FEATURES

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AMIGO steel and AWCI member, Novingers, Inc., of Harrisburg, PA, combined on the magnificent Ocean Club condominiums in Atlantic City, NJ. Novingers pre-fabbed all the panels for this job.

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NO TIMEOUT FOR DECLINE

The Unemployment Rate in Rockford, IL, Was the Highest in the Nation and Traditional Industry Moved With No Replacements, But Harry Vernetti Hangs On

It started by accident. He was a lab worker who’d developed an ulcer.

He was also studying mechanical engineering at Rockford College in Illinois when a visit to his doctor produced a no-holds barred admonition, “get into something where you can work with your hands—and you won’t be in here visiting with me.”

Harry Vernetti, chief executive officer of Mid-State Construction Systems, 746 N. Madison St., Rockford, IL, and First Vice President of AWCI, followed his doctor’s advice. He quit college, enrolled in a lathing apprentice program—and today presides over a diversified wall and ceiling industry which performs between $3 and $5 million annually.

Born in Ironwood, MI, son of the late John J. and Mary Miletto Vernetti, Harry has resided in Rockford since he was seven years old. His mother had re-located the family there following the death of his father, a worker in the iron mines, so her sons—Fred, Enzo, Rudy and Harry—could escape the mines.

After graduating from Wert High School where he won a football scholarship as a guard, Harry enlisted in the Air Force, serving as a B-50 flight engineer with the 97th Bomb Group, out of El Paso. Upon his discharge in 1952, he attended Texas Western University then switched back to the Rockford area.

That’s where tense laboratory work produced the stomach ulcer that ultimately led him into construction. He worked for one contractor and then chanced the ulcer route again by opening up his own business, Lathing Engineers, in 1957.

Four years later, he added plastering to his company line and renamed his company, Mid-States Plastering. That was the year, too, when Harry took his company into the old CPLIA—the forerunner organization of AWCI. By 1967 the company had further diversified into acoustical tile and drywall and Mid-States Construction Systems had moved into the multi-million dollar class.

Although his first headquarters was in his home, a beautiful rambling split-level contemporary home that Harry built himself in 1961, Mid-States now operates out of a two-acre complex featuring an exposed aggregate office building of 1,200 square foot and matching warehouse of 12,800 square feet.

The father of three children, Phillip, a company vice president; Linda Dunn, wife of a trucking firm owner, and Diane, a student at Marquette University, Harry is grooming his son for the company take-over—and getting ready, too, to head the Association of Wall and Ceiling Industries-International in another year.

He and his wife, the former Henrietta “Bunnie” Ambrose, have also taken an interest in golf, tennis, and racquetball in addition to a racing horse with fellow AWCI member Vito Arsena.

In the meantime, Harry Vernetti keeps busy with a company that also offers panelization, Dryvit, moveable partitions and fireproofing. The last few years have been no nicer to Mid-States than it has been to other construction firm, and keeping a company growing in a location like Rockford is a test of determination.
“Any diversification move has to strengthen you and the bottom line. I’ve never been excited about big volume: the measure of yourself as a businessman is the profit figure.”

DIMENSIONS: Recovery from the recession has been spotty around the country, Harry. You mentioned that it’s not been a bed of roses in your marketing areas. What’s the problem here?

VERNETTI: This whole area here was not merely hit by the recession. The industry base was heavily industrial relating to automotive and the housing industries which were both hard hit. At one point, Rockford had the highest unemployment in the nation—and it’s still bad.

You can see that a condition like this isn’t supportive of a lot of construction so we must dig down hard and find the work.—

DIMENSIONS: —and when you do find a job, I suppose the bidding is furious?

VERNETTI: That comment sounds like you’ve been talking to other contractors.

We’ve bid a couple of jobs right at our lowest cost—and the amount left on the table by which we lost was embarrassing. I honestly don’t know where people come up with such figures or how they rationalize what they are doing. They’re giving their own equity away.

DIMENSIONS: But why has this particular market gone sour?

VERNETTI: Much of the factory type work has moved south where the cost structure is lower. Then, too, the city’s leadership moved too slowly about bringing in the high technology industries . . . computers . . . electronics . . . that sort of thing.

As a consequence, there’s been a movement out of the city both in industry and population. That sort of thing doesn’t provide the stimulus to building that sustains the industry. We’ve had a few contractors throw in the sponge.

DIMENSIONS: You have a reputation for seeking a diversified base of business. Take curtain walls as an example. You quickly developed a capability and good name in this area. How’d you go about it?

VERNETTI: Any diversification move has to strengthen you and the bottom line. I’ve never been excited about big volume: the measure of yourself as a businessman is the profit figure.

When I thought curtain wall and pre-fabrication might help us, I started looking and talking to experts. Joe Carpenter, in Texas, was nationally known and he invited two of our superintendents and myself down to learn. We developed good insights into the business with Joe’s help and then Bill Carroll, in Albuquerque, and Jim Brueggeman, from Cincinnati, added to our knowledge.

By the time we were ready to commit the funds and talent we were pretty
confident we could make a go of it—and avoid necessary problems.

DIMENSIONS: The industry was ready for that. Now the new insulated exterior systems—the kind developed in Germany—are coming on strong. Do you see a viable market developing nationally?

VERNETTI: No question about it. We’re into Dryvit ourselves and this technology allows us as contractors to accommodate the designers’ desire for greater flexibility.

It’s a perfect product for the current problems. It offers less weight and economy in construction. It’s just right for an accelerated energy efficient system. If you’ll recall the oil energy crunch in the early 70’s gave it greater impetus—and current problems in the Mideast keep its advantages in the forefront.

DIMENSIONS: There’s the additional advantage, too, of being able to build off site, isn’t there? That’s what made curtain wall pre-fabbing the big benefit, too, right?

VERNETTI: No contractor — or buyer of construction services for that matter—should discount the advantages of being able to pre-build panels. You’re not a victim of the weather—the snow, rain, freezing weather—and employees perform better in a controlled environment.

As a contractor, you also have better control of materials and work periods. There’s no forced shutdown or slowdown so your productivity is good.

DIMENSIONS: On the subject of productivity, you’re obviously aware of The Business Roundtable. It’s their
It’s the lack of productiveness on the part of the mechanical trades especially that’ll slow down a wall and ceiling contractor.”

Veteran estimator Carlo Rossi kept up his estimating skills as swiftly and as surely as Vernetti took the company on a diversification movement.

contention that productivity dropped off 3% annual thru the 60s, then about .9% in the late 70s, and it’s now declining about 1.5% a year. What’s your opinion . . . has productivity in the construction industry really fallen off that much?

