BEST PRACTICES

FOR MANAGING COVID-19 RISK

COVID-19 Impacts on Surety & Subcontractor Default Programs

It's difficult to predict the ultimate impact COVID-19 will have on our economy. We are seeing disruption across the country with some geographic regions like NYC, Boston, NJ and PA feeling greater pain in the form of job shutdowns, sub and supply chain issues, delayed starts, and postponed bids impacting construction timelines. There is little doubt that these dynamics heighten the risk of contractor defaults and ultimate failures. Construction Risk Partners offers our thoughts on critical actions to be considered to maintain a surety and subcontractor default program that continues to be a competitive advantage for your business.

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PREPARING FOR **SUCCESS** IN THE **PRESENT** & **BEYOND**

Successful contractors continually evolve and grow in the face of market challenges and opportunities. There are common characteristics of quality contractors that withstand the test of time. Best-in-class firms focus on financial liquidity, set a financial roadmap for the company through realistic budgeting and forecasting, understand and proactively manage contract risk, and mitigate risk of subcontractors through a robust prequalification process.

CASH IS KING

Successful firms are cash and liquidity oriented. "Cash is King" is often cited, but is never more important than when facing disruption, surviving and ultimately thriving beyond the challenges of today. Given the uncertainty of the next few months, actions should be taken to build and preserve cash.

STRATEGIES

- **DELAY** nonessential capex and major renovation spending plans.
- **BE DILIGENT** in following job-specific pay requisition processes to ensure timely billing of Owners/GCs.
- **MAINTAIN** a laser focused approach on collecting outstanding receivables and preserve your rights where appropriate.
- **ENSURE** good standing with your bank through open communication and consider drawing down on credit lines while they are available.
- **ELIGIBLE** companies should consider taking advantage of programs offered through the CARES Act.
- **DO NOT** take advantage of early pay program discounts.
- **SLOW** payables to the longer side of acceptable.
- **TAKE ADVANTAGE** of overbilling when possible and closely monitor subcontractor overbillings.

READ THE FINE PRINT

Construction is ultimately a business of managing risk. Since much of the protection and exposure starts with your contractual responsibilities, it has never been more critical to thoroughly review all contracts with owners, GCs, downstream subcontractors and suppliers. Appropriate contract language can mean the difference between receiving time extensions and compensation for excusable delays or being forced to do the impossible with no means for cost reimbursement. We have seen numerous issues stemming from unfair contracts and there will undoubtedly be a renewed focus on language in new contracts.

SPECIAL EMPHASIS ON CURRENT AND FUTURE CONTRACTS SHOULD INCLUDE:

EXISTING CONTRACTS

- Review existing contracts for force majeure/excusable delay clauses. Determine the breadth of language and whether or not it provides relief for delays created by acts beyond the contractor's control.
- Does the force majeure clause identify "unusual delays in delivery" as an excusable delay providing some protection from supply chain disruption?
- How do contracts address suspension of work and your ability to terminate after a period of stoppage? For example, the AIA A201 affords contractors the ability to terminate and provides recovery of payments for work performed and reasonable overhead.
- Does the contract provide for compensation for force majeure events?
- It is critical to understand the notice provision within the contract with owners as it relates to force majeure, termination and potential change orders. Failing to file a notice in a timely manner could time bar an otherwise valid claim.
- Document, document, document all delays and costs associated with the negative impacts of the pandemic on a project for time extensions, changed conditions and possible cost reimbursement.

FUTURE CONTRACTS

- Consult with your attorney to ensure that contracts contain a broad force majeure clause identifying epidemics/pandemics as an excusable delay with associated contractual relief in line with state law.
- Ensure adequate remedies for excusable delays to include additional time, and additional compensation on a particular project.
- Negotiate to have compensable delay language included in contracts for those risks beyond your control.
- Cost escalation provision to protect against supply chain disruption.

