

# Potential Subcontract Default Risks due to COVID-19 and Recommended Risk Mitigation Strategies



*Cove Programs is carefully monitoring the impact of the COVID-19 virus on the construction industry and on subcontractor performance issues in particular. While the situation is unprecedented and fluid, we wanted to share basic risk management information with you. We will continue to share information with you as we develop it and are available at any time to help you work through these challenges. Please feel free to contact us at any time should you have any questions. We look forward to sharing the dialogue and bringing resources to you.*

## **Overview**

The purpose of this paper is to highlight potential impacts of COVID-19 on subcontractor default risk on construction projects. The paper also identifies risk mitigation actions that can be considered to address these risks.

### **Potential Subcontractor Default Risks / Scenarios**

- Schedule delays
  - Lack of labor due to illness, quarantine, or travel restrictions
  - Lack of labor due to layoffs for financial reasons
  - Supply chain issues – materials delivered late or not available
  - Failure to remobilize after a project delay, potentially due to subcontractors giving higher priority to other projects
- Quality issues
  - Failure to meet quality standards due to lack of qualified labor or supply chain issues
- Subcontractor insolvency
  - Insolvency due to revenue / cash flow disruption due to projects being delayed, postponed, or cancelled

### **Potential Risk Mitigation Actions for General Contractors for Projects in Progress**

- Review your own crisis management, business continuity and resiliency plans
  - If you don't have one, engage executive staff, legal and risk advisors to develop one
- Review and monitor state unemployment laws – many states are enacting emergency legislation and waiving waiting periods to collect unemployment

- Contact your legislators, trade associations and peer groups – discuss actions you can take collectively as an industry / leadership group
- Review force-majeure and termination clauses in your contracts and your subcontracts
  - In most cases, it is expected that the COVID-19 pandemic will entitle contractors (and subcontractors) to an equitable adjustment in the contract time but not the contract price
  - Review these clauses carefully with legal counsel and other risk advisors and confirm applicability of pandemic and communicable disease events
    - Consider providing written notice to project owners that the World Health Organization identified the COVID-19 outbreak as a pandemic on March 11th and this event could result in potential delays and additional costs that are outside the Contractor's control.
- Hold weekly internal meetings to discuss subcontractors' staffing levels, performance, and possible warning signs
- Maintain frequent and regular communication with subcontractors
  - Ask for and review business continuity, contingency and resiliency plans
  - Discuss actions subcontractors are taking to keep doors open
  - Understand and recommend risk mitigation actions subcontractors can take to protect their business and employees
  - Understand which of their projects and staff may be affected due to employee contagion and/or project shutdowns
- Consider mid-term risk mitigation actions to help subcontractors manage through the crisis
  - If projects are suspended, maintain frequent contact with the subcontractors to ensure they remain willing and able to return when the project restarts
  - Formally put subcontractors on notice with regard to their contractual obligations following a force majeure delay
- Request / require more frequent, internal financial statements from subcontractors
  - Consider engaging a 3<sup>rd</sup> Party to assist in collecting / analyzing mid-term financial statements
  - Monitor WIP (changes over last 6 months)
  - Monitor bank line of credit (Amount of LOC and available amount)

- Look closely at liquidity and leverage ratios
  - Restrict new awards to more leveraged / cash-strapped subcontractors and suppliers
- Increase frequency for reviewing credit reports
- Continue to closely monitor payments to suppliers
  - Consider increasing use of joint checks or direct purchase of materials
  - Monitor lien releases (100% verification)
- Continue to closely monitor quality
  - Emphasize material verification to ensure delivered materials are as specified and guard against unauthorized substitutions that may result from supply chain disruption
  - Verify installed work meets project requirements prior to authorizing payments
- Proactively begin a dialog with project owners
  - Where extensions of cost are allowed, protect / preserve those rights
  - Discuss worst-case scenarios and their contingency plans for the project
  - Discuss implications of potential project closure and actions from project financiers
    - Develop plans to safely and securely suspend construction if necessary

### **Potential Risk Mitigation Actions for General Contractors for Projects not yet Started**

- Renew emphasis on thorough and current Subcontractor Prequalification
  - Request current financial statements (interim if necessary) to review trends over the past 3-6 months. Measures / metrics that should be evaluated include:
    - Working Capital
    - Debt to equity ratio
    - Current ratio
    - Quick ratio
  - Review current work-in-progress (WIP) reports
  - Review current manpower and changes over last 6-12 months
  - Review banking relationship - current bank line of credit and available amount

- Verify current surety capacity and relationship
- Rely on those subcontractors who you have successfully worked with in the past
- Discuss potential supply chain issues with subcontractors
  - Identify long lead items and confirm sources / locations
- Review force-majeure and termination clauses in your contracts and your subcontracts for references to pandemic and communicable disease events
  - If existing force majeure clauses are silent on these issues, consider adding them in future contracts

### **Potential Risk Mitigation Actions post-COVID-19**

- After the COVID-19 pandemic concludes, it is possible the global economy will be entering a recession, which can bring additional risks of subcontractor defaults. While much of the guidance above will still apply, additional risk mitigation actions should also be considered at that time.

### Websites with additional information:

AGC Webpage	<a href="https://www.agc.org/">https://www.agc.org/</a>
AGC COVID-19 Resource Page	<a href="https://www.agc.org/coronavirus-covid-19">https://www.agc.org/coronavirus-covid-19</a>
AGC Risk Management Smartbrief	<a href="https://www2.smartbrief.com/getLast.action?mode=last&amp;b=AGCRisk">https://www2.smartbrief.com/getLast.action?mode=last&amp;b=AGCRisk</a>
AGC Smartbrief	<a href="https://www2.smartbrief.com/getLast.action?mode=last&amp;b=AGC">https://www2.smartbrief.com/getLast.action?mode=last&amp;b=AGC</a>
Centers for Disease Control and Prevention	<a href="https://www.agc.org/coronavirus-covid-19">https://www.agc.org/coronavirus-covid-19</a>
Construction Dive	<a href="https://www.constructiondive.com/">https://www.constructiondive.com/</a>
Construction Financial Management Association	<a href="http://www.cfma.org">www.cfma.org</a>
Engineering News-Record	<a href="http://www.enr.com">www.enr.com</a>
NASBP Smartbrief	<a href="https://www2.smartbrief.com/getLast.action?mode=last&amp;b=NASBP">https://www2.smartbrief.com/getLast.action?mode=last&amp;b=NASBP</a>
Smartbrief COVID-19	<a href="https://www2.smartbrief.com/getLast.action?mode=last&amp;b=COVID19">https://www2.smartbrief.com/getLast.action?mode=last&amp;b=COVID19</a>