VERNETTI: I don’t see anywhere near that decline in my own company. I’m not certain it’s even valid for wall and ceiling construction as a whole. The weather cycle always hurts construction, but our pre-fabbing capability has evened out our work flow.

Certain segments of the industry may be slipping a bit—mechanical and perhaps electrical—but of the CICE (Construction Industry Cost Effectiveness) reports that I’ve read I just don’t agree with what they say as applying to the wall and ceiling industry. It’s the lack of productiveness on the part of the mechanical trades especially that’ll slow down a wall and ceiling contractor.

DIMENSIONS: But there must be some validity for the users claiming that they aren’t getting their money’s worth?

VERNETTI: As I see it, there are two aspects of this problem. The first is the mechanical trades ability to slow a job down, and the second is the type of job. Much of the complaint arises from the big turnkey operators doing power stations, utility plants—that kind of thing.

In this area, the user is just as responsible. They want the job done under a specific deadline and they gear up far in excess sometimes of what’s needed and hang the cost. That’s a 14K gold opportunity to send costs skyrocketing.

There are people falling over each other and the supervision runs from lax to nonexistent. What do you expect under such chaotic conditions?

My son Phil and I handle communications for our company. We keep a close tab on everything. Our computer reports come in weekly and we keep in close touch. You move up the scale of operations and you’ll find waste. That’s the nature of things—and publication of a lot of reports won’t change matters much.

DIMENSIONS: So productivity is a money figure?

VERNETTI: What else can you call it? It’s the only way to measure efficiency. If my company communicates well, if my management team is talented, if we don’t lose control of a job—we show a profit. The alternative is obvious.

DIMENSIONS: How do you keep tight control? Is it a formal process?

VERNETTI: Yes and no. My own management style and that of Phil is to jump on little problems before they become big ones. We have surrounded ourselves with top people—so it’s easier to control our organization. There’s little that’s unique in that approach. Since 1964 we’ve had weekly reports on every job we do and we go over these with the supervision. Every one of us is cost conscious, more so since the recession.

DIMENSIONS: What’s the best way to post a profit?

VERNETTI: Do what every profitable contractor does: work hard, work lean—and keep the overhead down.

DIMENSIONS: A few moments ago you mentioned that you really liked the tough, complex job . . . the one that challenged you. That’s the kind where you can also lose your britches, isn’t it? Do you really like and want that kind of job?

VERNETTI: In one word, “yes.” Everyone likes a challenge, something that’s different or that’s out of the general run of things.

Remember this also about the tough job: it eliminates competitors. The possibility of not being smart enough and showing a loss scares them away.

My whole company works better, performs better when a big disparity on the bids exist. If you know the stages are chancy . . . that perhaps you made a mistake on the job . . . you follow up and work that job more carefully—and skillfully.
DIMENSIONS: Sometimes though, your span of control has little effect. What’s the answer if the general contractor sends over a superintendent and he needs to be told what a trowel is?

VERNETTI: From time to time, we’ve had occasion to shake our heads. It takes a bit more time to communicate successfully with a superintendent like that. But I’ve got people like Carlo Rossi, our estimator, and superintendents like Dick Fisher and Don van de Begert. They’ve been in that kind of situation before and they know how to deal with it.

If worse comes to worse we know how to get together with the other subs and coordinate our efforts to save a bad situation. Often, you just have to go to the general contractor and lay it out for him.

DIMENSIONS: In the past few years, accounts receivables have been getting longer and longer. Sometimes it’s a no-pay condition. How have you managed that end of your business lately?

VERNETTI: I manage it now as I’ve always managed it—personally. Any contractor who neglects his accounts receivables is neglecting the most serious part of his business. I don’t ever want any of my customers to get the idea I’m not interested in money due me. It’s human nature to let a debt slide. By keeping up with receivables I avoid problems. The cost of money today is just too prohibitive to be lazy about collecting. Every sub now knows that if you must borrow, the interest will eat up your profits.

DIMENSIONS: With money as expensive as it is, the matter of subcontract forms comes up. Do you generally sign the contract the general contractor offers or do you have your own?

VERNETTI: My only problem with contracts is with out-of-town general contractors. Most generally we use the AIA Form A401. It’s the agreement that’s in use in this area and it’s fair to everyone concerned.

When we do get a form and find some language that’s unacceptable we cross it out. I can’t think of one instance where this practice has lost us a job.

DIMENSIONS: With a widely diversified company, you must be involved in marketing to a great extent.
years. Our reputation for quick work on time really helps in landing work where there’s little or no bidding.

DIMENSIONS: With business conditions depressed in your own area, do you find it necessary to travel?

VERNETTI: I’m not against traveling, but in the past I’ve done it usually to follow a customer or some similar situation. If I must go into what I call a foreign area I always make it a habit to call the existing member there and try to work out a joint venture. The local company knows the lay of the land and the ground rules and that understanding or knowledge is vital.

We went to Fort Collins, Colorado, and it was a smooth transition. We joint ventured with Jim Yocum, out of Longmont, Colorado, and the job went like clockwork. We both took out a handsome profit.

DIMENSIONS: Where to from here, Harry? You have a big year coming up in 1985 as AWCI President

and a hard row to hoe business-wise. What’s your projections?

VERNETTI: I’m looking forward to serving as President of AWCI. I personally can’t see how any serious wall and ceiling contractor would remain outside the organization. I’ve served as chairman of the Great Lakes Conference, of the Continuing Study Council and the Bylaws Committee as well as the Plastering Technical Subcommittee.

Every one of those assignments helped make me a better contractor—and to see this industry from a clearer viewpoint. I wouldn’t trade that experience for anything.

As for Mid-States Construction Systems, things have to head up. They can’t get any worse—and it is improving. It’s taking hard work but we’re starting to see more daylight.

Another recession after the elections? I don’t think so. If there is one a lot more contractors will go under. But hopefully we’ll still be around. We’ve been in bad times before and managed our way through.

Keep lean, work tough—that’s the formula. It works. We’ve tested it enough times.
Anyone who feels the wall and ceiling construction market is changing fast has pretty much gotten in touch with the pulse of things.

For 18 months recession had savaged the industry but in the last year business opportunities came back strongly in most areas of the U.S. and Canada.

That’s what the eighth annual Business Volume Survey conducted by Construction Dimensions showed. With some 183 wall and ceiling contractors sending in completed forms, it was obvious that the industry was rebounding—with plenty of strength left over for a strong carryover into 1985.

