



Case Study:

The Importance of Reviewing Customer Contracts When Selling Turnkey

by Kent J. Pagel, WTCA Legal Counsel, & Libby Maurer

Sharing the story of a decision
that nearly ruined one business.

at a glance

- ❑ Perfecto Truss learned the hard way that customer contracts play a big role in the risks by component manufacturers selling turnkey.
- ❑ Perfecto did not protect itself from performance risk or sufficiently define its scope of work in the subcontract with the general contractor.
- ❑ This one contract with a large multi-family project caused Perfecto to lose millions in company equity.

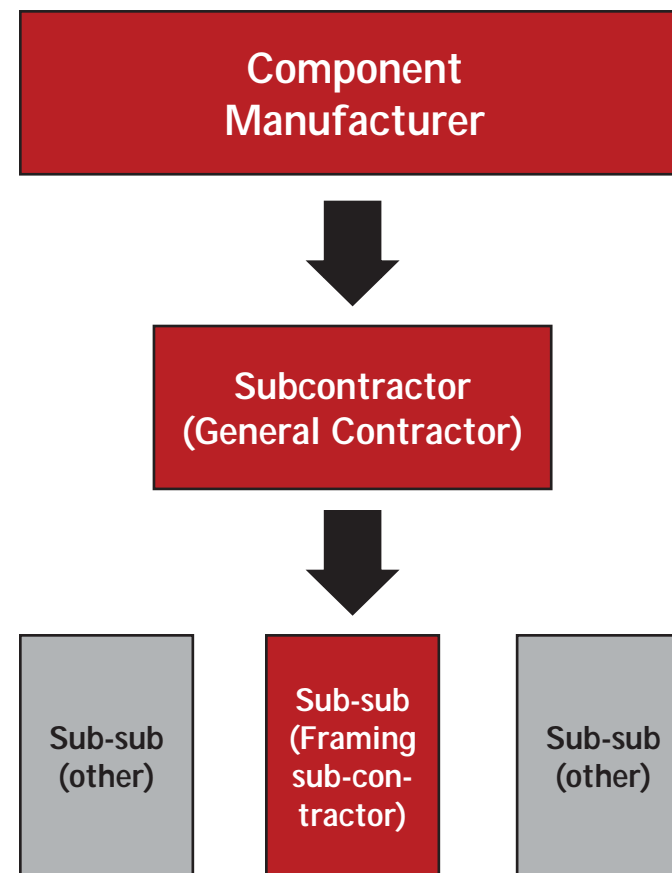
In this article we share the story of how a series of decisions regarding one particular customer contract nearly ruined the business of a long-standing component manufacturer. Throughout the article, important **Best Practices** concepts and helpful **Fast Facts** about the elements of a customer contract are broken out. (This format is similar to what you'll find in the *ORisk* Management Reference Tool. See sidebar on page 65 for more information about *ORisk*.)

For this case study, we'll refer to the manufacturer—who prefers to remain anonymous—as “Perfecto Truss.” A few years back, Perfecto Truss made its first steps toward implementing a new business model: selling turnkey. For years Perfecto successfully served its customers by designing, building and delivering components, but they concluded that moving to turnkey on a customer-by-customer basis was a perfect way to grow their business.

Fast Fact

For many component manufacturers, offering turnkey framing services has proven an effective means to increase revenue, boost wall panel sales and maintain control over the whole framing process, which reduces waste, call-backs, repairs and backcharges.

After making the determination to move into turnkey sales, Perfecto entered into



a low seven-figure subcontract to provide the components and framing labor for a multi-family project—its largest dollar amount contract ever. The subcontract stated that Perfecto would design and manufacture the wall panels and roof and floor trusses for this multi-building project, deliver all the components to the jobsite, and hire a sub-subcontractor to frame the entire project.

Fast Fact

A sub-subcontractor is a lower tier subcontractor. For example if a component manufacturer were to sign a subcontract with a general contractor and in turn ask another framing sub to perform the labor under that subcontract, that framing sub would be referred to as a sub-subcontractor and would enter into a sub-subcontract with the manufacturer.

A Perfecto company representative went looking for a framing company, and signed the company with the lowest bid to a sub-subcontract, deferring in large part on the recommendation of the project's general contractor. The decision to sign this sub-subcontract turned out to be a critical—albeit innocent—mistake that would haunt Perfecto for years.

Within a few months after commencing work, the framing sub-subcontractor declared bankruptcy and left little in terms of assets in its wake. Perfecto revisited the sub-subcontract to determine what legal action could be taken against the framing sub. It was shocked to find that nothing had been written into the contract securing the obligations of the sub to complete the job. The company had entered the contract without covering its risk with a performance bond issued by the framing company. Perfecto's officers didn't recognize the risk associated with the framing company, and therefore saw no reason to make sure a performance bond was in place.

