service factors on which reputations in the industry are built.

This scenario is typical. Early on in a project, the general contractor has strong leverage in the game, perhaps because all the responsibility lies upon the contractor's company and its subcontractors' shoulders. From this position in the beginning of a working relationship, payment processes typically go smoothly among all parties. Given this show of accountability by all, the general contractor can assume that things will run smoothly for the long haul and duration of the project.

The "Bad"

Too often, the good period lasts only until this financial strength of the general contractor is tested. At some point along the way, client payments begin to slow, dragging well behind agreed-upon schedules written into the contract. Change orders roll in, but payments for doing the work don't keep pace.

The bad period begins to take shape, and financing a project is no longer an act of pride but one of necessity. After all, subcontractors and vendors still must be paid. So, they continue to be paid as scheduled, but the general contractor starts to take on a financial burden of the ongoing project.

Worse is in cases where late client payments are made but fall short of the amount billed, with unexpected deductions. The contractor takes on the burden of the late payment. This occurrence qualifies as a "bad" ritual. It signals that leverage on the project has begun to shift in the client's favor. Projects and relationships can get particularly difficult at this time, and these are all warning signs that should make a contractor cautious about adding more work into the contract—work that would lead to an increase in both responsibility and liability.

A contractor might be taken for granted by the client, which has likely assessed the strong financial footing of the contractor. Work pertaining to change orders and field bulletins may be added into the scope, and expectations are still high that construction will move quickly and that payments will be made to the contractor in a timely manner. This is the best time for the contractor to take all possible proactive measures to legally protect its rights.

The "Ugly"

The situation can now easily progress from "bad" to "ugly." The entire project is put at risk because of an over-reliance on the contractor's financial resources. In this example scenario, payments stop completely. The words "liquidated damages" begin to appear in correspondence about the payment that fell short. The general contractor has little to no leverage because it is too late in the timeline of the project, and most of the work on the project has been completed. All change-orders have been completed, but payment on them has not been processed. Subcontractors and vendors continue to bill and drain the contractor's reserves.

This phase can be attributed to multiple factors such as:

- a transition in the project-management team on the client's side;
- a lack of project funding;
- a change in the client's project priorities;
- decisions made by client's new team players who lack

knowledge pertaining to the history of a project;
- the client's biased opinions and manipulation of the contract; and
- a lack of transparency between the client and the general contractor.

At this point, the client is in complete control of the project by holding the contractor's expenses, and the general contractor has little recourse. If it's a private project, the contractor might file a mechanics lien against the property if expenses go unpaid; if it's a public project, a contractor might file a claim against the payment bond. The general contractor's reputation is tarnished, nonetheless.

What Can Be Done?

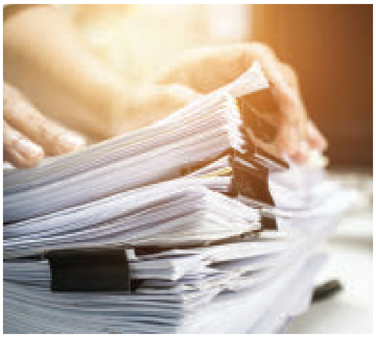
So how does a general contractor—one whose goal isn't looking to finance a construction project from start to finish—keep the cash flow in check? How does a general contractor avoid going from good to bad and ugly? In a couple of words: risk management.

Risk management is especially important when rush projects come out for bidding. Such projects typically lack vision for the end product and, in these cases, a contractor inherits change-order work that, while lucrative, can also turn "ugly" if the situation is not handled well by an effective project-management team.

There is no rule of thumb on how to overcome these challenges. Every project is unique; each has its own contractual terms and conditions. However, being proactive at every phase can significantly help reduce risks at the contractor's end.

All projects go through different challenges but what is critical here is to avoid a project turning ugly. It happens, but it can be mitigated, if not completely avoided, using the following guidelines:

- Gather and define detailed project-scope requirements prior to bidding and ask as



many questions as possible at the time of bidding. Do not assume anything.
- Understand and identify the site conditions, as well as the main project drivers.
- Familiarize yourself with the contract in detail, including general conditions. Hire an outside consultant, if needed.
- Document each and every piece of correspondence, even if it is an informal discussion.
- Know each project's specific schedules, particularly for filing any paperwork such as claims and/or lawsuits, or for notifying the client of unforeseen field conditions.
- Make sure compensation for change orders includes the time involved to finish change-order work, rather than just labor and materials.

What starts as a sound working relationship between a general contractor and a client can easily turn sour when there is an over-reliance on the contractor to fund the project. The trick lies in knowing when the tables start to turn and the leverage in the professional relationship starts to shift. At that point, best practices need to be carefully followed in order to save the project and the general contractor's reputation.

Nitin Gulati, a lead construction project manager, holds a master's degree in construction engineering and project management from the University of Texas at Austin and a Master of Science in structural engineering from Michigan State University. For more information, email littlengine@utexas.edu.