AWCI contractors, projected from the returns, performed some $963,338,020 worth of wall and ceiling work during the past 12 months. Their backlog runs a hefty $549,150,000. The current volume level represents a $282,958,000 advance over the previous year—almost a one-third jump.

Furthermore, the contractors taking part in the survey show a strong sense of optimism for the coming business year. Half of the contractors surveyed estimated that work volume will increase by about 18% this coming year for their own business. Their overall projections for the industry indicated a healthy 20% improvement over existing work volume levels.

Of the 183 contractors reporting, only 13 felt that business would take a downturn of about 5%. Some 65 contractors felt that work and volume levels would remain about the same.

A statistical indication that the commercial building market was coming back strong is reflected in the switch from sold or negotiated work to bid work. For the first time in nearly a decade, last year’s data indicated that contractors were out beating the bushes for work. The sold or negotiated percentage of work was up to nearly 30%.

In the past 12 months, the bid market apparently has reasserted itself. Wall and ceiling contractors said they obtained $684,551,647 in the bid market, while a primary emphasis on

### BUSINESS VOLUME SURVEY

**WHAT MARKETING APPROACH WAS USED**

- Work Obtained by Bid: $684,551,647 (71.10%)
- Work Primarily Sold or Negotiated: $278,786,344 (28.90%)

**CURRENT AND FUTURE BUSINESS PROJECTIONS**

- 98 Companies Report $549,150,000 Work Backlog as of June 30, 1984

**BACKLOG COMPARISON WITH PREVIOUS YEAR (BY REPORTING COMPANIES)**

- 163 Companies Report Current Backlog Greater by $187,550,787 Than a Year Ago
- 8 Companies Report Current Backlog Less Than Previous Year by $27,878,574
- 12 Companies Report Current Backlog About Same as Previous Year

**CONTRACTOR PROJECTIONS FOR WORK COMING UP FOR BID IN COMING YEAR**

- 91 Contractors Report Work Will Increase by Approx. 18%
- 13 Contractors Report Work Will Decrease by Approx. 5%
- 65 Contractors Report Work Will Remain About the Same as Previous Year

**PROJECTIONS BY WALL AND CEILING CONTRACTORS FOR INDUSTRY, 1984-85**

- 117 Contractors Feel Wall and Ceiling Sales Volume Will Increase by Approx. 20%
- 39 Contractors Feel Wall and Ceiling Sales Volume Will Remain the Same
serving and negotiating produced only 28% of their work...some $278,786,300.

**Drywall Strongest...**

Not surprisingly, the amount of drywall work demonstrated where wall and ceiling contractors get most of their volume. Showing a significant improvement over the previous year, drywall accounted for more than 12 percent of the total volume of work done. Contractors reported $369,329,300 worth of drywall installation, up from last year’s total of $309,400,000. Acoustical ceiling work also showed a sharp rise, increasing to $100,320,300.

Continuing to reflect growing interest in the product, exterior insulated wall systems showed steady improvement. Wall and ceiling contractors performed $68,734,500 — the fourth largest increase since Construction Dimensions started tracking the systems in 1980. This figure was up from last year’s $48,800,000.

It appears that exterior insulated wall systems has a bright future. A number of contractors commented on their survey forms that they would seriously look into a diversification move into such systems in the near future.

Tom Hawey, of Trinity Plastering Company, in Fort Worth, TX, said he anticipated a 40% improvement. “With the market developing for exterior insulated wall systems the way it is,” he said, “we expect an increase soon from 40% to 55%—or even greater—over what it is now.”

Other contractors who indicated they would be looking hard at the new systems include Brad Baker, of Triangle Plastering, Dallas, TX; Joe Conroy, who also operates Olympic Walls Company in addition to Conroy Brothers, in Minneapolis; John Whalen, Dewey & Whalen, Inc., Chicago, IL; Alex Browner, of A.G. Browner Plastering Inc., of El Cajon, CA.

Gerald Hardcorn, of J & A Interior Systems, Inc., Florence, KY, said he planned a combination approach. “We move more emphasis into retrofit along with the exterior curtainwall systems,” he wrote.

Because the exterior insulated wall systems appeal to contractors with plastering capabilities, it appears that lathing and plastering is strengthening as a viable market. Plastering contractors reported a 12-month volume total of $58,201,430—up considerably over the depressing $39,100,000 for the previous year.

At the same time, stucco and specialty coatings also enjoyed a resurgence with contractors reporting a work level of $22,859,600, a much better showing than the year before.

**Non-Union Growth?**

Is the non-union element growing in wall and ceiling construction? Judging from the survey returns, the expansion of non-union construction is continuing apace and showing no signs of slackening.

Of the 184 returns some 65 contractors—a record high—reported that they were non-union contractors. The division for non-union operation between AWCI members and non-members was also about even-with slightly more non-members operating...
open or merit shops.

One unionized contractor stated: “I lean toward the perpetuation of non-union contractors in our industry. The unions will gradually be phased out of existence due to the immense competitive advantage of non-union shops.”

None of the other reporting contractors were prepared to go that far in their predictions, but they did indicate a painful awareness of the non-union operators.

“I feel the non-union contractor along with small union ‘pick up truck contractors’ will make it more difficult competitively for small to medium sized work,” said Bob Weis, of George Weis Company, Millstadt, IL.

“Business is going to increase,” said Gerald Hardcorn, “but union contractors are losing a higher percentage every year to the open shop contractor.”

A non-union AWCI member, Obbie Hairfield, of Chesapeake Plastering Company, in Chesapeake, VA, predicts, “It’s been very good under the Reagan administration and I’m looking forward to another good four years.”

Many contractors, too, are implementing plans to sustain their volume levels and prepare for future years.

“In our line of work,” says M.J. Zellner, of Zellner Plastering Company, of Los Angeles, “I look for more projects bidding and an improved business climate over the next 12 months . . . particularly after the general elections.”

Some contractors are casting eyes at an expanded marketing area. Michele McIntyre, of AdA Drywall, Cincinnati, OH, will move into general contracting, while Tom McCartney, T.J. McCartney, Inc., of Amherst, NH, will be expanding his demountable partition business while working on organizational expansion, too.

In the final analysis, it will depend on the marketing situation itself and where the business can be found.

“Houston was a booming market while the rest of the country was depressed,” explains AWCI President Bill Marek, of Marek Brothers. “For the coming period, contractors here will simply have to wait it out, let the occupancy levels get back in balance, and stay in business until the pendulum swings back.”
The Price of Service Work

Service Work is Highly Labor Intensive So Many Contractors Tend Toward a Markup on the Hour Labor Rates For Overhead Recovery

**Do you have a service department?**
If so, is that department making money?

Most service work is highly labor intensive with only a small portion of your costs resulting from parts or materials. The best way to make sure you recover your service-related overhead, then, is to markup your hourly rates for labor to recover total overhead.

