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Considering Taking Possession of a Construction Project

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Twelve Initial Tasks Will Help Guide Your Decision

Lending money is an inherently risky activity. Construction lenders know this better than most—from cost overruns to poorly crafted construction documents to changing market conditions, there are numerous ways a construction loan can go sour. Fortunately, the U.S. has enjoyed a prolonged period of prosperity that has made construction lending highly lucrative. Now that an economic downturn is upon us, however, construction loans are souring at an alarming rate.

Lenders who are unused to dealing with troubled loans can lose even more time and money if they don't act quickly. If you're a lender who has a non-performing construction loan in your portfolio, you probably realize that easy, straightforward solutions do not exist. However, by following a handful of procedures that experienced loan workout consultants use on behalf of their clients, you can protect your bank from further losses while amassing information that will lead you to a sound solution.

Construction Loan Workouts: The All-Important First Phase

Construction loan workout scenarios typically involve five phases. The first—getting a handle on the situation—what we're discussing here—is extremely important, because all subsequent phases build on the information obtained in Phase I. The other steps include Phase II: Assessing the viability of the borrower's newly found equity investor; Phase III: Fighting over the project; Phase IV: Construction close-out, and Phase V: Implementing the disposition strategy.

During Phase I, construction loan workout specialists undertake 12 specific tasks designed to help lenders understand and assess the situation. The steps, presented below, don't need to be completed in the exact order presented, and many can be conducted simultaneously.

1) **Visit the Site.** A walk-through of the project's construction is necessary for preparing the cost-to-complete study and for identifying measures that need to be taken to protect the collateral from waste. Document existing conditions as well as the presence of any stored materials. But this initial site visit, which is usually the first of many, can reveal a great deal of additional information. For example, general housekeeping, or a lack thereof, can provide a sense of project management's staffing and organization practices. Approaches by disgruntled subcontractors looking for payment—not unusual—can help reveal discrepancies in funding allocations by the borrower or construction manager/contractor.

2) **Collate and Organize Construction Documents.** Construction documents not only include drawings and specifications, but also refer to building and special permits, approvals, CM/GC agreements, subcontracts, purchase orders, design agreements, change orders, schedules, budgets and payment requisitions, controlled testing reports, and more. Ask yourself: are the construction agreements assignable to the lender? Be sure to obtain all documents while everyone is still on speaking terms. They'll prove valuable, especially during Phase IV.

Make sure to review the lender's construction loan consultant's monthly reports. Is the last report's disbursement recommendation commensurate with the value-of-work in-place? Have any off-site materials been funded? Have any retainages been released? Has a title search been conducted to disclose the mechanic lien status?

3) **Update the Appraisal.** You need to know what the value will be upon stabilization as well as the necessary costs to get there. (In certain markets, stabilized values have

dropped 20% to 50%). For the appraisal's cost approach to value, a cost-to-complete study, inclusive of direct and indirect costs, will be required. Be sure that the appraisal considers the indirect costs to hold and operate the facility until stabilization is realized. The appraisal and the appraiser's expert court testimony will be needed to lift a possible stay to the foreclosure proceedings, should the borrower put the project under bankruptcy protection.

4) **Determine Permitting Status.** Review building department files to check for outstanding violations, fees for permits yet to be pulled, and to determine whether there are any developer proffers that must be satisfied to receive a certificate of occupancy. Remember, when a project becomes distressed, management usually becomes distressed, too. It is not unusual to find that permits have lapsed, stop work orders have been issued for safety violations or other concerns, or required as-built surveys or controlled inspections have not been conducted.

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5) **Review Design Agreements.** Most architectural and engineering agreements assign designer tasks and responsibilities throughout the construction phase, including periodic site visits, field report preparation, change order review and acceptance and certifying of compliance with the design documents. Review these agreements to make sure that the contractual responsibilities have been completed, and that the agreements are assignable to the mortgagor, or that the designers will continue to provide services under a "will serve" letter to the mortgagor. Be sure to review the designers' payment status as well, because in distressed situations, it is not unusual to find that designers have either been under- or overpaid for services rendered.

