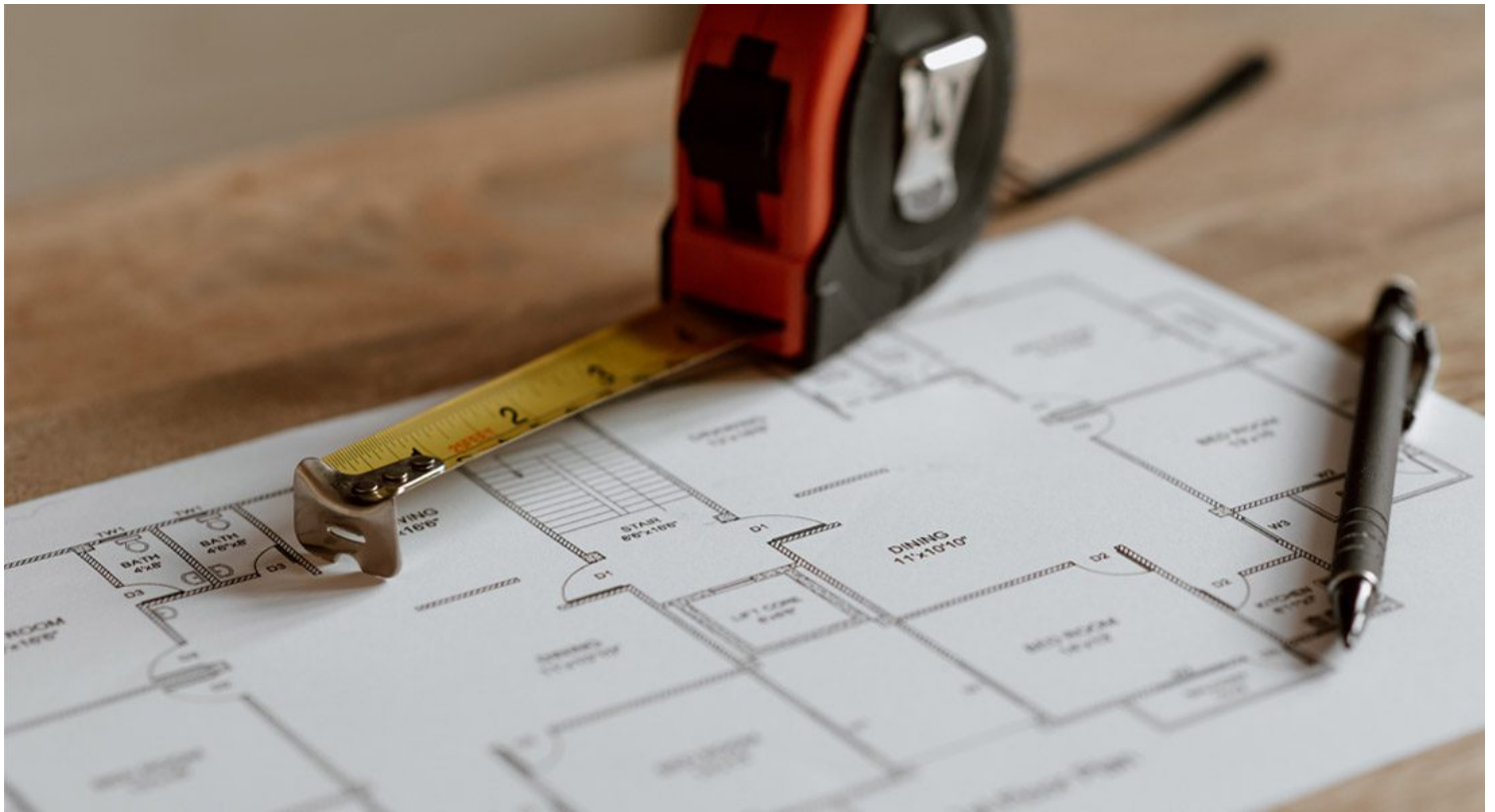


NEWS & INSIGHTS

Tactics for handling downstream insolvency on a construction project

INSIGHTSARTICLE

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Several news outlets have been reporting that economists are predicting a recession in 2023. When the economy struggles, it can create financial strain on developers, contractors, subcontractors, suppliers and others involved in the construction process. A bankrupt or insolvent subcontractor can completely derail a project, so, what measures can be taken to protect your company and the project from downstream cash flow issues?

Get financial assurances

For higher tiered contractors/subcontractors, if not already in your contracts, begin adding a clause that allows you to seek financial assurances from whomever you are contracting with. This is also useful for the prime contract with owner, if there is any concern of owner solvency.

Many contracts already contain such provisions, but in practice, few companies actually ask for the lower-tiered contractor to prove its financial strength. If there is ever a time to start using this protection, it is now. Asking for reasonable financial assurances from a subcontractor or reasonable proof of financing from the owner should be done regardless of whether it is a first-time business relationship or company that you have worked with for years.

The type of assurances requested will depend on your relationship and level of concern. While this can *potentially* be an uncomfortable initial conversation, the risk of being left high and dry with a bankrupt subcontractor or owner is not worth it.

Ensure payment down the line

Ensure your contracts require all subcontractors to provide sufficient documentation that they are progressively paying their labor and suppliers.

For example, require your subcontractor to provide you with a list of the subcontractors and suppliers it intends to use on the project. You should also require the subcontractor to provide reasonable lien waivers and certification of payment downstream, including second-tier lien waivers. For subcontractors that either cannot provide you with adequate assurances or you have specific concerns about, joint check agreements should be considered.

Watch for red flags on-site

Educate your on-site personnel to recognize signs of potential insolvency on the job site. While not foolproof, there are a few things that employees can look out for that signal a company might be having money issues:

- Key employees leaving
- Lack of manpower on site
- Delayed materials and deliveries
- Supplier demands for joint check agreements
- Mechanics' lien threats or notices
- Lack of cooperation in showing proof of payment down the line
- Third-party collection efforts against the subcontractor, such as asset freezes or equipment levies

Be sure to implement a procedure or process that allows your personnel on the job site to communicate these observations to management in an efficient manner.

Should you withhold payment?

Seriously consider the impact of withholding money for defective work. This is not to suggest that you do not withhold for defective work. But recognize the reality that withholding (or demanding curative work at no extra cost) from a subcontractor who is financially on the brink could result in other issues.

For example, if payment is withheld from a financially strapped subcontractor, that subcontractor may be unable to pay its suppliers. Just because you were righteous in withholding from the subcontractor will not prevent the downstream supplier from filing a lien or bond claim. Recognize that extra diligence and oversight should accompany any withholdings, including scrutiny and monitoring of downstream payments, to prepare for the potential that third-party claims arise from the direct withholding.

When to bring in an attorney

Do not be afraid to pick up the phone and contact your attorney if you suspect someone down the line might be headed towards bankruptcy. Each situation is unique and there truly is no one-size-fits-all approach.

Proper planning and strategy tend to lead to better results, and at least decisions can be made to try and steer clear of worst-case outcomes. Typically, ignoring the situation and hoping for the best tends to lead to compound problems.

Saxton & Stump's construction law attorneys, [Ron Pollock](#), [Matt Chabal](#) and [Mike Traxler](#) are available to assist companies in addressing risk allocation and problems that arise on projects, including drafting custom contract language, advising on lien waivers, and providing general advice on how to navigate projects where insolvency and bankruptcy are a concern.

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