Your hourly rates may be $20, $30, or $40—whatever is the competitive rate in your area. How do you know if those rates are high enough to cover your overhead costs? It’s easy to figure overhead as a percentage of labor.

$$\text{Service Department Overhead Last Year} = X\%$$

$$\text{Service Department Total Labor Costs Last Year}$$

Assume the overhead in your service department last year was $15,000 and your total labor costs were $45,000. Your overhead to labor would be 30%.

Now, for example, assume your raw labor costs are $9.00 per hour and taxes and fringes increase that to $12.00 per hour in labor expense. That $12.00 multiplied by 130% [total labor cost of 100% + overhead of 30%] will equal your breakeven rate on labor [$12.00 x 1.30 = $15.60]. If the breakeven rate on labor is less than your hourly charge-out rate, then the difference is your profit per labor hour. If, unfortunately, your hourly charge-out rate is less than the breakeven rate, then the difference is your loss per labor hour.

Of course, you’re allowed a markup on materials. If you’ve recovered all your overhead costs in a labor markup, then the markup on materials is all profit. Many contractors use a sliding scale to markup material costs similar to the one given below. If the...
material cost is between . . . Then the multiplier should be . . .

<table>
<thead>
<tr>
<th>Material Cost</th>
<th>Multiplier</th>
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<tbody>
<tr>
<td>$ 0-.99</td>
<td>3.50</td>
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<tr>
<td>1.00-4.99</td>
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<tr>
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<td>20.00-29.99</td>
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<td>2.00</td>
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<tr>
<td>40.00+</td>
<td>1.75</td>
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</table>

Try using these suggestions to price your service work. You may be pleasantly surprised to learn that your hourly labor rates could be reduced below the competition, yet still be high enough to recoup all your overhead and generate a profit. Add this to the markup on material, and you’ve made good money!

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**Tax Consequences: Proprietorship vs. Corporation**

A southwestern United States mechanical contracting firm began as a proprietorship. Through 1983, the largest net profit the company generated was less than $50,000 before taxes. Consequently, tax planning never required or received much attention. With the recent surge in activity in their particular region, 1984 operations are budgeted to generate $272,205 before taxes and officer’s salary. The following figures illustrate the tax consequences of remaining a proprietorship versus incorporating the business.

Total taxes due on a sale proprietorship are $114,803, while total taxes due on corporate income and officer’s salary are $89,665 ($70,465 + $19,200). The decrease in taxes and the increase in after tax income is $25,138.

As a small business grows, high marginal tax rates can significantly decrease after-tax profits. Incorporating and allocating income between the corporation and the owner can often produce substantial tax savings.

<table>
<thead>
<tr>
<th>Sole Proprietorship</th>
<th>Corporation</th>
<th>Salary</th>
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<tbody>
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<td>$197,205</td>
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<tr>
<td>Salary to Owner</td>
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<tr>
<td>Total Income Before Taxes</td>
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<td>$197,205</td>
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<td>Standard Deduction</td>
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<td>Personal Exemptions (2)</td>
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<tr>
<td>Taxable Income</td>
<td>$266,805</td>
<td>$197,205</td>
</tr>
</tbody>
</table>

**Taxes**

For Income Greater Than $162,400 at 50%

- For $162,400
  - $52,203
- Tax on First $25,000 at 15% $3,750
- Tax on Second $25,000 at 18% 4,500
- Tax on Third $25,000 at 30% 7,500
- Tax on Fourth $25,000 at 40% 10,000
- Tax on Excess over $100,000 at 46% 44,715
- Tax on $60,000 $15,168
- Tax on Excess at 42% 4,032
- Total Taxes $114,803 $70,465 $19,200
- Effective Rate 43.03% 35.8% 24.59%
- Income After Taxes $152,002 $126,740 $50,400
One of the most outstanding financial programs ever offered to wall and ceiling contractors who are members of the Association of Wall and Ceiling Industries-International is now a reality.

It’s the new industry insurance program which will enable contractors to purchase their company insurance through their own private insurance company.

The new arrangement went into effect May 3, 1984, when representatives of AWCI went to Bermuda and signed the final papers, making the Hereford Insurance and Surety Company, Ltd., of Bermuda, a private, profit-making corporation owned by AWCI for the good of wall and ceiling contractors.

Already, over $200,000 in premiums have been signed up by the company, representing contractors from various parts of the country.

Here’s how the “offshore insurance company” program operates—an approach used by many corporations and organizations. The foreign insurance consultant on the project. Standing are Laurance Fernald, of St. Petersburg; Ron Brady, of San Diego; Lloyd-Fox, from AWCI’s general counsel office, and C.E. Woodum, of Houston, TX.
A wall and ceiling contractor can now receive individual attention on his own work history and experience. That means his premiums should be less, reflecting a better knowledge of the contractor’s business, less promotional and overhead costs by the company,” Jim added. Biddle is Chairman of the Board for Hereford.

Goal is $1 Million . . .

The premium goal for 1984 alone is $1 million, says Larry Fernald, of Fernald & Wallace, Inc., St. Petersburg, FL, and chairman of AWCI’s national Blue Ribbon Insurance Committee. Fernald also serves as President of Hereford Insurance & Surety Company, Ltd.

“It’s the best service AWCI has to offer,” Larry promises, “because now a wall and ceiling contractor isn’t a small cog in a major insurance company wheel. That was the problem with past insurance writing efforts—the companies saw the contractor as just another policyholder to be given a number and shuffled around in a big bureaucracy.

“Now, contractors will be dealing with their own company and with people who know and understand their business.”

For contractors interested in investigating the potential in the new AWCI program, it’s as easy as a telephone call. They merely need to call one of the insurance company directors, all AWCI contractors, and they’ll find out how easy it is to participate—plus they can continue to deal with their regular insurance salesman or broker if they wish.

Members of the Board representing AWCI include: Laurance Fernald, President; Jim Biddle, Chairman of the Board; Joe M. Baker, Jr., Washington DC, Assistant Secretary-Treasurer; Michael L. Chambers, Mansfield, OH, Vice President; Carmen Paterniti, Far Hills, NJ, Vice President; C.E. Woodum, Houston, TX, Vice President; C.E. Woodcock, Albuquerque, NM, and Ronald P. Brady, La Mesa, CA.

