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Legal Landscape

Customer Changes to a Credit Application: A Credit Manager's Ballgame

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Construction Industry Credit Is Not for the Faint of Heart

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It goes without saying that a credit professional's gatekeeping function is one of the most vital in any business. Assessing the creditworthiness of potential customers and chasing down the occasional problematic customer are important, but the credit executive's basic function must always be guided by the much broader goal of optimizing company sales and bad debt losses while enforcing the corporate credit policy. If you are a credit manager, controller, chief financial officer or other financial executive working in the construction industry, you will likely agree that the legal issues in construction provide you and your company with unique challenges and opportunities.

For example, the security of mechanic's liens and payment bonds afford you much greater flexibility in extending credit to contractors that may not be so deserving. Of course, to maximize sales and guard against bad debt, you must have a thorough understanding of the lien law that applies in each jurisdiction where your company sells materials. At the same time, you may have to push back against the overly aggressive salesperson to sell to a certified disadvantaged business enterprise on a public project. Finally, you may even dare to suggest that your company re-evaluate its purchase order review process to truly fulfill your role as gatekeeper for the business.

Evaluating Available Statutory Remedies

Statutory remedies unique to the construction industry allow suppliers to maximize sales by giving a company the ability to extend credit well beyond a customer's credit limit, knowing that its receivables will be secured by the law. These remedies, including mechanic's lien rights, bond claims and stop payment notices (lien claims on construction funds in certain states), are available to some degree on almost all private and public projects.

The remedies that may be available to your company will depend on where (i.e.,

in what state) the project is located. Unlike the Uniform Commercial Code (UCC), which standardizes the law governing the sale of goods in all 50 states, each state has a different statutory scheme for construction lien law. In addition, the available remedies will differ on whether the project is public (local vs. state vs. federal) or private (commercial vs. residential vs. leasehold improvements).

Moreover, the procedure to properly enforce a lien or bond claim is also drastically different in each state. Most states (but not all) require the construction material supplier to serve a preliminary notice upon the project owner, lender (if any), and general contractor at or near the time when the supplier first furnishes materials to the job. Some states require a second notice advising of the claimant's intent to record a mechanic's lien or make a bond claim. And while some states follow the procedural requirements mandated by the Miller Act on federal projects, many states have unique requirements, mandatory forms, and time limitations on when and how to preserve and perfect statutory remedies. If you are a credit professional for a supplier transacting business across the country, you likely have a dizzying array of flowcharts and tables describing the various statutory remedies pertinent to your business on your wall or tucked away in a drawer next to you.

DBE Fraud

"HD Supply Waterworks to Pay Nearly $5 Million to Resolve Grant Fraud Allegations." This was the headline from the Aug. 12, 2015, press release from the United States Attorney's Office for the Northern District of New York that sent shockwaves throughout the construction material supplier industry. The press release highlighted that the nation's largest supplier of sewer, fire protection and storm drain products had agreed to pay the government almost $5 million to resolve allegations that it participated in a scheme designed to take advantage of the Disadvantaged Business Enterprise (DBE) program. Specifically, the Department of Justice alleged that HD Supply "... supplied materials on several federally funded contracts where invoices were 'passed through' a disadvantaged business enterprise in violation of law." The HD Supply settlement highlights the fact that DBE fraud is an important issue not just for prime contractors and subcontractors but increasingly for the "innocent supplier" as well.

Credit professionals are caught in the middle of a new enforcement trend in federal, state and local investigations of DBE fraud around the country. Investigators are increasingly cracking down on straight pass-through arrangements where the DBE "lends its name" in exchange for a small percentage of the contract value, adding no value and performing no commercially useful function. If the supplier knew or should have known of the scheme, the supplier becomes a target for DBE fraud.

