Risk Management in Construction Contracting and Accounting in 2021:

Get the tools you need to succeed

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Meet the Presenters:

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Learning Objectives

- Learn the top five contract clauses to keep an eye on for hidden risks and gain some action take-aways
- Get answers to the current five most frequently asked accounting and reporting questions
- Receive guidance through-out on how to strengthen your company and manage in this lingering pandemic and possible economic downturn

Hidden Risks in Construction Contracts

Kelly J. Gagliuso, Shareholder

Contract Clauses Addressed

- Prevailing Party Fee
- No Damage for Delay
- Pay-When-Paid and Pay-if-Paid
- Contractual Lien Waivers
- Acceleration and Compression

1. Prevailing Party Fee (PPF) Clauses

“To the Victor go the spoils…”

William Learned Marcy

What is a PPF Clause?

A clause which shifts the risk of paying the costs and attorney's fees incurred in litigation or arbitration to the losing party

What is a Typical PPF Clause?

"The prevailing party in any dispute resolution proceeding initiated by a party to this Agreement shall be reimbursed for its costs, expenses, and reasonable attorneys' fees by the opposing party."

What is the Risk Profile of a PPF?

- Risk 1: PPF Clause shifts the risk of the litigation expense of two parties to the loser
- Risk 2: Threat of loss may discourage legitimate enforcement actions
- Risk 3: Side with greater resources may spend heavily to win and skew results

Are the Legal Fees an Insured Loss?

- It depends on the policy and the law of your state
- Some courts have held that fees are covered losses flowing from an occurrence
- Some policies specifically exclude payment of fees to opposing party fees

What should I take away from this?

- Check your contracts for PPF Clauses
- Consider striking the clause if you are not financially situated to take the risk
- Determine whether your CGL policy covers or excludes opposing party fees

Poll Question #1:

Would the inclusion of a PPF clause in a construction contract deter you from bringing a claim against an opposing party?

2. No Damage for Delay (NDD) Clauses

“Defer no time, delays have dangerous ends”

William Shakespeare

What Types of Delays are there?

- Excusable / Compensable
  - Delays by the Owner
- Non-Excusable / Non-Compensable
  - Delays by the Contractor
- Excusable / Non-Compensable
  - Delays by Force Majeure
  - Unforeseeable delays beyond the control of the parties
  - Preventing performance by one or both parties

What is a No Damage for Delay (NDD) Clause?

- NDD clauses makes all forms of excusable delay non-compensable

- Contractor's sole remedy for an otherwise excusable and compensable delay is an extension of time

What is a Typical NDD Clause?

"Contractor shall not be entitled to compensation for delays to the progress of the work, including those caused by, or arising from, acts or omissions of the owner, or its separate contractors, consultants or other parties for whom the owner is responsible. The contractor's sole and exclusive remedy for such delays shall be an extension of time."

What is the Risk Profile of an NDD Clause?

- Enforceable in most states including ME, NH, MA, and VT
- Exceptions only for owner conduct tantamount to fraud (i.e. bad faith, willful interference, etc.)
- Often well hidden in long form contracts

Is there any defense to an NDD Clause?

- Waiver: Owners may risk waiving an NDD clause by approving and paying delay claims that are contractually barred by the NDD

What should I take away from this?

- Check your contracts for NDD clauses
- Contractors - negotiate to strike the NDD or add payment terms where there is owner fault
- Owners - monitor enforcement of NDD clauses to avoid waiver

3. Pay-When-Paid and Pay-if-Paid Clauses

“A promise made is a debt unpaid”

Robert W. Service

What is a Pay-if-Paid Clause?

- A clause which permanently shifts the risk of non-payment by the owner or contractor to a lower tier contractor or supplier

- Receipt of payment by the up-chain contractor is an express condition precedent to the lower tier's right to receive payment

What is a Typical Pay-*if*-Paid Clause?

“The contractor’s receipt of payment from the owner for the work completed by the subcontractor is an express condition precedent to the contractor's obligation to make payment to the subcontractor. Payments received from the owner are the sole fund from which payments will be made to the subcontractor.”

What is a Pay-*When*-Paid Clause?

- A clause which temporarily shifts the risk of non-payment by the owner or contractor to a lower tier contractor or supplier

- Receipt of payment by the up-chain contractor is not made an express precondition to payment

What is a Typical Pay-When-Paid Clause?

Two Types: open-ended and timed

"The contractor shall make payment to the subcontractor when the contractor receives payment from the owner for the subcontractor's work" (open-ended)

"The contractor shall make payment to the subcontractor within 7 days following contractor's receipt of payment from the owner for the subcontractor's work" (timed)

What if the Owner never pays?

- PIP: The lower tier contractor is not entitled to payment
- PWP: The lower tier contractor is required to wait a reasonable time frame for the owner to pay; if the owner doesn't pay, the contractor must pay the lower tier sub/supplier

What is the Risk Profile of PIP/PWP?

