

SUBCONTRACTOR DODGING THE DOTTED LINE

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HOW IT BEGAN

By late February 2004, Joe Williams, project manager at PC Construction in Minneapolis, was in a quandary. SL Steel was demanding more money for the steel they had already supplied for a project, and they still had not signed the fixed price contract awarded by PC Construction. Williams' promise to complete the project on time and on budget was in jeopardy. Williams pulled out his copy of the contract and stared at the empty space above the dotted line. As he thought about how to proceed, he reflected on how it all began.

Joe Williams had been a Project Manager for PC Construction¹ for a little over three years. PC Construction was one of the five largest general contractors and construction managers in the Minneapolis region. They had extensive experience with large, complex construction projects. The company generated approximately \$240M in revenues each year, ranking in the top 200 US firms in construction revenues. The company had approximately 150 employees.

Williams had worked on some very challenging jobs during his time with the company. He was well regarded by management, and many thought he would have a long, successful career with the company. Like so many other Project Managers at PC Construction, he was tired and almost burnt out from too many projects with too little support.

Late one afternoon in mid-December 2003, Williams was working at his desk, finalizing some paper work on a recently completed construction project for a renovated multi-purpose building downtown. Although PC Construction successfully finished the complex job on time, and the client was extremely pleased, everyone on the team (especially Williams, the Project Manager) was tired and still a little on edge. As Williams reviewed the project's challenges, he heard a familiar voice calling from across the room. It was the owner and president of PC Construction, Paul McLee. Williams felt a nervous twinge as he went to greet McLee.

McLee patted Williams on the shoulder, walked into Williams' office and gestured Williams to sit down. "Joe," he began, "we've decided to assign you to the new Integrity Bank project." PC Construction was a customer of the bank. They control PC Construction's line of credit and provided critical financial references to their bonding agency and potential clients. They had a good relationship with this bank since PC started business in 1979. Now they were asking PC to design a new branch office for them. "This is an important assignment," McLee concluded as he

¹ All company and personal names in this paper are fictional. The facts and figures are all correct and accurate.

finished describing the assignment, “And I think it will be a good experience for you. Do you think you can you handle it?”

Williams quickly replied, “Yes, absolutely! I’m looking forward to this new assignment. Thank you for the opportunity.”

McLee continued, “I don’t have to tell you this is an important customer, Joe. How well we do on this project will influence our reputation throughout the community.” He leaned forward in his chair. “You can see where this will lead. The bank’s customers will ask them about their building contractor. Other banks will see it and evaluate our work. They’ll consider using our services to build their new banks. Potential clients will look at our financial references from this bank.”

He stopped and looked Williams in the eyes before continuing. Williams nodded.

“On top of that, this branch office is in a highly visible location. Our name will be all over the project.” He paused and took a breath. “Most importantly, if the client is happy, I will be happy. Then, we can all be happy.”

McLee held Williams’ gaze before finally asking, “Understood?” Williams nodded in agreement. “Good.” Then, with a nervous chuckle that seemed to say, *‘I don’t know if you understand the importance of this client yet. We will be watching you closely,’* McLee motioned toward the door, and added, “You’d better take good care of this client. I’m counting on you, Joe.”

THE BANK PROJECT

Williams received the details of the project. Integrity Bank had asked PC Construction to build a relatively small, but very important \$2 million branch office. PC Construction had been a customer at the bank for almost 25 years and enjoyed a very good relationship with the bank’s executive leadership. The bank wanted the project completed within eight months.

Given the tight time frame, the bank established a \$75,000 contingency fund to cover PC Construction’s unforeseen project costs. To prevent delays, PC could use the funds to cover costs associated with scheduling conflicts or increases in the price of supplies. It was clearly stipulated that the bank had to review and approve all draws on the contingency fund. PC was required to return any unused contingency monies upon the project’s completion.

SELECTING A STEEL CONTRACTOR

In mid-January 2004, Williams started soliciting bids for the bank’s construction. He eventually awarded more than 20 fixed-price subcontracts for various parts of the project. In keeping with normal industry practice, PC Construction awarded jobs to the lowest bidders, since there was no clear justification for doing otherwise.

