Top 3 Contractor Risks and How to Reduce Your Exposure

Labor shortages and rising material costs pose a significant challenge to construction contractors, well beyond squeezed profit margins. Here are 3 construction risks to keep in mind and some guidance that can help companies manage through the current environment.

IAT Insurance Group

Notwithstanding Covid's onset in 2020, construction activity has been, and continues to be, robust. New home construction has risen 22% compared to a year ago, and multifamily residential has risen 37% over the same timeframe. 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 having to adjust 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 thoughts on these areas attempting to answer the question:

How can contractors adjust to the new reality and still maintain profitability?

Construction Risk has never been greater: What you need to know

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

Tight labor market

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 new employees and retaining existing ones. 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.

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Here are 5 ways your firm can walk the talent tightrope:

1. **Teaming 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.

2. **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 and talk about the industry, your career progression and what a job in the construction industry means to you personally and professionally. Partner with local trade schools and hire interns to learn directly from you. Recruit younger than you have in the past.

3. **Take care of 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 their gas mileage reimbursement or offer special bonuses such as weekly gas cards to make it easier to get to a jobsite.

4. **Offer safety training.** Create a culture of workplace safety by providing safety training to all employees, regardless of experience or role. Encourage teamwork and mentorship programs, which can foster an environment of cooperation rather than blame if something goes wrong.

1. Fortune, "New home construction soars 22% as America finally starts building houses again," March 17, 2022.
2. National Association of Realtors, "Commercial Real Estate Market Expected to Grow Despite Rising Interest Rates," May 4, 2022.
3. The White House, "FACT SHEET: Biden-Harris Administration Hits the Ground Running to Build a Better America Six Months into Infrastructure Implementation," May 16, 2022.
4. Quartz, "There are two open jobs for every unemployed American," February 1, 2022.

5. **Encourage work in the community.** Whether it's coaching high school students to work on their own projects or helping to actualize a dream for a disadvantaged family, community work makes everyone feel good. Organizations that regularly give back to their communities create loyalty among their employees.

2 *Supply chain and materials cost inflation*

The price of lumber has fluctuated wildly since the beginning of the pandemic, skyrocketing up 200% since pre-pandemic levels. Steel has followed a similar trajectory. Other building materials are up 33%. At different periods in the last year, and likely in the near future, some of these 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. And with contracts less certain relative to a contractor's ability to recoup increased project costs, pricing is tricky and becoming a true blend of art and science. Contractors must figure out how long they can guarantee a price — or how they will try and pass on rising costs to their customers.

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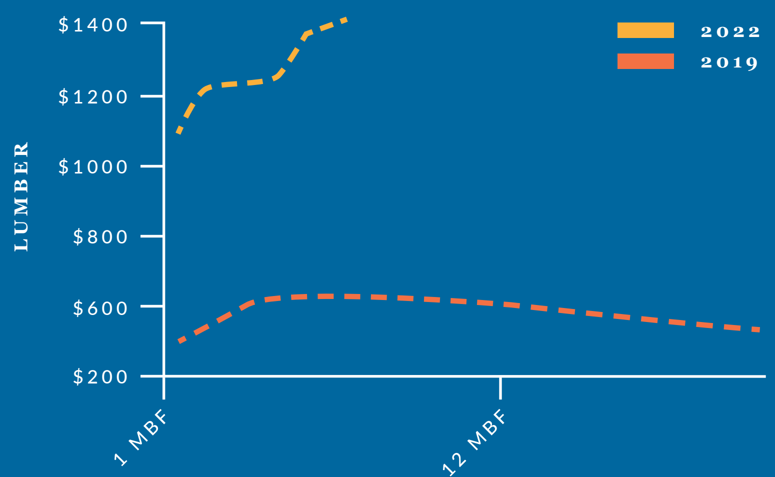

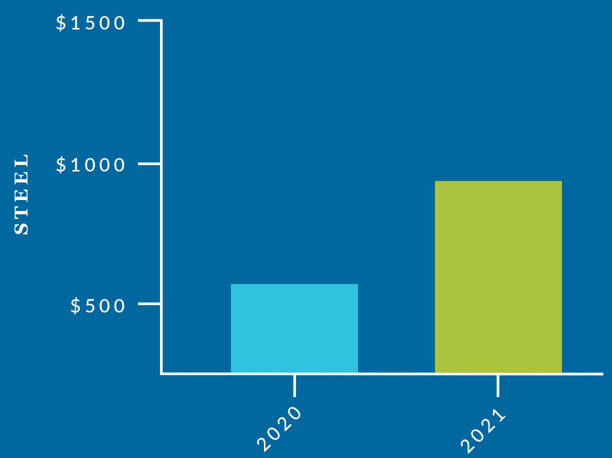

Here are 6 ways your firm can reduce the impact of rising material costs and supply chain fluctuations:

1. **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. A well-crafted escalation clause can result in the project owner sharing at least part of the financial burden when a significantly different and unforeseen circumstance occurs.