E. Arnold Powell, Director of Client Services for EBASCO, will be Hereford’s “Manager,” so to speak. Members may reach Mr. Powell at 212-839-1339. Insurance sales are limited to members in Canada and the United States.
On Long Term Accounting

The IRS Hasn’t Given Up in Its Efforts To Collect Taxes on Multi-Year Jobs as Latest Ruling Claims Painting Contractors “aren’t contractors”

Many in the construction industry see it as a ploy to crack the industry’s united front.

The controversy boiling in Washington DC right now is the recent effort by the Internal Revenue Service to deny painting contractors the right to traditional long term accounting methods through an IRS claim that painting contractors are not, in fact and deed, contractors.

The upshot of the IRS ruling produced a quick combination among the Association of the Wall and Ceiling Industry-International (AWCI), the Painting and Decorating Contractors of America (PDCA) and the American Subcontractors Association (ASA). For the past two months, the three construction associations have battled the IRS at The White House, the Treasury Department, and at the IRS itself.

Comes to Head . . .

Concerned with changing long term contracting methods in the construction industry, the IRS ignited the latest collision by citing Section 1.451.3(b)(1) to deny an industrial painting contractor the right to qualify in using a long-term contract method of accounting.

Although the painting contractor—who was not named in the incident—performed industrial and commercial painting services, the IRS claimed the contractor was ineligible for long-term contract accounting methods by virtue of the fact a painting contractor isn’t
a contractor because he does not “construct, build, or install anything. Rather the taxpayer only provides painting services.”

That’s what kicked off AWCI, PDCA and ASA in a quick, furious counter attack.

Current regulations allow the use of a long-term contract accounting method for “building, installation and construction” activities not completed in the same taxable year as that begun in. Contractor methods revolve around two basic approaches—completed contract method and the percentage-of-completion method. If the IRS ruling were allowed to stick, the painting contractor would thus be denied both long term accounting systems. Presumably, the only thing left would be some form of cash accrual accounting system—which would produce significantly more income tax exposure for the contractor.

What makes this latest effort by the IRS so sensitive is the view by many construction people that the probe is merely one to establish a precedent and then set up conditions wherein the IRS might be able to pick off contractor groups for modified accounting procedures.

Furthermore, the IRS Revenue Ruling 84-32—the one that denied the painting contractor the right to use long term accounting—is retroactive and applies to all open years. Normally, the statute of limitations expires after three years, but is often extended by agreement. If more than 25% of gross income is omitted (for example, by application of this ruling) the statute remains open for six years.

“The continuing hostility of the IRS with respect to the completed contract method,” said Touche Ross & Company, “is further illustrated by their position that the use of a long-term contract method by a painter constitutes a ‘Category A’ method of accounting.”

A “Category A” method of accounting is one that is “specifically not permitted to be used by the taxpayer by the code, regulations, or by a decision of the Supreme Court of the United States.

In effect, if the taxpayer—in this case, the painting contractor—doesn’t voluntarily request permission to change his accounting method (presumably to the cash or accrual method) before being notified that an exam will
take place, he’ll be required to report the full impact of the change in accounting method required by the IRS in the year of the examination.

Contractors Excluded . . .

A few years ago the construction industry warded off a similar thrust by the IRS. At that time, the problem really was large defense contractors who were using the long-term method to extraordinary tax advantage. Congress allowed the IRS to disallow these methods — but specifically excluded construction contractors from being denied long term contract methods.

This recent action by IRS would indicate strongly that despite the obvious intent of Congress the IRS is determined to chip away at contractor use of long term contracting.

Impact on Contractors . . .

Many subcontractors wonder just what the flap is all about over long term contracting . . . and whether or not such a change in accounting procedures would have much impact on their business.

Not too many contractors are involved in the matter. The ones who are, are involved in jobs that take more than one or two years to build. Because the profit realization on such a long term job is almost impossible to determine, contractors seek to avoid excessive tax exposure by following a percentage-of-completion method or by completed contract method.

What the IRS is after is to get the taxes up front as soon as the work is completed at the end of the current tax year. Contractors oppose IRS moves to end long term contract accounting because they feel they would need to pay taxes on projected or estimated profits, a chancy tax situation at best.

Tax collectors don’t like the long term methods because the taxpayer can manipulate the income and profits into the current year when the job is finished, thus getting a distinct tax benefit. Many of the large government contractors — not construction contractors — were playing this tax game like an electric organ and avoiding huge tax sums.

That’s why congress moved recently to abolish this kind of long term ac-
Contractors oppose IRS moves to end long term contract accounting because they feel they would need to pay taxes on projected or estimated profits, a chancey tax situation at best.

counting procedure. But construction contractors were specifically excluded from this congressional action. Now the IRS by regulation has moved against construction contractors, too.

Actually, the move against the painters is not an isolated case. Earlier the IRS published three similar rulings covering engineering, architectural and construction management contracts. In each ruling the taxpayer had no contractual obligation other than one of three services.

The IRS successfully held that none of the contracts represented the necessary “construction, building, installation or manufacturing” responsibilities necessary for long-term accounting eligibility. This new ruling clearly implies that other activities absolutely essential to the physical completion of a construction contract may not be eligible for long-term accounting.

IRS has confirmed to the Associated General Contractors (AGC) that “dirt hauling” is being studied as the next subject matter of a ruling which may be published in the future.

Subsequent rulings such as 84-32 and its three predecessor rulings can be expected to be used if the IRS attempts to require contract divisions in the future. For example, if a general contractor also performs as a subcontractor for any of the prohibited activities under a single separate contract he is required to report income from that contract by using a non long-term contract method, i.e., cash or accrual.

It has been suggested that the IRS may take a future course of action in which it would divide an overall contract into different contracts depending on the activities being performed and report income accordingly. This second possibility is not now a requirement but the first—asking in a separate contract capacity in one of the prohibited activities—is.

Rulings processes take considerable time, but subcontractors should keep in mind that rulings primarily reflect an IRS position that the service is willing and ready to litigate. The eventual disposition of completed contract reporting will take a considerable period of time.
The Growing Interest in Computers

The Computer Revolution Has Hit the Construction Industry as Contractors Get on the Electronic Bandwagon

Do you plan to buy a business computer in the next year? According to one recent survey of construction contractors, 95 percent of your competitors do—70 percent of whom have at least one computer already, including 30 percent who own at least five.

“Interest in computers cuts across all types and sizes of construction companies,” says John Smith of accountants Arthur Andersen & Co., conductor of the survey. Smith told a recent IBM Construction Executives Conference that, “contractors are now in the ‘awareness’ stage, creating a bandwagon effect for computers. The next stage is experimentation, followed by proliferation. By 1990, even today’s exotic technologies like computer-aided design will become standard.”