- PIP and PWP are enforceable in most states, including ME, NH and VT (void in MA)
- PIP clauses permanently bar payment
- PWP clauses requires an non-specific "reasonable" waiting period for payment

PIP/PWP Risk Profile (cont.)

- Often well hidden in long form contracts and can be missed
- Sureties in some states may use PIP/PWP as a defense to payment bond claims
- May prohibit lien filings where there is no current right to payment due to a PIP/PWP condition

What should I take away from this?

- Check your contracts for PIP\PWP clauses
- Clauses arelikely to be enforceable unless prohibited by statute
- Lower tiers should try to strike or modify to set an outside payment date
- Owners/GCs use proper condition precedent language to enforce as a PIP clause

Poll Question #2:

Have you or any of your clients ever refused to sign a contract containing a pay-if-paid or pay-when-paid clause?

4. Contractual Lien Waivers

"He who signs a construction contract without reading lien provisions is a fool"

Kelly J. Gagliuso

What is a Contractual Lien Waiver?

- An advance waiver by a contractor (or lower tier sub) of all lien rights it could potentially assert on a project

- Contained within a long form contract

- Effective prior to the actual provision of labor or materials by the contractor

What is a Typical Contractual Lien Waiver?

"Contractor unconditionally waives all of its current and future statutory and common law rights of lien against the project, or the property on which it is situated, arising out of the work. Contractor shall (1) include this waiver in each of its lower tier subcontracts, and (2) defend and indemnify the Owner for all claims, suits, and damages arising out of its failure to do so."

What is the Risk Profile of CLWs?

- Often well hidden in long form contracts
- Enforceable in many states (ME and NH enforce; MA and VT do not)
- Waiver sacrifices the priority status of a mechanic's lien
- Reduces mid-project payment leverage

What should I take away from this?

- Check your contract for contractual lien waivers
- Lower tier contractors should strike them or modify to create a progress waiver only
- Owners and contractors should word them clearly and properly to avoid ambiguity

Poll Question #3:

Do you or your clients include contractual lien waivers in construction agreements?

5. Acceleration and Compression Clauses

“No complaint is more common than that of scarcity of time”

Adam Smith

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What are Acceleration and Compression Clauses?

- Clauses requiring the contractor, upon request by the owner or up-chain contractor, to accelerate its performance, thereby compressing work into a shorter time frame than required by the contract, in order to meet the needs of the owner or the general contractor

- Compensation is often foreclosed by A/C clauses

What is a Typical A/C Clause?

"Upon demand by the owner, the contractor shall accelerate its performance (or compress the schedule) to meet the demands of the project, including, but not limited to, extending its work hours and providing overtime labor at no additional cost to the owner or the general contractor. Contractor agrees that it has considered this requirement in setting its pricing."

What is the Risk Profile of an A/C Clause?

- Often hidden in long form contracts
- Contractor is without fault, but denied comp for OT and PT paid to employees and subs
- Contractor may also have to hire additional crews to fully accelerate to Owner’s pace
- Destroys project profitability

What should I take away from this?

- Check your contracts for A/C clauses
- Contractors may want to strike the clause or modify the clause to provide for payment
- Owners should seriously consider impacts of A/C clauses – when profitability incentives are lost, so is motivation and quality

6. COVID-19: CONTRACTING IN 2021

"Losing your head in a crisis is a good way to become a crisis"

C. J. Redwine

How is COVID-19 Impacting Construction Contracts?

- Safety Provisions – PPE, wellness checkpoints, sanitation, social distancing, and monitoring

- Price Escalation – Mechanism for pricing changes due to shortages and stockpiling

- Termination/Suspension – Determining what happens if there is a government shutdown

What should I take away from this?

- Look at the big picture - see the forest for the trees
- No contract provision can predict every COVID-19 scenario
- Resist elevating form over substance
- Solutions to unique scenarios that are negotiated are usually best
- Contract can be amended to meet the needs of the parties

Answers and Insights to Accounting and Reporting FAQs

Linda Roberts, CPA, CCIFP, Prosci® CCP

FAQs Addressed

- What impact does a termination clause have on contract revenues?
- How are balances reported under an extended term line of credit?
- Where do I begin in preparation for the new lease standard?
- How do I report the PPP loan balance or forgiveness?
- Stock repurchase obligations hit us with down-sizing. What do we record or disclose?

What Impact Does a Termination Clause Have on Contract Revenues?

- Check the contract terms
- Termination for convenience
  - Lays out how unbilled work in progress is compensated
  - Gives info to help determine over-time or point-in-time revenue recognition
  - May indicate margin as variable consideration
- Consider impact on contract assets and receivables

Poll Question #4

What is your current line of credit term arrangement?

How Are Balances Reported Under an Extended Term Line of Credit?

