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Case study: Strict vetting of your subs will save you from major headaches

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The problem: A client who runs a construction management company ran into a big problem when one of their subcontractors started experiencing financial difficulty. The client received a call from the subcontractor saying that they were in need of an advance on the next progress payment to get them through a "temporary cash flow crunch." Because this subcontractor was on the critical path of three very large projects, all at varying stages of completion, the client had some major impacts should this subcontractor default or go out of business. After considering potential options, the client called Grassi & Co. to determine the best way to manage the problem, while keeping the projects on track and minimizing losses.

Options and solutions: A team of Grassi & Co. professionals, including partner Geri Gregor and myself heeded the call and flew to the subcontractor's location as soon as possible to see firsthand, exactly what was happening. After reviewing the financial records of the subcontractor, the Grassi & Co. team quickly surmised that the subcontractor was in dire financial condition. Geri and I, given their extensive experience in the industry, concluded that there were three viable options available to the client in order to keep the work on track.

The client could:

* Buy the subcontractor's business, allowing the client to use it as a profit center for future work, pending the client could find someone to run it effectively.
* Default the subcontractor and find a replacement for the unfinished work.
* Layout cash to pay some of the subcontractor's overhead expenses and keep their plant running until at least the manufacturing phase of the projects were completed.

An evaluation of each option was performed, including analyzing production costs for the plant, installation costs, amount of time to complete and necessary overhead to be funded. The Grassi & Co. team worked closely with both the project's personnel at the subcontractor and the client to identify and evaluate all the critical decisions that had to be made. From there, the team processed this information and compiled the "dollars and cents" breakdown of each critical decision. Recommendations were made to the client's upper management team.

The decision: It was ultimately decided that the client would not buy or invest in any part of the subcontractor's business. The premium set of logistics for a successful vertical integration just did not exist. After carefully analyzing the options for each project, the client chose to default the subcontractor and replace them completely on one project, though they were able to utilize some preliminary work that was already completed to minimize lost time. The other two projects were kept with the subcontractor, and the operations and overhead was subsidized by the client until they could finish the production phase of those two projects. Thereafter, the subcontractor was replaced for the installation phase.

To assist in the management of effectuating this plan, the Grassi & Co. team stayed on site for the six-month duration of the project - monitoring progress, crews and processes, to both ensure a positive outcome and also notify management if there were any adjustments to the initial cost estimates. Additionally, the team set up protocols and procedures to track and pay various costs on each project. Cost-tracking reports were developed from the subcontractor's job costing system, and were ultimately used for claim submissions to insurance and surety companies for indemnification of the losses incurred.

Lessons learned: The lesson in all of this is to vet your subcontractors, and vet them well! This situation, if not managed properly, could have sunk the client financially, and potentially put them completely out of business. Although the client ultimately lost over a million dollars, they actually stood to lose tens of millions of dollars had they not made the correct decisions. Contractors are extremely susceptible to sliding down a very slippery slope if even one subcontractor goes off track. It is incredibly important that you evaluate the financial compatibility of your subcontractors' ways of doing business against your own. Financial stability is just as important as technical qualifications when selecting a subcontractor. Remember, an ounce of prevention is worth a pound of cure, and the lowest price is almost never the best deal for your business.

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