Williams and his estimating team found the steel fabrication bids bewildering. Surprisingly, three out of the five bids for the ~\$78,000 steel package were all within \$500. Even the highest bid was somewhat lower than expected. It was very unusual to see sealed bids so close in price.

Table 1 presents a summary of the steel bids. The steel package amounted to five percent of the total construction cost.

Table 1: Summary of Steel Bids

Summary of Steel Bids					
	SL Steel	Sub #2	Sub #3	Sub #4	Sub #5
Final Bid:	\$ 78,304	\$ 78,450	\$ 78,782	\$ 84,464	\$ 89,820
% from Winning Bid:	0.0%	0.2%	0.6%	7.9%	14.7%

Source: Company documents

The three lowest bidders all had good reputations in the area, and they all submitted complete bids. Williams was familiar with all the steel contractors except the lowest bidder, SL Steel. In fact, no one at PC Construction had worked directly with SL Steel. Williams knew that, in general, when the contractor and subcontractor had a long-term relationship the work always went more smoothly. PC’s working relationship with the other two low bidders would mean that technicalities and other small problems would not become major issues. However, it was company policy to accept the contractor with the lowest qualified bid. To be safe, Williams called SL Steel to learn more about their company and to confirm its bid of \$78,304.

“Mr. Poe,” Williams said to an elderly gentleman on the other end of the phone line, “Thank you for sending us a bid on the Integrity Bank project. We are calling all the low bidders to briefly discuss their proposals. You have some healthy competition for this work, and I want to make sure your bid is still good. To compare apples to apples, I also need to verify that you are proposing to supply *and* install.”

Alan Poe, President of SL Steel, sounded a little nervous. He slowly replied, “Well, I guess I shouldn’t be surprised that the bids are so close. Business has been tough for everyone lately.” He stopped and cleared his throat. “This is such an important job for us, and I don’t know if I have ever seen such a competitive environment. It’s terrible out there. Project bids are getting more and more cutthroat every day, and we don’t have a lot of markup on this job. It was different when I was younger. Working in an environment like this really makes an old guy like me nervous.” He stopped and sighed. “But that’s another story. Let’s talk about this job. What questions do you have?”

“Well, I want to make sure that your price of \$78,304 is still good,” Williams responded.

Joking nervously, Poe said, “Well, yes, I think our price is still good. It depends on how low it was!”

Williams replied, “You know I can’t tell you where the other bids came in. But I don’t think you have anything to worry about. You were pretty close to each other, and this job should be simple.”

Poe spoke quietly and slowly, “Oh, nothing is simple anymore, son. Times are changing. I am getting close to retirement, and I worry about this business. Soon, I will be leaving it all to my

son, Terry. He's going to be our new president before too long. He will be the main contact for this job if we win it."

After talking a few more minutes, Poe again confirmed that SL's price was still good, that the company intended to supply and install all the steel as shown in the construction drawings and specifications, and that the company was ready to sign PC's standard fixed-price contract. Williams felt confident that SL Steel was going to pull through and execute the work effectively. After all, he thought, it was a simple job, wasn't it?

Because Williams was already familiar with most of the major players in the region, he felt that financial and reference checks on SL Steel were necessary before actually sending a contract.

Williams sent an e-mail to everyone in PC Construction, and only one employee replied that he had heard of SL Steel. The employee said that he had once heard the company had done a job well, but that was some time ago.

Because the company was private and its financial statements were confidential, Williams also obtained a Dun & Bradstreet report to assess SL's financial soundness. The Dun & Bradstreet report did not indicate any problems, aside from revealing that SL Steel was a small company. In fact, SL Steel had solid ratings, as indicated in Table 2.

Table 2: Summary of a Dun & Bradstreet Report

Dun and Bradstreet Indicator	Rating	Joe William's Evaluation Notes
Year started	1984	<i>Long standing history in construction business.</i>
Employees	8	<i>Small company in the industry, but the bank job is also quite small.</i>
Sales	\$1,500,000	<i>Solid for company size.</i>
Financing	Secured	<i>Standard and extremely desirable for reputable company in industry.</i>
12 Month D&B Paydex	83	<i>Indicative of prompt payment to suppliers and good cash flow for construction industry.</i>
Business Registration	Good Standing	<i>Vital for this industry.</i>
Overall D&B Rating	2R4*	<i>Acceptable given size of company.</i>
* "2R4" means that the company has less than 10 employees and has a Composite Credit Appraisal of "Limited" (Source: www.dnb.com/us/customer_service/paydex_tables.html)		

Source: Dun & Bradstreet

Though SL Steel was a very small, independent firm, Williams felt more confident after the financial check. He called a few contractors in the area to ask about SL Steel, and received good recommendations.