- Revolving line of credit with >1 year term remaining at year end
- FASB ASC 470-10 guidance - **current liability traits**
  - Agreement expires within 1 year of balance sheet date
  - Presence of lock-box or sweep features
  - Subjective acceleration clause
  - Zero balance requirement
- **Portion could be long-term debt**
  - Management’s estimate of low-point
  - Consider any changes in maximum borrowing capacity
- Equipment lines:
  - Use repayment terms through agreement expiration only

Where Do I Begin in Preparation for the New Lease Standard?

Definition under FASB ASC Topic 842 *Leases*

A contract that conveys the right to <u>control the use</u> of an <u>identified asset</u> for a period of time in exchange for consideration.

Poll Question #5

How many lease agreements do you think you have?

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Where Do I Begin in Preparation for the New Lease Standard?

Where to Start

- **Select implementation method**
  - Transition Method A: Retrospectively apply to each prior reporting period presented in the financial statements
  - Transition Method B: Apply retrospectively only to the beginning of the year of adoption
- **Adopt available practical expedients**
- **Set thresholds – now and future in mind**
- **Build lease inventory**
- **Consider need to obtain software**

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Where Do I Begin in Preparation for the New Lease Standard?

- Where to look
  - Rental agreements
  - Contracts – jobs and service agreements
  - Dreaded **embedded leases**
  - Data mine into G/L – recurring monthly payments
- Month-to-month agreements
  - Consider intended renewals
- Agreements with no-penalty return
  - Consider intended period(s) of use

How Do I Report the PPP Loan Balance or Forgiveness?

- **Treat as debt** (FASB ASC Topic 470 *Debt*)
- **Analogize grant accounting** (International Accounting Standard (IAS) 20 *Accounting for Government Grants and Disclosure)*

How Do I Report the PPP Loan Balance or Forgiveness?

Treat as Debt (FASB ASC Topic 470 *Debt*)

- Reflect using repayment terms in the note – current portion and long-term portion
- Forgiveness is recorded when legally received – i.e. on the date loan cancellation is received from the lender
- Subsequent forgiveness is treated as a Type 2 non-recognized subsequent event – disclosure only

How Do I Report the PPP Loan Balance or Forgiveness?

Forgiveness received before year-end

Report as separate line within **Other Income (Expense)**

- Why not credit the expenses reported to gain forgiveness?
    - Results are distorted; not comparable to any other year
    - Skews contract performance and status
    - Federal regulations prohibit billing for credited expenses
    - Expenses paid to parties other than the one granting forgiveness
- Why not report within operations?
    - Results not comparable to other years
    - Debt treatment dictates reporting outside of operations

FASB ASC Topic 450, *Contingencies* disclosure of SBA's subsequent rights under a specified audit period if >$2M

How Do I Report the PPP Loan Balance or Forgiveness?

Reporting as debt, loan still outstanding

Report within term debt

or

Report as separate lines on the balance sheet

Current liabilities

Current portion of forgivable debt from government agency

Long-term liabilities

Forgivable debt from government agency, net of current portion

- Accounting should reflect the repayment terms in the note
- Using the word “forgivable” implies forgiveness is expected
- Forgiveness is recorded when legally received – i.e. on the date loan cancellation is received from the lender
- Subsequent forgiveness is treated as a Type 2 non-recognized subsequent event – disclosure only

How Do I Report the PPP Loan Balance or Forgiveness?

Reporting as debt, loan still outstanding

Example: Terms for the first round were 2 years, deferral of repayment until 7th month, leaving 18-month repayment period. Assuming proceeds were received in April, the first payments are due under the agreement in November 2020.

Assume for 12/31 year-end, an $1,800,000 PPP loan where no repayments are made in 2020.

In this case, 14 months in payments would be due within 12 months of the balance sheet date and reported like this:

Current liabilities (Current portion of forgivable debt from government agency)	$1,400,000
Long-term liabilities (Forgivable debt from government agency, net of current portion)	400,000

Disclosures

- Terms – payment amount, maturity date
- Management's forgiveness expectations
- Date forgiveness was received in 2021, if applicable

Poll Question #6

Was your PPP loan forgiven on or before your year end?

How Do I Report the PPP Loan Balance or Forgiveness?

Analogize IAS 20 and report as grant income, loan still outstanding

- Report as **Grant Income** (separate line) within Other Income and Expenses

Disclosures

- Accounting policy – analogizing IAS 20 grant accounting
- Grant income details, including ASC Topic 450, *Contingencies* disclosures of SBA's subsequent rights under a specified audit period if >$2M
- Date subsequently forgiven, if known
- Loan terms per agreement if legal forgiveness is not received by the report date

ESOP Stock Repurchase Obligations… What Is Recorded or Disclosed by the Company?

- Internal Revenue Code Section 409(h) requires the Company to provide funds if ESOP other assets aren't adequate
- **Record**

  Accrue company obligations related to redemption events initiated before the balance sheet date
- **Disclose**

  If material, disclose the redemption obligation balance and number of redeemed shares

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Questions?

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