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Bulletin # 50: The Dot Bomb

ZZZ Sheet Metal found itself caught up in the frenzy of a high−tech construction boom unlike anything it had ever seen before. Large buildings and entire campuses were under construction for firms that had only been a glimmer in a 30−year old's eyes several years before. The high−tech firms had typically secured venture capital or private placement funding, and were only weeks or months away from the initial public offering that would make everyone in the company a millionaire, from the CEO to the janitor. The projects were all fast track design/build, and the schedules were accelerated beyond any rationality. Construction costs were clearly of secondary importance to the tech firms. The key was the date of substantial completion, and move in, regardless of the cost. The phrase, "regardless of the cost," had great appeal to ZZZ, as it did to the other contractors and subcontractors in the area.

During the peak of the construction frenzy, a 250,000 square foot office/high−tech manufacturing facility fell into ZZZ's lap. The HVAC system would be extremely complex, with intricate filtering systems. Of course, the project was set up on a fast track, and proposals were being sought for the HVAC system on a direct bid, design/build basis. The ZZZ executive team met with the construction manager and principals of the high−tech firm. ZZZ personnel felt out of place, surrounded by blue jean clad 20−somethings. However, ZZZ ultimately convinced the high−tech firm that it had the expertise to design the HVAC system, and the capacity to meet the nearly absurd timetable established for completion of the project. ZZZ agreed to a contract structure under which its hard costs would be paid in cash, but its contractor's fee would be paid in the form of stock options. A letter agreement was signed, and ZZZ went immediately to work. While it was noted that the performance specifications were somewhat unclear and inconsistent, and the project schedule was unbelievably aggressive, ZZZ management viewed the project as an almost certain “home run.” The stock options alone would likely make this the most profitable project in the history of the company.

On the way to work each morning, the ZZZ project manager could not help but notice the tower cranes dotting the landscape in all directions. It was predicted that the construction of high–tech space in the immediate area would exceed 3,000,000 square feet over the next year alone. On the weekends, the manager calculated and recalculated the potential value of the options that he expected to receive once the project was complete. Almost miraculously, ZZZ was managing to adhere to the project schedule (even though it paid substantial overtime), and the installation was going quite smoothly. Apparently, most of the contractors and subcontractors on the project were to receive stock options, and they were all anxious to see the facility in operation. They had been told that the initial public offering of the company’s stock could not be completed until the facility was up and running.

In the fourth month of the project, the happy–go–lucky atmosphere started to subtly change. Two monthly pay requests were outstanding. The tech firm’s predictions of interim financing “any day now” were starting to sound like a broken record. An article appeared in the local paper announcing the layoff of one–third of the employees of the firm, because of “financing delays.” Several weeks later, the articles concerned the company’s loss of a major contract to an overseas competitor. Next came the resignation of the CFO. While the project work continued, everyone on the site was becoming increasingly nervous. The ZZZ project manager made it a point to call the company’s offices at least once a week to ask about the overdue payments. The answers were always the same: “We expect the funding early next week.” Finally, when the ZZZ manager called one week, there was no one answering the phone. The newspaper reports the next day stated that the company had been unable to secure required financing, and had run out of money. All of its employees had been laid off, and its doors had been closed. The project stopped in its tracks.

ZZZ management was facing a major disaster. The company owed its vendors hundreds of thousands of dollars for equipment and materials. It had been funding employee wages out of its credit line. The stock options were obviously worth nothing, and the “pending” pay requests were now pending “in name only.” ZZZ filed a mechanic’s lien on the property (along with most of the other contractors and suppliers) in the hope that the value of the property would at least provide some source of payment.

The tech firm had originally intended that the project be funded with cash from its various equity financings. However, the costs were sufficiently high as to require the company to obtain mortgage financing for approximately one half of the project cost. The construction mortgage had been filed against the property prior to the commencement of work, and ZZZ's attorney advised that the contractor's lien was likely to be subordinate to the mortgage. When the mortgage was placed in foreclosure, ZZZ had a choice between letting its lien lapse (and losing its only theoretical leverage), or paying off the construction mortgagee in an attempt to recoup its losses through a subsequent sale of the property. The contractors and major suppliers met to consider that option, since the construction mortgage balance was so much less than the project cost. While ZZZ did not have sufficient cash or credit to pay off the mortgage, perhaps all the contractors and suppliers together could raise the necessary funds to buy out the mortgage and sell the property. There was finally a glimmer of hope.

The glimmer was short lived. While the mortgage lender was enthusiastic about being paid off and transferring the property to the contractors, the master plan had one major flaw. There was no extra value in the building, notwithstanding its higher cost. The collapse of high–tech firms throughout the area had produced numerous projects that were now complete and empty, or partially complete and shut down. There was no demand for the space, and there were no buyers for the buildings. ZZZ heard through the rumor mill that the construction lender was now pessimistic about even recovering the amount of its construction loan on a re–sale of the property. Across the area, the bruised and battered contractors packed up their equipment, and went home. The project manager had a moment of optimism when he overheard a comment by the receiver of the property (appointed by the Court at the request of the construction lender) that the contractors should hold onto their plans, since finishing the project was one option for the construction lender. Many months later, the plans still sit in the corner of the project manager's office as a constant reminder of the project that seemed too good to be true.

Contractors and subcontractors are faced with financial risk on every job. The discovery of environmental contamination can stop a project in its tracks. A project can lose a key tenant or its financing. A glut in the market or an economic slowdown can cause a building to be worth less upon completion than what it cost to build. A developer or contractor can go bankrupt after having failed to pay its subcontractors and suppliers. The list is almost endless. While there is no way to eliminate the risk, a subcontractor coming into a major project can hedge its risk by understanding the players involved, and its contractual rights in the event that something goes wrong. Among the questions the subcontractor should be asking itself are the following:

1. Is the owner/developer creditworthy so that it can pay, even if things do not go exactly according to plan?

2. Is there committed project financing?

3. Is there a bond on the project or some other third party commitment to protect the subcontractor against nonpayment?

4. Is the general contractor financially strong and reputable, and does the subcontractor have a right to payment even if the general contractor is not paid?

5. What other rights does the subcontractor have under its contract if timely payment becomes an issue?

As the old saying goes, if something seems too good to be true, it usually is.

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