



## A Best Practices Checklist

The following best practices are designed to inform your risk management strategy. They are not a substitute for a tailored strategy reviewed by your risk management, pre-construction, and operations leaders, along with business partners (brokers, attorneys, consultants, etc.). While these practices have proven helpful, not all will apply to every situation. Each contractor must independently determine what is relevant and appropriate for their specific circumstances.

### **PREQUALIFYING SUBCONTRACTORS**

#### ✓ **Create a Fair, Objective System**

- Generate a short list of firms that are qualified to bid on a project to:
  1. Mitigate the risk of subcontractor default.
  2. Increase the chance of on-time, on-budget delivery of the project that meets the expectations of the owner.

#### ✓ **Financial Review**

- Assess financial condition (statement preparation, cash flow, over/under-billings, liquidity ratios, and other relevant financial ratios)
  1. As a best practice, liquidity, consistency in past performance, and major changes to business structure/strategy are paramount considerations.
- Review the corporate structure and understand which entity you are contracting with and its financial condition.
- If a consolidated financial statement is provided, consider requiring a parent or related entity guarantee.

#### ✓ **Insurance and Bonding**

- Review available insurance coverage, including cyber insurance/security.
- Review and understand their bonding capacity and how much capacity is available at the time of contracting. Is their surety financially sound?

#### ✓ **Office Visits and Key Personnel Meetings**

- Visit the subcontractor's office and meet key management personnel.

#### ✓ **Reference Checks**

- Conduct thorough reference checks (contractors, suppliers, bank, surety).
- Request notification of a change in executive team or ownership of the company.

#### ✓ **Company History**

- Understand the company's history, including years in business, litigation experience (claims, conflict resolution), and project history (market segment, geography, project size, project scope).

# Preventing and Managing the Risk of a Subcontractor Default...



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- Conduct a public records search to assess whether there are any outstanding tax liens or other litigation matters.
- ✓ **Current Projects and Resource Availability**
  - Review current projects under contract or in the pipeline to understand capacity.
  - Analyze volume for the last three years to understand capacity.
  - Understand workforce size and any recent appreciable changes.
  - Assess the availability of resources (labor, equipment).
  - Assess safety training and quality programs.
- ✓ **Claims/Incident Data**
  - Stay informed on claims data to support understanding trends in default reasons. (Some SDI carriers can provide this information.)
  - Verify EMR for the past three years.
  - Review the history of OSHA incidents.
- ✓ **Ongoing Due Diligence**
  - Personal guarantees do not absolve you from necessary due diligence.
  - Update prequalification before contract award if significant time has passed since the original pre-qualification.
  - Continually request updated financials (Income Statement, Balance Sheet, Work-in-Process, backlog, etc.)
  - Recheck insurance before project commencement to ensure required coverage is in place.
- ✓ **Risk-Benefit Analysis & Mitigation Plan**
  - Conduct a risk-benefit analysis to determine whether best price equals best value and acceptable risk.
  - Compare bid value with other subcontractor bids to ensure an unusually low bidder is not undercutting themselves too much, or not able to cashflow enough to pay everyone themselves.
  - After prequalification, create a comprehensive risk mitigation plan tailored to the major risks discovered.

## **USING CONTRACTS TO MANAGE AND REDUCE THE RISK OF SUBCONTRACTOR DEFAULT**

- ✓ **Sub-Subcontractors and Suppliers**
  - Require identification/listing of sub-subcontractors and suppliers.

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- Consider creating and enforcing the right to approve (or reject) sub-subcontractors and suppliers.
- Consider creating and enforcing the right to see (and approve) sub-subcontracts.
- Require that key contract requirements be flowed down.
- Require that payments be promptly flowed down.

### ✓ Lien/Bond Waivers

- Require lien/bond waivers and certification of downstream payments at all levels; and specify forms to be used.
- Ensure lien waivers are valid in the states in which you operate.

### ✓ Insurance and Bonding

- Require appropriate insurance coverage and ISO forms where appropriate (may include design E&O insurance).
- Consider bonding subcontractors or utilizing subcontractor default insurance.
- If bonds are used, verify NASBP rating, and specify the form of bonds. Review bonds upon receipt for accuracy and verify authenticity for anything other than the actual bond form with power of attorney.

### ✓ Procurement and Materials Control

- Consider procuring major, long lead time, and critical materials/equipment directly.
- Control stored materials (payment, ownership, security, and insurance).

### ✓ Payment Terms

- Establish clear terms and conditions for withholding payments in appropriate circumstances. This does not advocate that the General Contractor has the right to unilaterally and arbitrarily withhold money that is due. The subcontract should establish the circumstances under which the General Contractor can withhold money and when the General Contractor cannot. (\*Pay-if-paid language is a reported reason for subcontractor defaults.)
- Authorize joint payments when necessary.
- Be clear about retainage. Align retainage terms and flow down the same terms to your subcontractors.

### ✓ Termination Provisions

- Include appropriate termination for default provisions (without an overly long “waiting period”).
- Include termination for convenience provision.

### ✓ Warranty and Compliance

- Consider post-completion warranty obligations.

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- Require trade partners to maintain prequalification status.
- Include specific provisions in the subcontract to assist the project team's compliance with the risk mitigation plan for the trade contractor.

### ✓ Project Management

- Include milestone dates in the subcontract agreement (e.g., pre-construction items like submittals) to monitor subcontractor progress.
- Inquire and enforce crew # onsite – include within subcontract expected crew size and duration to complete scope of work. This will help GC and subcontractor to begin determining worker needs and shortfalls.
- Include expected lead times for materials in the subcontract. GC can then flag the submittals to ensure that the materials are ordered in time for scheduled installation.

## MANAGING THE RISKS OF SUBCONTRACTOR DEFAULT DURING CONTRACT PERFORMANCE

### ✓ Contract Adherence

- Honor and enforce your contracts.
- Pace payments and progress.
- Be careful about “helping out.”

### ✓ Financial Vigilance

- Monitor for overbilling and do not overpay to assist with cash flow.
- Ensure that penal sums of bonds are increased if contract value increases.
- Obtain surety consent to payments and change orders.
- Be vigilant: watch for early warning signals of financial distress.
- Ask questions/communicate.
- Beware of “robbing Peter to pay Paul.”

### ✓ Termination and Resolution

- If a parting of ways is necessary, consider “kinder and gentler” options, e.g., negotiated resolution, deductive change order, or termination for convenience.
- If termination is necessary, act promptly and follow contract and legal requirements.
- Be aware that filing for bankruptcy cannot be a reason for termination, even if the contract states otherwise.

### ✓ Rights and Obligations

- Know your rights, obligations, and deadlines under any surety bonds, insurance policies, or letters of credit.

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- Act timely – problems do not usually improve with time.
- Exercise contractual remedies.

### ✓ Communication and Documentation

- Maintain a continuous feedback loop between pre-qualification, pre-construction, risk management, and operations resources. If one link in the chain sees early warning signals of distress, alert everyone else in the chain and manage accordingly.
- Document all costs associated with the replacement or supplementation of a subcontractor for support of an SDI (subcontractor default insurance) or surety claim; set up separate cost codes to track expenses.

### ✓ Attendance and Quality Control

- Monitor daily attendance to track actual people showing up against the schedule to identify potential financial distress.
- Conduct early safety orientations to verify if the crew size showing up for safety orientation matches the expected crew size per the subcontract.
- Utilize in-place mockups to ensure qualified labor, quality control (QC), and proper installation methods.