STRESSFUL TIMES

We are in unchartered waters, but it is reasonable to expect a dip in construction activity. Project stoppages, bid postponement and questionable demand for private sector construction projects are all concerning and could lead to lower company revenues. Stress test your financial position for the next 12 months. Significant revenue decreases will warrant a hard look at overhead adjustments. Stress test your income statement and cash flow at various decreased revenue levels determining at what point overhead cuts are required to maintain profitability. A slower market typically means lower gross margins, so your financial forecasting should contemplate the impact various factors have on your business. Most contractors are built for growth, but this unpleasant exercise can be a saving factor in riding out tougher times.

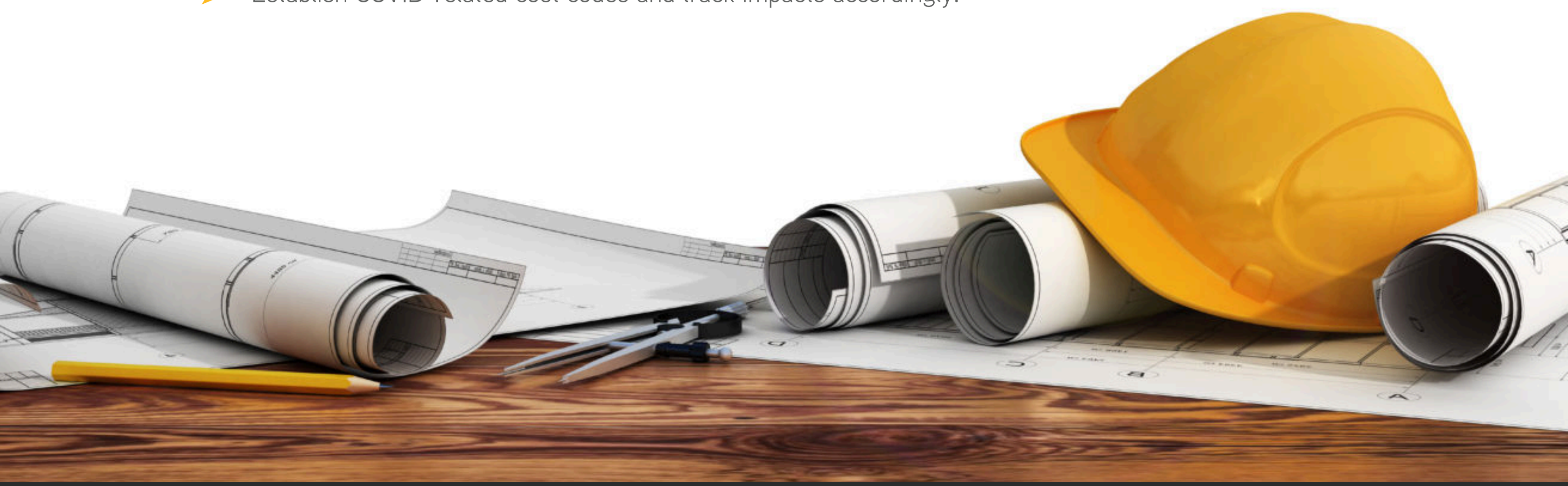
SUBCONTRACTOR DEFAULT INSURANCE CONSIDERATIONS

Though difficult to accurately predict the impact the COVID-19 pandemic will have on subcontractors, it is reasonable to assume there will be a spike in subcontractor issues and defaults. The points below summarize our thoughts around recognizing potential issues for ongoing projects, touch on SDI coverage, managing prequalification in the short-term, and consideration of broader risk mitigation strategies.

IDENTIFY PROJECT **RISKS**

- **Refocus management and risk mitigation efforts on previously identified high-risk subcontractors through the prequalification process.**
- **Reevaluate the supply chain for the project and identify potential exposures of quality and timely materials being delivered to the project.**
  - Develop a revised and fluid material delivery/procurement schedule
    - Include production, ship and delivery dates.
    - Obtain commitment letters and/or confirmation of anticipated deliveries.
  - Analyze and update the submittal schedule.
  - Identify potential production delays (plant shutdowns, for instance).
  - Look to the potential of alternative sourcing.
    - Stay vigilant about onsite material inspection and track deficiencies closely.
  - Is there concern around material cost escalation impacting the project?
- **Schedule analysis is very important for both determining how/when the project will be complete, but also in supporting potential delay-related claims.**
  - Is there an opportunity to reevaluate schedule?
  - Prepare/status the schedule pre-COIVD (as the new "baseline").
  - Insert fragnets for each COVID related delay/issue.
  - Establish COVID-related cost codes and track impacts accordingly.