The construction industry’s rush into the Computer Age—which experts all agree is upon us—is bound to shake up long-established ways of doing business. But how? Clearly, company’s own internal operations — accounting, estimating, billing — will be profoundly impacted.

But as all parties gain easy access to project-wide information once available only to others, many are asking whether the influx of computers will affect the relationships between owners, designers and contractors by changing the way construction projects are managed.

Past is Prologue

History is replete with examples of new technologies that have changed the construction profession. In cen-
“The construction industry’s rush into the computer age—which experts all agree is upon us—is bound to shake up long-established ways of doing business.”

turies past, for example, the increasing sophistication of building methods saw owner-supervised construction give way to master builders.

Or consider the use of written contracts, a development springing from the need to clearly describe increasingly complex work responsibilities. (It is not even until 1911 that the American Institute of Architects introduced the first standardized owner-contractor agreement!)

And even more recently, in our own post-war era, changes in building technology have profoundly altered the face of the industry.

As AWCI general counsel McNeill Stokes writes, “No single general contractor can keep up with every development. For that reason, most construction work today is performed by specialized subcontractors who can install building components faster, better and cheaper than the general contractor could with his own forces. The general contractor is no longer the traditional master builder of old, but is often just a broker of subcontractors.”

Interior finishing contractors need not be told the growing use of subcontracting has created new situations—such as poor coordination, slow pay-

ment and inequitable subcontracts—that the industry is struggling with even today.

And now that computers promise to be the newest technology sweeping the industry, what do the cards hold for contractors? The present structure of the construction industry is based upon a sequential flow of information among parties: the architect must go to the engineers and builders for feasibility data; the general contractor must go to his subcontractors for labor and material prices. But with computers, all that may change.

Architects could test stress loads in their own offices by computer; general contractors could pull together up-to-the-minute prices from several computer subscription services already available. And these are just two examples of the instantaneous flow of information computers can provide.

So will computers tomorrow change
the way construction projects are managed today?

Designing and Building

Computer-aided design—or CAD—is the hottest new buzzword in the engineering and design professions. Why? Because the most exciting advances in construction applications for computers are being made in this area.

Elbert Ray, president of Louisville, KY., consulting engineers Proctor-Davis-Ray, last year invested nearly $1 million in new computer systems. Having seen his firm’s workforce double the past twelve months, and its profits up 500 percent, Ray is enthusiastic about developments in CAD technology.

“We broke even after cutting our engineering and drafting time in half, and have gained since then,” Ray told the IBM Construction Executives Conference. “Our revenue is up 40 percent. And it only takes 34 days to train our people, two months to get them up to average proficiency, and only six months to make them experts.”

CAD systems already on the market can store common symbols in their memory and enable the drafter to create drawings—turned out by high-speed printers in eight different colors—which meet all ANSI requirements and are uniformly better than those produced by hand. Designs can be modified instantly on a screen monitor, and then tested for stress and other use requirements by computer models—eliminating any need for redrafting by hand.

“Before long, computers will do away with hard copy altogether. Blueprints will become obsolete, as engineers and contractors bring their computer work stations to the jobsite and refer to the design on their screen monitor,” said Ray. “In the future, screens will feature color, and designs will be rendered in computer-generated animation. Also, there are even prototype systems now under development that can automatically engineer a building without human assistance once the requirements are entered.”

Ray believes that as hard copy disappears and information is increasingly shared through computers, “all parties will have to interface more.” But will this bring about changes in the relationship between design professionals and contractors?

“I don’t think so,” said Ray, who holds the view—shared by many—that computers are “simply a tool, just like trucks or cranes, that only help you do your own job better.”

However, Arthur Andersen’s Smith speculates that as computers help designers get easy entry into questions of constructability, “they could start moving more into project manager roles”—and thus accelerate the current growth of alternatives to the traditional single contract method of construction, such as construction management (CM) and design/build arrangements.

Asked whether increased cooperation between designers and contractors would blur traditional lines of professional responsibility, Smith was uncertain—but did cite the example of Britain and many other foreign countries where subcontractors can be selected by the architect, and are accorded special privileges over other subcontractors in recognition of their design work.

Bidding and Paying

The IBM Construction Executives Conference was also addressed by a general contractor, William Robinson of the Mellon-Stuart Co.—a Pittsburgh-based firm which recently built that city’s landmark PPG Plaza building—on the company’s experience with computerized estimating.

“Computers let general contractors get a sense of line-item prices,” said Robinson, who explained that, “our branch offices are able to share pricing data with the main office. And we subscribe to reporting services which give us labor and material prices up dated daily via computer. So we are less susceptible to inflated subcontractor bids.”

Some at the conference worried such information could afford general con-
tractors new leverage in “negotiating” subcontract prices, or could provide justification for increased bid shopping. However, Robinson believes, “when we have a good handle on prices, we are more likely to go with a new or less experienced sub, because we know he’s not underbid and can do the job at his price.”

Others suggested any advantage the general contractor might realize over his subcontractors would be canceled out as the owner and his representatives presumably gain access to the same labor and material pricing information.

“Practices such as front-end loading by the general contractor could become more difficult,” said one observer, as computers would afford owners a better grasp of true prices. “And for that matter, it might be harder for GCs to delay subcontractor payments when scheduling and percentage-of-completion data is available for all to see at the touch of a button.”

Mellon-Stuart’s Robinson agreed that “with CAD, contractors will have to interface more with architects and engineers.” But on the question of increased data sharing with subcontractor, he was more circumspect, saying only “there will always be an arm’s length between GCs and subs.”

Robinson’s comment gets to the heart of the issue: For computers to be fully effective in construction, data must be shared across all the parties involved in the building process. Yet in such an environment, are traditional arm’s-length arrangements adequate? Can a general contractor, to name just one example, share full project scheduling data with subcontractors knowing this may reveal when he receives funds from the owner and shows when other trades are being paid?

Clearly, computers will be a great boost to construction contractors—though in many respects, only to the extent they are willing to accept closer relationships with other parties and to share data over which they have control. But given the traditional-bound nature of the construction industry, computer technology is likely to advance faster than the industry can accept new business relationships suited to that technology.
Using a Management Consultant

A Contractor Faces Many Management Obstacles and Sometimes an Outside Expert Can be Most Useful in Sorting Things Out

By Harold Winslow, CPA

The small contractor faces a multitude of problems in the operation of his business. He must decide when to expand, what collection procedures to use, the extent of promotion, establish hiring policies, purchasing, and of course, the problems connected with record keeping and payment of taxes.

