Top Three Contractor Risks and How to Reduce Your Exposure

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YOUR GUIDE TO NAVIGATING TODAY'S CONSTRUCTION ENVIRONMENT

Notwithstanding COVID-19's onset in 2020, construction activity has been, and continues to be, robust. New home construction and multifamily increased, and with few exceptions, commercial building shows no signs of slowing down either. The public and federal construction market is also picking up steam, with the federal government making a multi-year $550 billion infrastructure investment through the Infrastructure Investment and Jobs Act.

Still, there is reason to be cautious. Because some construction projects can take months or even years to complete, the construction industry has likely not yet felt the full impact of the pandemic and its attendant economic challenges.

Contractors are adjusting to the scarcity of key construction inputs like labor and material. Companies that are effectively managing this disruption still may be experiencing impacts to their profit margins as costs increase. Aside from project margins, lack of material and/or labor also has the potential of impacting project schedules and creating additional overhead expense.

Despite today's difficulties, the good news is that contractors have some level of control in how they manage these variables. We'll share ways contractors can adjust to the new reality and still maintain profitability.

Construction Risk Has Never Been Greater

With the U.S. economy in flux, it can be hard to identify the right way forward when it comes to the tight labor market, supply chain, material cost inflation, and new and emerging contract risks. Make sure the management of these risks is the key to success — not the mark of failure.

1. LABOR SHORTAGE

There are currently two open jobs for every unemployed American, according to the U.S. Bureau of Labor Statistics. With construction activity remaining strong and the well-documented industry labor shortage, it's no surprise that contractor businesses are focused on attracting and retaining employees.

This can be a challenge if your business is growing, as you have more projects than usual or you are moving into a new area for work.

Here are a few ways your firm can navigate labor issues:

» **Partnering with other contractors.** If you need subcontractors on a semi-regular basis, it may help to pool resources with other contractors. Share subcontractors or refer work to contractors you know and trust when you're over capacity. Develop a pool of contractors to work with regularly and refer to.

» **Start building the talent pipeline "yesterday."** With the labor shortage growing, it's more important than ever to attract younger workers into the business. Consider visiting high schools to discuss the construction industry, your career progression, and what a job in the construction industry means to you. Partner with local trade schools and hire interns to learn directly from you. Recruit younger than you have in the past.

» **Support your employees.** Beyond offering a fair salary, it's the little things that create engagement and a sense of belonging to an organization. Offer benefits to make sure they can take care of their health and wellbeing, and that of their families. Increase gas mileage reimbursement or offer special bonuses such as weekly gas cards to make it easier to get to a jobsite.

» **Create a culture of workplace safety by providing safety training to all employees.** Encourage teamwork and mentorship programs, which can encourage cooperation rather than blame when mistakes occur.

» **Encourage community outreach.** Not only do community projects make everyone feel good, but many employees feel loyalty to companies that give back to their community.

2. SUPPLY CHAIN AND MATERIALS COST INFLATION

The price of lumber and steel have fluctuated wildly since the beginning of the pandemic. At different periods in the last year, and likely in the near future, some building materials may not be available at all.

Runaway prices are a major concern for contractors accustomed to just-in-time delivery. Materials that are stored on-site can be prone to theft, but just-in-time delivery has contractors relying more on trucking companies and other logistics organizations and may lead to delays down the road.

Because material costs have and continue to show volatility, contractor risk is magnified, and pricing is difficult. Contractors must figure out how long they can guarantee a price — or how they will try and pass on rising costs to their customers.

Your firm can reduce the impact of rising material costs and supply chain fluctuations in the following ways:

» **When possible, include a cost escalation clause in your contract.** You can't control whether prices will change, and in today's environment, a lot can change from when a bid estimate is put together and when a contractor can mobilize and execute the work. An escalation clause can result in the project owner sharing at least part of the financial burden when a significantly different and unforeseen circumstance occurs.

» **Value or reengineering of a project.** When you face a shortage of material, labor, or other inputs, consider a discussion with the owner or owner's representative and discuss ways to modify the project while still meeting the owner's building needs.

» **Seek alternate suppliers or materials.** Contractors and customers have to be more flexible. When materials aren't available, it may be necessary to shift suppliers or materials to complete the project. New materials may provide their own challenges — whether it's a change in sizing or use — but adaptability enables success.

» **Document all changes.** Keep track of any changes, from product pricing to additional supply chain costs. This can help prevent legal issues and conflicts with the project owner. Contractor losses are often caused by insufficient record keeping. To prevent losses, you should document every aspect of a job, including site conditions, scheduling issues, change orders, and material price escalations. To avoid being held responsible for additional project costs beyond a contractor's control, as well as to recover any additional costs that are incurred above and beyond the contractual responsibilities, thorough documentation is key.

» **Secure your site.** Construction site accidents, theft, and mishaps can be cause for significant financial loss. Make sure appropriate work site safety protocols are in place and there is a process for reporting work-related injuries. Jobsite theft may be more likely since material costs have increased. Materials can also be damaged by nature, potentially causing a major loss. Automated monitoring devices like water or theft alarms are relatively inexpensive and can be moved from site to site as needed. Be sure everything is fenced off and/or under surveillance to protect your investment.

» **Maintain the right insurance coverage.** Appropriate coverage goes hand in hand. If the project is bonded, a surety company will also want to know that the contractor has procured the contractual limits of coverage from a financially strong insurer.

3. TRANSFER OF CONTRACTUAL RISK

Risk transfer can be challenging. With all parties trying to minimize their own exposure, it can be challenging to transfer risk sufficiently — and to ensure all the risk is administered proportionately based on the stakeholder's obligations.

The construction contract's terms with the project owner can have an impact on a contractor's ability to secure surety or insurance support. Be aware of this and screen your contracts carefully. The owner, mortgagees, contractors, and subcontractors are additional named insureds under a builder's risk policy, meaning there are very limited, if any, options to transfer risk for the project to other parties. Sureties will also be looking at these risk elements and many others, like liquidated damage and dispute resolution clauses, as they evaluate project support.

Here are a couple of ways your firm can reduce contractual risk:

» Understand the contract. Don't sign anything until there is a full understanding of the risks. Make sure the contract specifies ample time and includes a process to resolve conflicts on-site, including the ability to work with the owner to resolve the conflict.

» Consult with an attorney. It's a good idea to develop a relationship with an attorney who specializes in construction law and have them review your contracts before signing. If concerns remain, consider having your surety company engage their legal team. Having good communication with your surety agent and surety company and, where needed, providing the contract language for their review will not only provide valuable insights, but help to establish trust between you and the surety.

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