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### **Construction Due Diligence: Sooner Is Always Better than Later**

The recent economic downturn in real estate development and construction has significantly and negatively impacted contractors, subcontractors, and material suppliers. Non-payment of receivables is an ongoing problem even in good times, but even more so during the current recession and recovery (albeit slow) period. Having knowledge of one's alternative available legal remedies gives contractors, subcontractors, and material suppliers a distinct advantage, especially as the market for local contractors, subcontractors, and material suppliers is growing to encompass the entire country.

When a contractor, subcontractor, or material supplier "sells" a job, it is selling three things - "labor, materials, and credit." The sales department job is to sell the "labor and/or materials," while the credit department's job is to evaluate whether to extend credit on such sales. These conflicting goals could result in friction between the sales department and credit department. In fact, it has been said that the ultimate conflict in life is not between good and evil but rather between sales and credit. However, if the parties work together towards an acceptable solution balancing the sale with the extension of credit, ultimately the company will benefit. This is where the construction due diligence process and understanding the laws that benefit contractors, subcontractors, and material suppliers is valuable.

The first step in the due diligence process is the determination of the creditworthiness of the customer. This is performed by the credit department of a contractor, subcontractor, or material supplier. The review of the creditworthiness (or so-called "credit due diligence") of a potential customer is not only good practice but essential in becoming a part of a successful and profitable construction project.

While credit due diligence is an important factor, there is no guarantee that a particular construction project will be successful or that otherwise having a "good customer" will result in payment in full. Let's face it, contractors, subcontractors, and material suppliers sell to and/or work with many qualified contractors and owners but still find themselves in the middle of a troubled project, whether as a result of lack of additional financing to complete, a bankruptcy within the tier of contractors, or some other circumstance.

What can a contractor, subcontractor or material supplier do to help protect themselves in such situations? An important option to consider is to perform "legal" due diligence up front at the same time that the credit decision is being made. In other words, in the event of non-payment by your customer, what rights and legal remedies may you have in the event of such non-payment above and beyond a breach of contract action against your customer? Such rights as to third-parties (other than your customer) are known as "third-party" rights. Such third-party rights may include mechanics' lien rights against the subject property, lien rights against undisbursed constructions funds, and/or rights against a surety under a payment bond.

The availability of such rights varies by state and are based upon the type of project (i.e., public project or private project) and the nature of the owner (i.e., federal, state or local agency, or private entity). Also, the determination of where a contractor is within the tier of overall contractors (i.e., general contractor, subcontractor, sub-subcontractor, material supplier, etc.) is crucial in making such determination. As part of the analysis, it is essential to obtain as many facts related to the project as possible at its beginning (i.e., owner's name, legal description, etc.).

It is important to consider the availability of third-party rights "sooner rather than later" because depending on the circumstances, in order to preserve one's rights, affirmative action in the form of a notice and/or filing may be required at the beginning, during, and/or within a limited period after the completion of the work or shipment of materials. If any deadlines are missed, the rights are waived.

Knowledge of the availability of third-party rights is extremely beneficial in making a credit determination about a customer and assessment of a project. To the extent third-party rights are available, a contractor and/or material supplier may still decide to perform work and/or sell to an otherwise questionable creditworthy customer. Other forms of protections to consider are personal and corporate guaranties, joint check agreements, and a requirement that questionable customers provide a surety bond for the company's benefit.

Third-party rights are a valuable tool for contractors, subcontractors, and material suppliers in securing payment on their construction projects; however, without having performed the appropriate due diligence prior to acceptance of the project and commencement of the work, these third-party rights may be waived or relinquished as a result of a contractor, subcontractor or material supplier failing to take appropriate action to protect such third-party rights. In today's financially turbulent world, it is more critical than ever to consider the availability of third-party rights on a project, if any, sooner rather than later.

If we can assist in analyzing whether a construction project with which you are involved or may be involved has any third-party rights, please contact your Thompson Coburn attorney one of the attorneys listed below:

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