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*“The company
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mance bond issued
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company.”*

Fast Fact

A performance bond can be purchased by a subcontractor (usually at a price of 2.5 percent of the contract price) and is issued by a surety (usually an insurance company). In the bond, the surety guarantees that the subcontractor will faithfully perform contractual obligations to another party. To obtain a performance bond the subcontractor will usually need to have (a) a history of successfully completing projects on time and without claims, and (b) assets in place enabling the surety to take the risk under the performance bond.

“In addition to performance risk, there is also ‘claim’ risk that manufacturers need to consider when hiring framing companies. Claim risk is the risk of being exposed to third-party claims arising out of the work of the framing company.”

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Like Perfecto, most component manufacturers offering turnkey will sub-subcontract out the actual performance of the jobsite labor to third parties. However, this does not absolve them of liability to their customer if the sub-subcontractor they hire in some way fails to perform. In other words, the manufacturer's ability to perform its contractual obligations

depends in large part on the performance of the sub-subcontractor. This is called “performance” risk. Since many framing companies have little in terms of available assets and are not known for honoring contractual obligations, the performance risk to a manufacturer can be significant.

In addition to performance risk, there is also “claim” risk that manufacturers need to consider when hiring framing companies. Claim risk is the risk of being exposed to third-party claims arising out of the work of the framing company. These risks include “third-party over” claims asserted by injured framing company employees and other third party claims for injury or property damage. To some extent, the claim risk can be passed off to the framing sub-subcontractor through an adequately prepared sub-subcontract and ensuring that the framing company has sufficient insurance from highly rated insurance companies.

Best Practices

When contracting with framing companies to undertake the labor service the component manufacturer has agreed to perform for its customer the following should be considered:

- Due diligence
- Bonding
- Collateral
- Sub-contractor contracts
- Insurance
- Supervision
- WTCA's ORisk Management Reference program goes into a much more detail on these critical issues allowing you to make wiser contract choices.

Faced with a situation where they were contractually obligated to their customer to supply the framing labor, Perfecto aggressively sought a replacement framing company to finish the job. Unfortunately, Perfecto could not find another framing sub to take on the work for the original low-ball bid. The company also explored a mutual termination of its subcontract, but the general contractor would not allow it. So Perfecto, intending to do what they thought was honorable, hired local crews from the area to complete the framing and imported its own managers to supervise the framing crews. Unfortunately, the cost to get this done was significantly higher than the amount Perfecto originally bid the labor to their general contractor customer.

Further complicating the picture was the fact that the scope of work was not sufficiently defined in Perfecto's subcontract with the general contractor, nor did the subcontract reference the applicable set of plans and specifications. Accordingly, the general contractor kept asking Perfecto to perform extra work, such as provid-

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“We lost *everything*.”

Don't let this happen to you.

ORISKTM

For information about the ORisk Management Reference Tool or to access a best practices guide, visit www.sbcindustry.com/orisk.php.

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ing the materials and labor for the siding. This was the case even though Perfecto had never intended and had not bid siding materials and labor. Perfecto ultimately decided not to fight the issue because their subcontract didn't specifically indicate that siding was outside their scope of work. Because Perfecto primarily looked at the

subcontract they signed from the standpoint of a material supplier and since they were contracting out the labor, they did not spend the time necessary to review and negotiate the scope of work exhibits to the subcontract.

Meeting after meeting was called by Perfecto and its customer and agreements were reached at those meetings concerning scope of work issues. Unfortunately, Perfecto failed to put the agreements into

writing. This allowed the general contractor, who had a less than stellar reputation, to go back on those verbal agreements that were reached.

Best Practices

Properly defining scope of work is so important on turnkey projects from a risk management and liability avoidance perspective. To do so, the manufacturer must carefully describe in writing what is to be provided as well as what is not being provided, in terms of both materials and labor. This helps clarify what, in fact, is being provided. When a bid is made "per plans and specifications," the manufacturer must also identify any part of the specifications that do not apply to its intended scope of work. This should be indicated clearly in writing.

Best Practices

Extensive and accurate records are vital to establishing your position at a later time, especially if you find yourself in litigation. A follow-up email after a telephone conversation can sometimes be the difference between winning and losing a lawsuit. A written RFI may prove to be quite helpful in the event claims are asserted with respect to a truss design. Be in a position to refresh a person's memory by carefully documenting work progress, telephone calls, meetings, inspections and evaluations. Records prepared simultaneously, or shortly after an event, are far more useful and convincing. Most importantly, reduce agreements made on a particular project to writing, even after the contract is entered into.