Nevertheless, Williams was apprehensive about working with a relatively unknown contractor on such a tight schedule. Steel fabrication was a critical component of the construction project, and

the subcontractor had to complete it properly and on time. On the other hand, Williams admitted that steel fabrication was a small component of the overall project, and he could not foresee any major problems. Williams was unsure how to proceed.

After some deliberation, Williams and the project team officially selected SL Steel. Williams could not find any legitimate reason to reject SL's bid, so he followed company policy and awarded the project to the lowest bidder. In Williams' mind, SL Steel won the bid, fair and square. SL had confirmed that their proposal was valid for a certain number of days, and the contract award would be made within that time frame. Besides, Williams thought, not much could go wrong.

Williams drafted the subcontract and sent it to SL for review and signature on March 10, 2004. SL Steel needed to get started right away.

THE DODGING BEGINS

After SL Steel won the bid, Williams heard that Poe and his son Terry were elated. The average gross profit for a steel fabricator for a job this size was around 10%. As one of SL's largest contracts of the year, this project would boost SL's revenue nicely (a 13% margin).

PC Construction was on its way to making the new bank a reality. By the time Williams sent SL Steel the subcontract, the project was already a few weeks underway. The concrete foundation and slab work started a week earlier. PC Construction already awarded the earth work for the site preparations, concrete foundations, underground utility work, plumbing and electrical rough-ins. Steel would be needed shortly, so SL Steel did not have much time to review the subcontract.

The day after Williams sent the subcontract, he called Poe to follow up.

"Alan, this is Joe with PC Construction," Williams began. "Did you receive the subcontract in the mail?"

"Yes, I sure did." Poe replied.

"Good. Have you had a chance to review it?" Williams asked.

Poe replied, "Well, I just got it this morning. I am reviewing it now. I don't think there will be any problems. I will get it to you in the next couple days."

"That will be great. We really appreciate it. As you know, we are under the gun with the two concrete pours coming up. Everyone is working a lot faster than we expected, which is great. But we need some embedded steel plates as soon as possible for the vault walls. They have to be put in while the concrete slab is still wet. Is there any way you can send some steel to the jobsite right away? It will hold up the work if there is any delay."

"I don't see a problem with that, Joe. What you need is really easy to fabricate. We already have the steel we need in the yard. We'll get on it right away." Poe assured Williams.

“Okay, thanks. Please send us that contract as soon as possible, too.” Williams reminded Poe.

“Not a problem, Joe.” Poe said, and he hung up.

Even though Williams was asking for steel before he received the signed contract, he felt it was a reasonable request. He was only asking for about \$1,300 of steel to be delivered to the jobsite, and SL Steel had the contract on its way.

Williams began to worry that he should have awarded the steel package much earlier – before the other materials packages - since he did not allow SL Steel much time to review the contract. Williams hoped that he wouldn’t regret this mistake later. Generally, Williams didn’t feel comfortable asking a subcontractor to deliver material before signing the subcontract. However, Poe had not objected and promised to send the steel right away. Poe also said that the signed subcontract would be right behind it.

STEEL DELIVERY AND SHOP DRAWINGS

In construction, a subcontractor awarded a specific item of work typically begins working on the submittals (common term for submissions in this industry) and shop drawings. Although the construction drawings and specifications already detailed what the subcontractor was supposed to supply and install, submittals were still required. The architect had to verify exactly what was planned.

For the steel package, the main construction drawings provided a general idea of the dimensions and layout of the steel in the building. The steel subcontractor was responsible for hiring a professional engineer to draw the shop drawings in more detail. The drawings, made very specific to convey the exact installation details, needed to be submitted to the architect and the engineer for review and approval. The steel contractor could only begin fabricating the steel once the architect and the engineer approved the drawings. Thus, it was critical that the shop drawings be started immediately. SL Steel, however, delivered some of the steel early, before the shop drawings were submitted.