2. **Value or reengineering of a project.** Where material, labor or other inputs are in short supply, 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.

3. **Seek alternate suppliers or materials.** Contractors and customers have to be more flexible. When materials aren't available, it has been necessary in many cases 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 the ability to adapt helps enable success.

4. **Document all changes.** Keep track of any changes, from product pricing to additional supply chain costs. This can help to avoid future legal issues and potential disputes with the project owner. Poor record keeping is a major cause of contractor losses, therefore it's important to carefully document all aspects of the job including but not limited to, site conditions, scheduling issues, change orders/additional work 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.

5. **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.

5. Lesprom, "North American lumber prices rise again," March 15, 2022.
6. Fortune, "Steel prices are up 200%. When will the bubble pop?" July 8, 2021.
7. National Association of Home Builders, "Building Materials Prices Start 2022 with 8% Increase," April 15, 2022.

Now that materials are so much more expensive, there's potential for more jobsite theft. Similarly, any water or fire damage to materials in a construction yard or jobsite could create a devastating 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.

6. **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*

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

False Claims Act violations are more common than you think

Contracts with the federal government are often lucrative and desirable. Yet they can also increase a contractor's exposure. Under the False Claims Act (FCA), the federal government's primary tool for combatting fraud in government contracting, anyone submitting a claim for payment to the government or avoiding an obligation to remit payment to the federal government on the basis of misrepresentations of material facts, is subject to fines, treble damages, and other penalties under federal law.

Therefore, anyone contracting with the federal government must make it a priority to understand the current regulatory environment and the key issues. This is especially true when it comes to small business and minority set aside contractors which can face FCA exposure if they do not meet the criteria of the programs for which they are certifying compliance. Under certain circumstances, such liability can also extend to the surety company and/or surety agents of such contractors. In addition, the majority of states also have their own version of the FCA.

Contractors and vendors alike must understand the government regulations and certifications associated with set aside contracts and that the FCA is still applicable even when entering into a federally funded state or municipal project.

Some of these risks include:

- **Cybersecurity** – including a new requirement for third-party certifications and an initiative by the Department of Justice encouraging whistleblowers (private parties nominally acting on behalf of the government) to increase prosecution of contractual cybersecurity requirement violations
- **Buy American Act** – increasing requirement for American-sourced materials.

Don't let lack of oversight and potential noncompliance cost you. Learn about the guidelines and risks of FCA implications to protect you and your company against an increasingly complex regulatory environment and punishable violations.

For more information, read our blog: The False Claims Act: What contractors and businesses need to know.

4 trends to consider today

TREND #1: Modular Building

More contractors will engage in modular building. Building better and less expensively in a warehouse can help streamline and reduce construction costs and reduce mistakes in the field. This will, in turn, lead to other challenges, such as transporting large panels (or even a complete building) to the site. Good crane operators will be in demand.

TREND #2: Carbon Footprint

There is increasing pressure to focus on the industry's carbon footprint during construction. Construction is often less environmentally friendly than certain other industries, but there are steps companies can take to limit the impact. For example, most large construction equipment is still gas powered, but there is rising support for using electric equipment instead.

TREND #3: Digital

Of course, many areas are becoming digital – some organizations have even started to deploy wearable monitoring devices for employees to track their mental and physical health, and to ensure they're following safety guidelines.

TREND #4: Cyber Exposure

Cyber exposure is growing. Ransomware and business email compromise (BEC) are some of the more common risks construction firms face as hackers attempt to withhold the electronic information of ransomware victims which can impact project timelines. Meanwhile, BEC schemes can divert progress payments. Construction firms have a lot in the way of confidential information, from employees, vendors and project record keeping. With the costs of cyberattacks rising, cyber insurance is an effective means to manage risk.

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.

Successful projects are in part managed through effective risk sharing on both a macro and a micro level.

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

1. **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.

2. **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.

What's next for contractor risk?

Changes will continue to come down the pipeline in the construction industry, yielding new and different risk. Knowing what to expect, both now and in the future will help your construction business weather the storm today and help guide your next move.

For one, firms that keep an eye on current and up-and-coming regulatory issues and industry risks will be well suited to respond to them because they anticipated the challenges.

Secondly, it is best to bring issues and concerns your firm faces to your insurance agent or broker during the year, and ahead of your insurance renewal. Likewise, discussion with your surety providers is essential to their understanding of your business challenges and opportunities. Effective management of these key relationships will ensure your firm is in a position to transfer risk appropriately, respond to challenges with best practices for safety, accountability and profitability and to maximize your bonding support.