How is that project financed - or, is it at all?

by Sewall C. Cutler, Jr.

As many subcontractors know, the Texas "Contingent Pay" law encourages general contractors to notify subcontractors as to how the owner of the project is paying for the project (if they even know!). Some general contractors are very diligent in seeking and distributing this information to subcontractors for their use in risk evaluation, while others could not care less – but it does matter!

Most private projects are financed through a combination of investor funds, and money borrowed from lenders, usually commercial banks. Subcontractors need to make it their business to learn who is lending on projects, and the basic terms of the lending package (most importantly, that it is not in default), before extending credit. If the general contractor provides no information about how the project is being funded, the subcontractor (or the subcontractor's construction-skilled lawyer) can find out important information about the financing, including what banks are lending, what security they have in the project, and whether there is a payment bond on the project. With this information the subcontractor is ahead of the game in the event of payment issues on the project, because it will know who and how to notify the lender of any defaults in payment, at the *same* time the subcontractor notifies the owner, and of course, who the surety is for notice of unpaid account, as well.

In our experience, notifying lenders of slow payments often has quick and beneficial effect on payment to subcontractors because lenders do not like to have their security (the project) placed at risk. But what if there is no lender? We recently encountered several high-profile projects on which payment had essentially ceased, and to our amazement, a diligent review of the property records showed that there was no secured lender on the project. The owner of the project intended to fund all construction from its own capital reserves, without borrowing any money. At first blush, this looks great – who better to work for than a wealthy owner with lots of money? The problem is, while the owner owned the property free and clear, it did not have enough cash left to complete the construction. The result? Project shutdown, unpaid subcontractors and litigation!

Ironically enough, for large-scale projects, a subcontractor might be more secure, rather than less secure, if there is a commercial bank involved in the project. That is because before banks or other responsible lenders will extend credit to project owners for construction projects, the owner must have demonstrated to the loan underwriters that the project is financially viable. In addition, when such a project goes into actual default (and it does happen, as we have all seen), the lender usually has a financial motive to get the project completed, thus protecting its security interest; and this means there is a greater likelihood of contractors ultimately being paid for the work. On the other hand, an owner-financed project that gets half built may be worth less than the value of the unimproved property, depending upon how far along the project got and the viability of the business case for the project itself.

The moral? If a subcontractor is looking at extending credit to a general contractor on a construction project with no apparent lender, it should be very cautious, and "drill down" to find out whether money is really there to build the project. A little prevention goes a long way!