Since steel was on the critical path and needed to remain on schedule, Williams wanted to make sure that SL Steel would begin the shop drawings as soon as possible. Although the contract was not yet signed, SL Steel promised Williams that they would start immediately.

SL Steel’s work during the initial stages of the project proceeded well. The project team informally reviewed SL Steel’s preliminary shop drawings, and the engineer said he only needed a couple of days to review them (versus the normal two weeks of review time).

SL STEEL REFUSES TO SIGN CONTRACT

For the next two weeks, Williams spent his days choosing the remaining subcontractors and working out various project details. He almost forgot about SL Steel’s subcontract, assuming the company was simply busy with its shop drawings. SL Steel had already delivered the steel for the slab (see Appendix A) and promised expedited drawings and steel fabrication. To Williams, the project was looking good. After two weeks, Williams realized that he was still waiting for the signed subcontract.

Williams immediately tried to reach Poe. Terry Poe was available, so Williams spoke with him about the contract. Terry Poe said that the signed contract was already in the mail, and PC Construction should expect it any day.

A week later, Williams was still waiting. Williams called SL Steel again. Terry Poe said that he had been mistaken during their previous conversation. In actuality, the contract was not signed, but was “under review and ready to be signed.” Poe was just waiting for his father to find the time to “put pen to paper and sign on the dotted line.”

Typically, large subcontractors returned signed contracts quickly. Since three weeks had passed and the signed contract had not arrived, Williams began to worry. Williams took comfort knowing that SL had already delivered some steel and that the shop drawings were (supposedly) almost done.

Another week passed with Williams leaving phone messages and sending faxes to SL Steel, hoping to finalize the contract. Williams’ anxiety and frustration grew with each unreturned message.

Suddenly, approximately four weeks after the subcontract had been sent, Williams received a fax from SL Steel requesting a revised contract. Alan Poe wrote that the original price was no longer valid and demanded an additional \$2,789 to cover escalating steel costs. Without the extra money, Poe would not sign the contract.

Williams finally reached Poe and asked him about the fax. “Alan, what’s the deal with this fax and the request for more money?”

Poe was clearly very anxious. “To be honest, Joe, we didn’t even start reviewing your contract until after we had delivered the \$1,300 worth of steel and started working on the shop drawings. You asked us to get started on those things right away. Then, we started reading your subcontract and, beyond the money issue, there are a lot of things in there that make us uncomfortable.”

Williams replied, “Well, okay. To clarify, we can explain the contract language. I don’t think you have anything to worry about. We have hundreds of subcontractors that sign our contracts every year. We have encountered most concerns and questions before.”

“But there is another serious problem,” Poe continued. “I have been in this business a very long time, you know. I have never seen what is going on now with these steel prices. They are going through the roof! Our suppliers are telling us that steel prices are going to increase 10-20% in the next few weeks. We haven’t ordered all our major structural steel yet! What am I supposed to do? There is nothing I can do. I am just a small subcontractor, and my suppliers aren’t honoring the prices I quoted in my bid.” Williams heard Poe’s voice crack slightly as he spoke.

Williams began to understand why SL Steel had not returned the contract. He had heard rumors about rising steel prices. Other steel subcontractors on other projects were demanding more

money and threatening to quit. Everybody in the industry was getting a little nervous. However, Williams felt that SL Steel was obligated to honor its bid price.

Poe continued anxiously, “Joe, let me break this down. Two things are happening that I have never seen in my 30-plus years in construction. One, steel prices are rapidly rising. I will have to buy the steel at a loss. My suppliers are telling me that they see no end to the rising prices. And second, I don’t think I have ever seen such a strict and one-sided subcontract. Your insurance requirements are outrageous. It will cost me even more money just to meet your insurance requirements.”

“Alan, we need to set up a meeting right away to work through these issues,” Williams answered calmly. “When can you come to our office?”

Poe needed to look at his calendar before committing to a meeting time, and promised to call Williams back with his available times. Before hanging up, Poe agreed to sign the contract if they could reach a compromise on the steel price increases. He assured Williams that the subcontract language and insurance requirements would not be a hindrance.