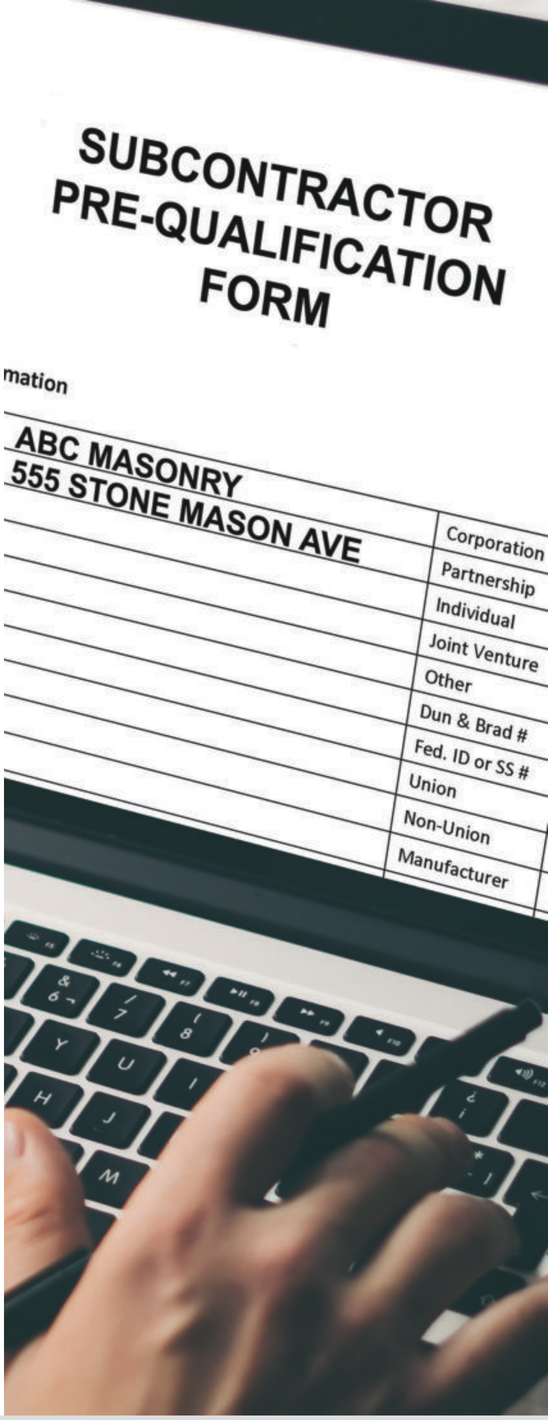
It is vitally important to understand how subcontractor performance may be impacted by COVID-19 issues. GCs and CMs can put themselves in the best possible position to deliver the project with minimal impact by attempting to get ahead of issues and developing strategies to mitigate the effect of subcontractor challenges.



SDI **COVERAGE**

In anticipation of project delays and subcontractor performance issues, means of relief should be evaluated now. We expect both contractual considerations and SDI to play a role in allowing projects to move towards completion.

- Identify exposure with all open subcontracts by policy term and determine if there is aggregation concerns relative to policy limits.
- Understand the contractual obligations between the insured and owner.
- Understand the contractual obligations between the insured and subcontractor.
- Evaluate conditions of notice to cure, formal defaults and possible remedies. This is a "new normal" and the previous way of thinking may not be applicable.
- Use your resources (i.e. SDI broker and legal representation).



PREQUALIFICATION IN THE **SHORT TERM**

A robust prequalification program relies upon a timely and accurate financial picture coupled with an operational review and qualification. In the short term, both of these areas will be difficult to determine until we are completely through this pandemic.

