



Factoring Commercial Construction Projects

Tempting but dangerous, lucrative but risky...that's factoring in the construction industry.

BY FRANK SKELLY

Construction is booming, yet it's an industry with a desperate need for financing solutions. I would argue that cash flow issues in the commercial construction industry dwarf that of any other industry, particularly those of the commercial subcontractor. Margins are moderate, operating expenses significant, supplies are expensive, and favorable terms are few and far between. Billing is

typically monthly, and payments usually show up about 55 days after the subcontractor has already carried a full month's worth of expenses. The 1st tier subcontractors are the ones that bear the brunt of the cash flow burden on commercial projects as almost all general contractors have 'paid when paid' or 'paid if paid' clauses in their agreements.

The result is the typical 1st tier subcontractor carries up to 90 days' worth of expenses and payroll. Even if they are fortunate enough to have terms with their suppliers, 30 days simply doesn't cut it. On commercial construction projects, the little guy carries the financial burden. If one were to describe the ultimate candidate for factoring, it would surely be the typical 1st tier commercial subcontractor. For the most part, it's an industry that has not been touched by factors and it is ripe for the taking.

HOWEVER, CHALLENGES DO EXIST.

When factoring traditional industries, the risk is usually apparent. We know if we get good verification from a creditworthy account debtor 99 times out of 100 we will get paid...in the construction industry, it's not nearly that simple.

In construction, once verification is secured the factors work is just beginning. The risk is not limited to the creditworthiness of the account debtor; it's the subs, suppliers, and vendors brought onto the project where the real danger lurks. Miss one supplier and you have a problem. Workers don't get paid, union dues are missed, insurance lapses.... it's even worse.

Although an estoppel should carry the day in a court of law, from a practical standpoint, it takes years to get to that day. In the meantime, if there are unpaid subs, suppliers, vendors, payroll or union dues, the factor will not get paid regardless of the strength of the estoppel.

The reason is simple; subs, suppliers, vendors, and laborers all have mechanic's lien rights and those rights trump almost everything. The system makes it very easy for unpaid subs, suppliers, vendors, and workers to file a lien and encumber a project. Some states even provide

for Stop Notices which allow an unpaid sub, supplier, vendor or worker to freeze 150% of the money they claim is due them. From a practical standpoint, the sub, supplier, vendor or worker's lien will always get paid right away while the factor will be left hoping for that day in court.

To be fair, estoppels do put pressure on the general contractor, but they

will always feel more pressure from the project's owner to get the lien removed. Since nobody is ever in a rush to pay something twice, the factor will be left holding the bag. The good news is these powerful liens cut both ways...although they can be a huge liability and put your collateral at risk, they are also one of your biggest assets if you know how to use them to your advantage.

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RISK IS EVERYWHERE.

Although your construction clients know who they have hired to work on their jobs, it doesn't mean they want you to know who they are. Getting your clients to voluntarily identify everyone they have hired can be challenging. Sometimes clients omit them intentionally with the hopes of pulling more money out of a job, money that should be going to subs, suppliers & vendors.

However, there are times when your client will not know all the subs, suppliers and vendors working on the job. This can happen when your client hires a 2nd tier sub who in turn has subs, suppliers, and vendors of their own. This can be problematic and can lead to offsets and deductions if any of these parties aren't paid. It is critical that the factor understand not only who their client

has hired to provide products or services on the project but also who those parties have hired (see 'true stories' below). Other challenges involve calculating union dues and which unions need to be paid (there are different unions for different trades). If changes occur on the job that you are unaware of it is very easy to overlook a party that should be getting a portion of the proceeds the factor is disbursing.

MCA's can be especially problematic; if a default occurs, funds intended for project-related expenses such as payroll, workers comp, and suppliers might end up being intercepted by the MCA.

Consider the following true stories.

- The client was pouring concrete slabs for a chain of retail stores in the

southeastern region of the US. We reviewed the contract carefully, and the client dutifully identified all the subs, suppliers, vendors and workers on the job. As the job progressed we secured the appropriate lien releases, cut joint checks and funded the client. It turns out that about halfway through the job our client had opened an account with another concrete supplier which we were unaware of. We continued to fund the job but as we were about to collect the final \$139,000 payment we were contacted by the general contractor who wanted to know why there was a lien on his project from a concrete supplier. How do you make sure your client doesn't open other supplier accounts during the job?

- The client was a 1st tier subcontractor hired by the prime contractor



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to hang sheetrock at a yearlong project worth \$1 million, located at a Connecticut university. Our client brought in a labor subcontractor to help them stay on schedule. About midway through the job, the Department of Labor shows up on the job to ensure prevailing wage conditions are being met. Unbeknownst to our client, the 2nd tier subcontractor providing the labor was not complying with the required payroll conditions (Davis-Bacon Act). DOL fined the general contractor \$200,000 which, of course, the general contractor immediately offset against \$365,000 due us. Although we had an estoppel, the general contractor refused to pay. 37 months later, we finally had a trial date.

- An Asset Based Lender who lost their credit line and was attempting to sell its portfolio which included a \$1 million line to a construction company. With over \$1.2 million in AR the ABL felt secure, except when they approached us they learned the hard way that most of that AR was encumbered by subs, suppliers, vendors, workers and union dues. When the dust settled, the ABL realized that they only had \$126,000 coming to them and that was only if the \$1,200,000 was paid in full.

WHAT IS THE SOLUTION?

Good verification is critical; relying on anything less than an estoppel is asking for trouble. Identifying and paying anyone with lien rights including subs, suppliers, vendors, payroll, union dues and insurance premiums is a must. Monitoring the job closely including the schedule of values, lien filing deadlines, open and closed AP & AR reports, bank statements, insurance, contractor's license, IRS 940 & 941's as well as other projects is mandatory. The overall health of your client is key when factoring construction. Problems from one job quickly spill over onto other jobs.

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Specific steps to take:

- Manage all sub, supplier and vendor releases, do not leave it to the client.
- Collect certified payroll and union status letters with each funding.
- Pay all subs, suppliers, vendors, payroll service and union dues by joint check.
- Monitor deadlines for filing a Notice to Owner (Florida) or a Notice of Furnishings (MI) or a 20 Day notice (CA), each state has different requirements. Miss one of these deadlines and your ace in the hole is gone...your client loses their lien rights and so do you.
- Monitor lien filing deadlines.
- Monitor bank statements along with open and closed AP reports. This is an excellent way to see whether the client has brought in an MCA or if they are not disclosing subs, suppliers, or vendors.

- Insist your clients use outside payroll & bookkeeping services.
- Monitor that insurance policies, including workers' comp, remains in effect.
- Ensure compliance with the Little Miller Act & Davis-Bacon Act on all public jobs.
- Comply with the 12 states that have statutory mechanic's liens.
- Be aware that at least 15 states have sub, supplier, vendor & workmen's trust fund statutes that the factor needs to be aware of.

Some of these steps are easy to adapt, such as monitoring insurance (have agent name you as additionally insured so you will be notified if policy is cancelled); others are not so easy.

Having funded over 250 commercial construction projects in 34 states in the past five years, I can tell you that it is a lucrative niche but it is also fraught with danger. However, if you have the stomach for the risk that comes with factoring construction and develop the right system of checks and balances, it can be profitable. •



Frank Skelly runs a cash management and funds control group which provides financing to the commercial

construction industry. He works with Factor King, LLC, a New York-based factoring company. Frank has a 30-year background in both finance and construction. He has previously served as CEO of an investment bank and President of a distressed real estate investment fund. He can be reached by phone at (800) 918-7830 or by email at FSkelly@factorking.com.