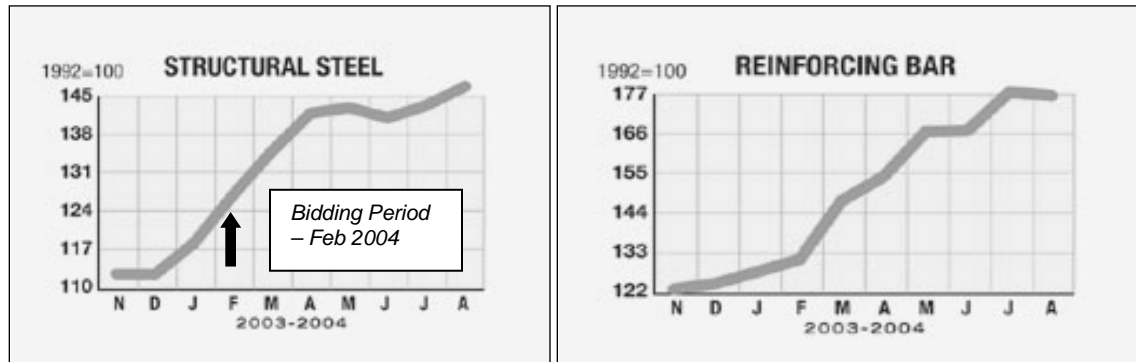
Williams was irritated. Why didn’t Poe bring up these concerns five weeks ago? This was not good business, especially in a competitive bid situation.

At the same time, Williams felt sorry for the old man. Obviously, the rising steel prices were shaking the industry and upsetting Poe. Williams realized that Poe probably avoided these issues with PC Construction for fear of losing the job and ruining his reputation. For SL Steel, this was a big job. Poe and his son Terry were hoping to build a strong relationship with PC Construction. Williams felt that a face-to-face meeting would be good, and he was willing to be accommodating and fair.

RISING STEEL PRICES

SL Steel’s claim of rising prices had turned out to be legitimate, and the company would incur higher costs (see Figure 1). As he reviewed the price indices, Williams began to understand the current volatility of the steel markets. The price instability led to unusual and unexpected risks for the construction industry. If SL Steel had signed the original contract, it would have lost money.

Figure 1: Steel price increases over the last month and the last year



ENR's Construction Materials Price Indexes			
	Structural Steel		Reinforcing Bar
Price:	\$32.97	Price:	\$36.23
monthly % chg.	+2.4	monthly % chg.	+2.9
annual % chg.	+26.6	annual % chg.	45.4
	Prices for wide-flange steel resumed their upward climb after a brief pause.		The end may be in sight for Rebar's annual price run-up that is close to 50%.
	Footnote: ENR's 20-city average monthly price for 8-in. deep, wide-flange beams per cwt.		Footnote: ENR's 20-city average monthly price for grade 60 bar per cwt.

Source: www.enr.com – 8/17/04

Although prices were just starting to rise in late 2003, steel fabricators believed the situation would get much worse before it improved. Suppliers told SL Steel that this was only the beginning of future price increases because of the huge increase in demand for steel in Asia, particularly China causing a steel shortage. One of SL Steel's suppliers relayed a story about a large ship loaded with structural steel bound for the United States from Latin America that was ordered mid-journey to reroute and deliver its cargo to China.

BAD TO WORSE

Williams, aware of the bank's deadlines, began to worry. Should he find a new subcontractor? No, valuable time would be lost by bringing in a new subcontractor. Could PC Construction purchase the steel? No, PC Construction did not have the resources or expertise to fabricate the steel.

Since PC had already lost critical time trying to obtain steel, Williams decided to pay SL Steel for the increased cost of materials to get the project back on track. It was a small price to pay for completing the project on schedule.

After informing Poe of his decision, Poe assured Williams that the price increase had been a regrettable result of temporary market conditions, and there would be no more increases. Poe promised again to return the signed contract immediately.