Unlike large business firms engaging nationally-known accounting firms which provide management services, the small contractor often utilizes the services of an individual practitioner or the services of a small sized accounting firm. Many of these accountants can offer useful and practical advice on business problems, but by and large, most are not equipped to render the full range of managerial services.

This is where the professional management consultant comes into the picture.

The consultant tries to show a contractor how to realize full productivity, how to make the highest net profit consistent with sound business practices, how to create a good public image in the community and how to take excess business profits and invest them to assure the building of an estate.

Results cannot be guaranteed and the consultant usually cannot take a business hopelessly mired in debt and red ink and turn it into a profitable venture. What the consultant does do is to act as a doctor and diagnose business ills.

Reputable professional management consultants do not (and cannot according to the code of ethics of those belonging to the Society of Profes-
“The consultant tries to show a businessman how to realize full productivity, how to make the highest net profit consistent with sound business practices, how to create a good public image in the community and how to take business profits and invest them to assure the building of an estate.”

Professional Business Consultants) accept commissions from companies which they recommend to furnish supplies or services to their clients.

Management consultants do not ordinarily advertise their services but depend upon recommendations. If your business is ailing and expert help can conceivably offer a ray of hope to salvage your investment and livelihood, give some consideration to the retention of the services of a professional management consultant.

One way to find one is to check your local telephone classified directory under the heading “Management consultants.”

Costs Vary . . .

Costs involved vary with the amount of work entailed and the extent of the services to be rendered. Most reputable consultants will confer with you, listen to your problems, and arrange to set a fee so that you can decide whether or not you want to make the expenditure.

Sometimes the consultant will be unable to arrange an overall price because of the complexity of the work involved and in this case will arrange to charge a flat fee for an overall survey, after which he will list the areas to be covered and ask for a per diem fee to undertake the assignment.

What will you get for your money? The consultant’s survey will check on your business practices as they relate to the productivity of employees and management, the adequacy of quarters and facilities, the record keeping systems, collection practices, pricing policies, promotion and bidding expenditures in relation to sales volume, and the overall efficiency of all personnel.

The consultant will check into your plans to keep abreast of new developments in your industry, and he’ll check the morale factor by examining provisions for fringe benefits and proper application of sharing profits through planned incentive increases in remuneration. In this regard, the consultant will review any union contracts existing and make suggestions for any future contract negotiations and renewals.

Care will also be taken to examine corporate buy-sell agreements made by stockholders and the buy-sell agreements of partnerships. He’ll look for inadequacies in insurance (or other funding) coverage to assure the continuity of the business and the carrying out of the desires of the parties with respect to providing for the widow and children of a deceased stockholder or partner. And, the sole proprietor is not overlooked. Here too the consultant seeks to offer ways and means whereby a business does not go down the drain with the death of an individual owner. Plans are established for achieving some value for what is in many instances a valuable asset only during the lifetime of the owner.

Becomes Third Member . . .

Changes suggested are not put forth without first discussing them fully with your own lawyer or accountant. In fact, the consultant becomes the third member of the professional team most concerned with your business success.

Not all consultants provide the same services but basically it can be said that the following are representative: Installation of easy to manage, proper and complete business records; meeting with accountant to provide more meaningful statements and reports to measure changes suggested; recommending changes in production; methods of promotions to improve the bidding ratio or to sell work; reviewing collection procedures to free capital tied up in overdue accounts; review of hiring policies; examination of bidding structure; a review of materials handling to eliminate bottlenecks and to in-
crease flow and reduce costs; examining purchasing policies and recommending ways of more orderly ordering to effect efficiency and cash savings; teaching office personnel or supervisory personnel how to implement recommended procedures for increased efficiency; offering counsel in the rearrangement of insurance coverage to reduce overlap and cut costs; (done through broker of your choice to retain present relationship); the establishment of a course of action for setting up investment fund; to examine relationships within the organization to reduce friction and reassign duties, etc.

There are some consultants who will undertake the preparation of financial reports and tax returns, but these are best done by your own accountant who has been professionally trained in this specialty.

The aforementioned services offered by consultants can be obtained on a one-shot deal wherein the consultant surveys your situation and then is engaged to put into effect his set of recommendations, agreed to by management. After this is accomplished his services end and management has to follow through to see that there is no lapse back to the old inefficient ways.

Or, if you so desire, you can make an arrangement for a periodic check-up on a continuing basis. In this case the consultant will review the results of his efforts and will make further recommendations if he deems them necessary.

Not Guaranteed . . .

As stated previously, results cannot be guaranteed. But, if a business is not past the point of no-return and can be redeemed by a change in policy and method of operation, the consultant’s advice is bound to produce some good. How much can be measured by your own examination of what has taken place and your examination of your accountant’s financial rendition.

There are quacks and incompetents as in any business operation. That is why you have to exercise care in the selection of a consultant and perhaps have him interviewed by your accountant, or depend on the recommendation of a fellow businessman who has experienced satisfactory results.
“OR EQUAL” SUBSTITUTIONS

A Contractor is Entitled to Recover Cost Differences For Substitutions

When the specifications permit “or equal” substitutions, the contractor is entitled to make a substitution of materials or equipment which is equivalent or equal to the equipment or materials specified in the contract. If the design professional rejects the contractor’s substitution of materials or equipment which are less expensive but equal and directs the contractor to install more expensive equipment, then a constructive change has occurred and the contractor is entitled to recover the cost difference between the less expensive product and the product which he was directed to install plus a reasonable profit. The submission of an item pursuant to an “or equal” clause is not the same as a request for a deviation from or change in the contract. In executing the contract, the owner has given the contractor the right to use any item which is equal to the quality and performance of the brand-name standard.

Private owners and design professionals frequently prefer to demand the use of a single name-brand item. It is perfectly within their contract rights to draft the contract documents to make that demand, and in such a case the contractor will be bound by the contract’s language. In public contracts, however, competitive bidding is often statutorily mandated. A demand by a public owner that the contractor use one item would circumvent competitive bidding. The largest contractor in the world, the United States Government, has long adhered to “or equal” clauses; and the administrative boards which rule on federal contract disputes have consistently held that the refusal to approve an “equal” substitution constitutes a constructive change in the contract specifications and entitles the contractor to an equitable adjustment in the contract to cover the increased costs of procuring the more expensive product. The courts interpret an “or equal” clause in a construction contract as creating a valuable contract right for the contractor.