A FEW AREAS FOR CONSIDERATION ARE AS FOLLOWS:

- Assuming financial statements were issued prior to the COVID-19 pandemic, a lot may have changed and updated statements reflecting the impact may not be available until this time next year.
- Can the subcontractor provide a current "in-house" generated balance sheet and income statement?
- Review current WIP reports and understand how a sub's backlog lines up with your project's needs

- Areas that may provide some insight to a subcontractor's current status may include the following:
    - CARES Act – Was the subcontractor able to qualify and secure access to the loan/grant associated with the Paycheck Protection Program (PPP)? If so, what impact has this had to the subcontractor's financial condition?
    - Bank Debt – What is the subcontractor's line of credit? How much is available and does the subcontractor foresee utilizing the line in the short-term? Securing evidence of available credit from the bank is suggested.
    - Labor - Will the subcontractor be able to bring adequate labor to execute the project? What was the labor impact during work slowdown or shutdown to the subcontractor's labor?
    - Surety – Is the subcontractor's surety remaining supportive? A current surety letter from the surety directly may be helpful.
    - Cash – Asking about current outstanding accounts receivable and overbillings may provide important insights when compared against past trends of that subcontractor.
    - Outstanding AR beyond normal timeframes.
- Implement a risk mitigation plan on any subcontractors that reflect signs of potentially being in stress.

RISK MITIGATION STRATEGIES **NOW**

With the short-term uncertainty surrounding the financial condition of subcontractors, it will be important to manage subcontractor risk with more vigilance than ever before. This will need to be balanced with project management needs and resource availability, however a higher level of project de-risking in today's environment likely preserves the ability to perform successfully.

- Liquidity is very important to subcontractors.
    - Consider expediting payments to subcontractors in exchange for discount. This may be an early sign that a subcontractor is struggling financially.
- Look at purchasing material/equipment directly and labor only contracts with subcontractors.
- Joint check trades with meaningful material spends or underlying subcontracts.
- Monitor and verify lien releases, including sub-tiers.
- Evaluate the possibility of multiple awards per trade.
- Avoid awarding work to new/unknown subs and rely on subs you have successfully worked with in the past.

SURETY **CONSIDERATIONS**

The current environment of uncertainty creates added stress on credit providers like sureties and banks. It is essential to maintain an open dialogue with your surety in these challenging times. Now is the time to communicate more and not less, and a superior broker ensures there are no surprises for any member of the surety relationship. Your surety is interested in your plans to manage through potential risk created by the pandemic.

INFORMATION OF INTEREST

- **DELAY** or suspension impact on current projects in backlog.
- **DELAY IN STARTS ON NEW WORK** - recalibrate internal pipeline/project forecasting reports.
- **RESULTS** of your review of current contracts for appropriate force majeure, termination by contractor, delay of delivery and price acceleration provisions (also subs/suppliers).
- **SUPPLY CHAIN RISK IDENTIFICATION** - risks and any mitigation plans (alternative supply sources).
- **STRATEGY** for negotiating language in future contracts.
- **CURRENT** cash flow and 3-month cash flow forecast.
- **BANK DISCUSSIONS** and any change in bank line usage.
- **ACCESS** to the Paycheck Protection Program (PPP) funds.
- **OVERHEAD CONTINGENT PLANS** relative to potential revenue decreases.
- **STATUS OF BONDED PROJECTS** including notification to owner pursuant to a stoppage/delay.

CONTRIBUTING TO YOUR **SUCCESS**

There is little doubt that the unprecedented events of the day are creating a heightened level of angst for sureties and subcontractor default insurance carriers. Even prior to COVID-19 there was some performance stress with increased SDI and surety claims. The convergence of events certainly warrants concern to anyone affected by construction performance defaults.

The ability to proactively identify potential hazards and mitigate the risk before it has a negative impact on your business is key. Engaging a quality team of professionals such as your CPA, attorney and insurance and surety broker is critical in side-stepping the land mines that lie ahead. At Construction Risk Partners, our singular focus is construction. It allows us to have a deep understanding of the challenges that can arise and how to address them before they become issues. Be it advice on items that will impact your surety capacity like balance sheet decisions, contract language and forecasting results or designing the best subcontractor default insurance program and subcontractor prequalification process, we are passionate about finding ways to contribute to your success. It's what drives us every day.

PLEASE REACH OUT TO ANY OF OUR SURETY OR SDI EXPERTS WITH QUESTIONS.