One week later (now five weeks after SL Steel received the original contract), Williams received a fax requesting an additional \$3,052 for the latest increases in the cost of materials. Again, SL Steel declared that before signing the contract, they needed a promise that PC Construction would pay for the increases. In addition, they wanted to be paid for the materials before they were ordered.

QUANDARY

Williams thought about what had transpired to date (see Table 3 for a summary of key events). He seriously considered hiring another subcontractor immediately. However, the project was too far along to easily bring in someone new. Finding a new steel subcontractor meant losing at least another two weeks, and they were already three weeks behind schedule! Since SL Steel's initial work was acceptable, Williams was not concerned about the quality of the company's work. A new steel fabricator would need to find another engineer to do the shop drawings. Then, it would take at least another week for the structural engineer to review and approve the drawings.

Table 3: Summary of Key Events

ACTUAL DATE	ACTIVITY
12/15/2003	Joe Williams approached by boss to take on the Bank project.
01/12/2004	PC Construction starts soliciting bids for 20 subcontracts.
02/16/2004	PC Construction mobilizes on site – Site construction starts.
03/03/2004	Steel bids come in.
03/10/2004	Subcontract sent to SL Steel.
03/15/2004	SL Steel delivers some steel early, before signed contract.
03/24/2004	Original due date for steel shop drawings.
04/07/2004	SL Steel - 1 st request for more money before signing contract.
04/14/2004	SL Steel - 2 nd request for more money before signing contract.
04/15/2004	PC Construction approaches owner requesting extra money to pay SL Steel. Owner agrees.

Source: Company Documents

All the original bids from other companies would surely be invalid by now. Most subcontractors only promised their prices for 30 to 60 days. Given the existing market conditions, Williams knew that steel fabricators responding to a new call for bids would submit proposals with costs comparable to those requested by SL Steel.

Williams also wondered whether quality might be compromised if the company continued working with SL Steel. Although the subcontractor seemed to be competent at the job site, it could not manage its cost estimates (in spite of the realities of the existing market conditions). Did SL really have the experience and leadership necessary to perform well on such a sizeable, important contract?

Legal action against SL Steel would produce its own set of complications and undoubtedly cause a major delay. SL Steel had already provided some miscellaneous materials and had already started to prepare shop drawings. No money had changed hands between the two companies. PC Construction's contract language was quite direct. By contrast, the bid documents did not

concretely address this kind of difficult situation. Legal action would incur costs of its own, and might result in significant penalties for a small vendor without deep pockets.

Project timelines and budgets were now seriously jeopardized. After assessing the situation, Williams determined that PC Construction would lose more time and money if it were to select another subcontractor. Williams felt pressured to address the problems with SL Steel and keep the project on schedule.

Williams deliberated about informing his boss of the situation. Technically, Williams had the authority to remedy the situation on his own. However, the problem with SL Steel could possibly lead to serious negative consequences that would destroy the trust he had earned at his company. Williams considered all his options before approaching his boss so he could demonstrate that he had exhausted all possibilities to get SL to sign the contract.

Aside from analyzing how Williams handled the situation, Williams' boss would want to discuss the possibility of contacting the bank owners and informing them that the subcontractor problems could cause a delay and a budget overrun. Williams wondered if he should recommend dipping into the Integrity Bank contingency fund. The unusual market volatility did justify using the contingency fund.

If the bank was going to be informed, Williams knew he would be the bearer of the bad news. Williams was ashamed to admit to his boss and the bank that he could not handle such a small subcontractor. The bank would find it difficult to understand how a large project run by a company as large as PC Construction could be affected by such a small vendor. The bank had provided critical financial references to PC's bonding agency and potential clients not only based upon financial history, but also because of its perception of PC Construction's ability to manage and outsource projects.

CONCLUSION

Williams stared at the empty space above the dotted line on the steel subcontractor contract. He thought about how he could "connect the dots" to make this all work out. Should he inform the owner of the problems they were having and ask for an extension? Should he ask the owner to pay the extra costs out of his own contingency fund? Who should absorb these extra costs? Should he rebid the steel? Should he claim restitution from SL Steel when this was all over? Why was such a small portion of the work causing such a big headache? Why was this contractor dodging the dotted line?

APPENDIX A

Pictures of Steel Supplied By SL Steel
Pictures provided by "PC Construction Company"