There is a modern trend in “or equal” substitutions to require that proposed substitutions be submitted by a definite deadline prior to bid date so that they can be approved or rejected prior to the bid date to enable all bidders to be on the same equal footing. If a supplier, manufacturer, or contractor does not submit the proposed substitutions for approval prior to the bidding date, then the specifications will be limited to the brand named and those that have been submitted and approved. Design professionals and owners should maintain flexibility to allow substitutions in order to keep manufacturers and suppliers competitive. A sole source manufacturer or supplier in effect becomes a complete monopolist and can exact a monoplistic price from the contractor who will have no choice but to deal with the designated supplier or manufacturer on their terms and prices. The design professional will not know that the supplier or manufacturer is exercising the monopolistic position because the price will be buried in a lump sum bid by the contractor. Design professionals and owners are often victimized on sole source specifications by suppliers and manufacturers who once they think that they are locked in often greatly increase their normal margins.

The word “equal” as used in “or equal” clauses does not mean that to be approved the substitution must be identical in every respect to the brand named as the standard of quality. The substitution may be “equal” and at the same time have a somewhat different
design; equality is to be defined by the quality, performance, and design of the substitution versus the brand-name specified. But “equality” does not mean “identity.” If the proffered substitution functions as well as the specified equipment, it should be accepted by the owner as satisfying the “or equal” clause.

Clauses which provide for the use of a particular brand-name product “or equal” or which provide that brand names are used merely as a “standard of quality” have been common in construction contracts for many years. In construing these clauses, the courts have held uniformly that the contractor has a contractual right, agreed to by the owner, to the use of any product which is “equal” to the brand-name standard in quality and performance. A contractor also has a right to the benefit of an honest judgment by the owner or its design professional of the quality of the proposed substitution in relation to the brand-name standard.

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**Stopping Work: What Are Your Rights?**

What are a contractor’s options if a customer doesn’t make a payment? The one that comes most readily to mind, especially as anger and frustration mount, is simply to stop work. Sometimes this is the contractor’s only recourse—and an effective weapon that should be considered. However, the contractor should never “simply” stop, because the legal repercussions are far from transparent. It is the threat of stopping work that is more important than actually stopping work because the threat of stopping work usually gets action.

The operations of most contractors are predicated on an uninterrupted cash flow. As expenses for labor and material and equipment are incurred, they must be matched by an equal amount of income. Few contractors can wait until the end of a project for payment. When a contractor does wait until the end of a project for payment, the contractor is financing or “banking” the project—a function which should not be the contractor’s obligation.

A construction project reaches the crisis stage if the contractor is not given a monthly progress payment. The contractor is placed in the position of having incurred great expense without gaining the compensating income. Often, the contractor is faced with the prospect of continuing work, thus incurring greater expense, without knowing if it will be reimbursed.

Viewed from the contractor’s position, a missed progress payment is usually the result of one of three causes: (1) For some reason, the lending institution has refused to pay; (2) the contractor’s work is defective, and the owner refuses to make payment until the work is corrected, or (3) in the case of a subcontractor, the general contractor has been paid but has applied the full payment to its own debts and thus does not have any money to pay the subcontractor.

Certainly a contractor should not stop work without the legal right to do so. On the other hand, the contractor should not continue to work and finance the project if stopping work is a legally valid remedy—that would be adding to expenses which may never be reimbursed.

Once the contractor has decided to stop work, the contractor must thoroughly check out how to do so legally, since failure to observe the legal niceties can ruin the strategy, possibly in a way that’s going to cost money. First, see if the contract specifically describes conditions where stopping work is justified. Such a typical stop work clause appears in Standard Form Subcontract (AIA Document A-401),

“... The Contractor agrees that if he fails to make payments to the Subcontractor as herein provided for any cause not the fault of the Subcontractor, within seven days from the time payment should be made . . . the Subcontractor may, upon seven day’s additional written notice to the Contractor, stop his Work without prejudice to any other remedy he may have.”

Another form, AIA General Conditions (AIA Document A-201), recognizes the similar right of a general contractor to stop work seven days after giving written notice to the owner and architect. If a clause like this exists, the contractor must follow it to the letter. Accordin
tractor cannot stop work immediately after the progress payment date has come and gone with no check in sight. The subcontractor must instead wait the required number of days.

Let’s say that the subcontractor is due to be paid August 10. The subcontractor cannot possibly stop work before August 24—seven days until the subcontractor serves notice, seven more until subcontractor stops work. And if the subcontractor is a little slow on the draw, giving notice on August 21 rather than August 17, the subcontractor then has to wait seven days until August 28 to stop work. Note that August 21 and August 17 are the days the general contractor receives notice, which may be different from the day notice is given.

Where these notices are required by the contract, they are vitally important and should not be overlooked. Stopping work is the most drastic remedy which a contractor has, especially when the action will shut down a major project. The contractor should proceed cautiously to ensure every legal issue is covered.

Often contracts make no mention of the right to stop work. This is especially true when the contractor draws up the subcontract or the owner writes the general contract. After all, why should they worry about this? It’s your problem. So while checking over contracts in the future, be sure you add a stop work clause.

In cases where a contract has been signed without a stopwork agreement, common-law concepts of “material breach,” will be used by the courts to come to their decisions. The contractor’s job is to do construction work; financing is for owners or bankers. But financing is just what the contractor would be doing if the contractor continued on the project after the customer had missed a payment. A small or immaterial breach of contract will not justify the injured party’s ceasing to perform their obligation.

If the sum of money withheld is not too great, contractors actually do have to occasionally finance their own work. That’s because in a society like ours, which is heavily dependent upon commercial relationships, the law must be designed to encourage fulfillment of obligations. It must likewise discourage nonperformance.

The legal doctrine of “material breach” presents the other side of this coin. The injured party may cease performance and sue immediately for his damages if the breach of contract is considerable. A sliding scale determines just when a nonpayment becomes substantial enough to be called a material breach. A review of past court decisions indicates that default on a progress payment involving a significant percentage of the total contract amount is likely to be ruled a material breach of contract.

Unfortunately, everybody reads this scale differently. A large missed payment near the end of the project might not be considered material because most of the project has already been financed. The contractor’s “financing” promises to be short-term and risk of growing involvement is slight. On the other hand, a rather small missed payment early in the construction process would be grounds for long-term concern. The contractor might be justified in nipping the problem in the bud. There is one situation where the contractor ought to be able to predict how the court is going to react: when his own work is unsatisfactory. To stop work after doing a poor job is risky business, to say the least.

Although one of the contractor’s strongest remedies, stopping work can produce drastic results. Therefore, the contractor will not be able to exercise its right in every case. Only by weighing the economic disadvantages of continuing work—and becoming “banker” for the job—against the economic disadvantages of stopping work—risking a law suit—can the contractor determine whether the right to stop work is worth exercising.