Best Practices

Without a signed and well-written written contract in place, there are many potential outcomes in the event of a dispute. Further, without a well-written contract, the component manufacturer may have very little leverage if a customer attempts to overstep its bounds. As you can see, a carefully drafted written contract can provide vital protection. For these reasons, we have devoted four tracks to the topic of customer contracts in *ORisk*.

labor crews. This notion of being "held hostage for payment" is a common tactic deployed by general contractors.

Fast Fact

I recently came across a subcontract provision that stated that even if the general contractor failed to pay the turnkey component manufacturer, the manufacturer had NO right to either suspend or stop performance of its work. In other words, this means that even if I do not pay you for good reason, you must continue to perform and your recourse is to pursue a claim of litigation or arbitration under the subcontract.

Running out of options, Perfecto sought the advice of an attorney located in the city where the project was being constructed. Having not been involved on the front end with reviewing and negotiating the original subcontract, the lawyer reviewed the one-sided subcontract. It advised Perfecto that if they stopped working, they would run the risk of get-

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Don't Risk It: Use the *ORisk* Management Reference Tool

By Libby Maurer

"There are many companies that don't recognize how important risk management is. We did not take it seriously."

As Perfecto learned, the shifts in business models and changes in the way manufacturers go to market with their products make risk management techniques vital to the protection of companies in this industry. The builder and developer community has, for a number of years, put pressure on manufacturers in industry to accept more of their risk. Those still involved with the legacy Perfecto state: "We see this every day in the contracts we review and sign, and we hear about it from our competitors."

So what can you do about it? First, accept that this is no longer the exception, but the norm. Second, commit yourself to protecting your company and educating yourself. You can do this by investing in a program developed to guide component manufacturers through the review and negotiation of customer contracts. Our Online Risk Management Resource or *ORisk* was developed by Kent Pagel and WTCA staff, at the urging of the WTCA Management Committee. *ORisk* is a valuable reference resource in learning how to create a comprehensive risk and liability management program to protect your business **now**.

Using this tool, you will learn how to foster a culture of risk management, the elements of a contract and their implications, what to look for when reviewing a contract, and helpful negotiating techniques. With *ORisk*, you can learn how to take control of customer contracts and properly manage the risks that you face every day. Think of it as an online reference resource that you can consult at any hour of the day, any day of the year.

You may have always had good luck with contracts in the past, but don't let that stop you from continuous protection. "We didn't take that seriously because the company had been successful for so many years. And one job turned the company upside down," said one of the members of legacy Perfecto.

Looking back on the events that led to Perfecto's contract troubles, company management wishes it would have had the opportunity to purchase *ORisk*: "If we'd had the opportunity to spend \$2,500 on a reference tool we could use all year long, it might have saved us from losing as much money as we did on one job. It's a drop in the bucket."

For information about *ORisk* as a reference tool or to access a best practices guide, visit www.sbcindustry.com/orisk.php. **SBC**

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Best Practices

Involving experienced legal counsel is paramount when customers begin to assess claims, whether for larger dollar backcharge, product warranty claims, truss collapses, design responsibility claims and construction defect litigation. Manufacturers need to hire not just any attorney, but a construction industry knowledgeable attorney with experience representing subcontractors (and hopefully component manufacturers) who understands the courtroom and/or arbitration matters. The best fit is an attorney who has worked in the past with your company and has a good working relationship with you and understands the industry you work in.

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ting sued and losing potentially even more money, as the cost to complete the project and delay damages the general contractor would seek could be quite significant. Perfecto chose the path of least resistance and kept on working—telling themselves they could untangle the mess and make it work.

The Perfecto story ends with the company choosing to file a lawsuit to collect monies they claimed due from the general contractor after they completed most of their work under the subcontract. As is typical in these situations, the general contractor countersued. This lawsuit led to a chain of additional lawsuits between Perfecto and its customer that occurred over a three-year timeframe eating up even more of Perfecto's money in legal fees. To avoid further expenditures of legal fees, Perfecto finally settled with the customer and failed to recoup any of its losses.

This project caused Perfecto to lose more than \$5 million in company equity. The owners will tell you, "because we didn't cover our risk in one big contract, we lost it all." Attorneys advised Perfecto to file for bankruptcy; but they instead decided to sell off the company. Out of the sale, Perfecto's creditors got paid most of their money, and the owners were left with nothing.

Nearing the end of this fiasco and hoping to avoid similar problems in the future, only then did the management at Perfecto decide the company needed to brush up on some basic risk management fundamentals. Anyone who touched contracts for Perfecto, more than 25 in number, attended a full-day seminar. To this day, Perfecto has become fully dedicated to risk management education.

The Perfecto story, while tragic, should persuade all component manufacturers to take pause and evaluate how they handle risk management within their companies—especially with customer contracts and particularly where involved in selling turnkey. Too many companies seem to reach out for risk management training and education only after a bad experience. **SBC**

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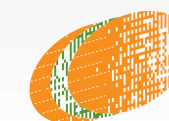
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