In the typical scenario: the contractor provides a purchase order to the DBE subcontractor/supplier; the DBE puts the purchase order on its letterhead; and the DBE then submits the purchase order to a non-DBE supplier. The non-DBE supplier fulfills the purchase order, delivers materials to a project and then invoices the DBE. The DBE, in turn, invoices the contractor with a 3% fee and then pays the non-DBE supplier. By engaging in this scenario, the "innocent" non-DBE supplier potentially commits a crime, even though: (1) it is the DBE that is the sham; (2) the DBE is "certified"; and (3) the contractor insists on using the DBE as the pass-through. When prosecutors determine non-DBE suppliers knew about the scheme or were "willfully blind," they may charge non-DBE suppliers with aiding and abetting, conspiring to commit a fraud on DBE programs and/or submission of false claims for payment to the government.

The key takeaway from the various prosecutions around the country is that whenever a material supplier is asked to contract directly with a DBE, the supplier should always verify the DBE is performing a "commercially useful function." It is important for the supplier to perform basic due diligence in asking both the contractor and the DBE what commercially useful function the DBE will be performing on the project. Credit professionals must educate sales staff and others within the business that do not understand the prevalence and consequences of DBE fraud.

Federal law provides that "[a] DBE does not perform a commercially useful function if its role is limited to that of an extra participant in a transaction, contract, or project through which funds are passed in order to obtain the appearance of DBE participation." 49 C.F.R. § 26.55(c)(2). Many state statutes and local ordinances use similar verbiage.

At a basic level, indicia of a commercially useful function may include the DBE's performance of tasks such as: (1) sourcing materials; (2) negotiating price; (3) verifying that the quality and quantity of materials meet contract requirements; (4) purchasing and making payment for materials from the DBE's own funds; (5) warehousing materials; (6) scheduling the delivery of materials; and (7) invoicing for the materials. It is important to note that certification of the DBE is not determinative since certification focuses squarely on ownership status and control structure of the company.

On the other hand, common indicators of sham DBEs include: (1) when the DBE firm works for only one contractor; (2) the work is outside of the DBE's known experience or capability; (3) the volume of work is beyond the DBE firm's capacity; (4) the DBE does not maintain a store or warehouse where products are bought, stored and sold to the public; (5) the DBE does not generally purchase and sell the materials being supplied; and (6) the DBE does not supply materials to a non-DBE goal project.

Without a doubt, the credit professional's gatekeeping role is put to the test in safeguarding the company from knowingly (or even unknowingly) committing DBE fraud.

The Contractor's Purchase Order

Credit professionals understand customers' purchase orders come in all shapes and sizes and levels of sophistication. Purchase orders in the construction industry are no different.

Occasionally, general contractors and even project owners will negotiate the direct purchase of significant building components or large-scale systems.

Often, purchase orders from general contractors and owners are customized and specially prepared for a particular transaction. Such purchase order forms may look more like a short-form subcontract agreement. Subcontractors, on the other hand, typically use standard form purchase orders with pre-printed boilerplate terms and conditions since subcontractors purchase materials on a daily basis for both significant and trivial building materials. In either case, material suppliers must remain vigilant and carefully review the terms and conditions of all purchase orders they receive. This is especially important in the construction industry because contractors' purchase orders tend to include troublesome provisions such as liquidated damages for delay, lengthy warranty terms, broad indemnity clauses, and flow-down provisions that hold the supplier liable for upstream contractual duties and responsibilities contained in the prime contract and subcontract.

Many suppliers are lulled into assuming their carefully drafted credit agreement, sales order confirmation or invoice forms will override a purchase order's troublesome language. If the material supplier's employees or agents (e.g., salesperson or general manager) sign a contractor's purchase order, the terms and conditions of the contractor's signed purchase order will almost certainly override any preexisting credit agreement and may exclusively govern the transaction at issue. But it is also almost always true that if the material supplier simply ignores the purchase order terms and conditions, in the event of a dispute, the Uniform Commercial Code will dictate that a "battle of the forms" has occurred, leading to a very buyer-friendly outcome.

In reality, the material supplier may be "betting the farm" without even knowing it. Therefore, it is imperative for every supplier to secure the contractor's agreement to modify, change or delete any objectionable terms and conditions before filling any order. Although it may not be palatable to sales departments, the purchase order review and modification process should be the rule and not the exception. And if you are one of the construction industry credit professionals that never sees the customer's purchase order, it is a scary world indeed.