6) **Determine Compliance with Contract Drawings and Specifications, and Status of Controlled Inspections.** A lack of controlled inspections could jeopardize permitting and issuance of the certificate of occupancy. Audit the controlled inspections issued to date, determine if there are any outstanding inspections, and prepare a schedule of the required controlled inspections going forward. It is not unusual prior to and during the construction phase for the borrower to implement value engineering or cost reduction opportunities. Often these may be identified within subcontract agreements as "alternates." Determine if such CROs were implemented or authorized, and whether such substitutions or alterations deviated from the construction documents. If material deviations did occur, determine whether they were approved by the appropriate designer-of-record so as not to jeopardize any designer responsibilities.

7) **Conduct or Update a Phase I Environmental Site Assessment.** Environmental issues, such as stockpiled contaminated soil awaiting disposal, can impact negotiations and exit strategy. Sometimes the original assessment is deficient, so be sure to review the assessment thoroughly.

8) **Analyze the Mechanic Liens.** Review the mechanic liens, determine whether they were filed appropriately, and reconcile them with the subcontracts, agreements, purchase orders, and change orders. On a lien by lien basis, preliminarily opine on the merits of the claim so as to include a forecasted amount for same, once negotiated, within the cost-to-complete study. Usually, such liens are inflated so as to include retainage not yet released, anticipated profit, re-mobilization costs, and possibly inflated change order amounts.

9) **Conduct a Direct and Indirect Cost-to-Complete Study.** The complexity of this task varies by project; a great deal depends on the construction delivery process, the status of completion, the available information, and the cooperation of the borrower and the CM/GC. Keep in mind two things: the study will need to be updated as "new" information is disclosed, and there is usually a significant re-mobilization cost if the project is to be closed-down and then re-started. Be aware that the cost-to-complete study is critical, because it will serve as a basis for your argument that the borrower has no equity in the project should a stay be placed on foreclosure proceedings as a result of a borrower entity bankruptcy motion. Be aware that the person who prepares the cost-to-complete will most likely be called on to provide expert court testimony. If the lender takes possession, the study will help determine whether to dispose of the project as-is, mothball it, leave it partially complete, or complete it fully. Should a project get to the point where construction ceases, it most probably will be encumbered with liens by sub-contractors, material men, and the designers. You can also expect vandalism and theft of stored materials, fixtures, and equipment that have secondary market value. Usually, it will take more funds to complete the project than simply totaling the cost-to-complete on open subcontract agreements.

10) **Protect the Asset from Waste.** By the time a special assets group enters the picture, construction has usually

ceased or is merely muddling along. As a lender, you need to take measures to protect your collateral from waste, including making watertight provisions, fencing, new locks, notification to local fire and police departments, making sure that adequate insurance coverage is in place, and more. Should the building be at an advanced stage of construction, it may be necessary to provide temporary heat during winter months to prevent problems, such as frozen pipes, caused by extreme temperature differentials. Don't count on using existing subcontractors to secure the asset. At this stage, many have likely placed mechanic liens on the building and would be reluctant to return until such liens are satisfied. Be prepared to make a protective advance under the provisions of your loan agreement. Most construction loan workout consultants have an affiliated CM firm that they control; consideration should be given to using such a firm so the bank can be shielded from contracting directly with subcontractors.

11) **Focus on the Capital Structure.** Know the players and the amount of their contribution to equity, debt, or both. Review any participation agreements and determine whether the players are strictly finance-oriented or whether they're construction lending types. (If their knowledge and experience is solely financial, they may retain their own construction consultant to serve as their advocate.) Knowing the capital structure also prepares you for Phase II, when the borrower may claim to be bringing in a new equity investor to rescue the project. If the cost-to-complete study clearly indicates that the borrower no longer has equity in the project, it will then be his or her personal loan and completion guarantees, along with the tax consequences resulting from debt forgiveness, which are keeping him involved in lieu of simply handling over the keys.

12) **Audit the Construction Costs.** A direct and indirect cost audit will tell you where the money went and possibly something about the borrower, which is important for your exit strategy. It is not unusual for audits to disclose duplicate payments, inappropriate purchases, and more. Audits may also disclose monies diverted to other borrower projects, personal expenditures, and subcontractor payments totaling less or possibly more than what has been disclosed on the G702 or lien waivers. Should the lender avail themselves of the services of a full-service accountancy, it is usually necessary to have both the indirect and direct costs reviewed by a firm that knows project management and how to read drawings and construction agreements to determine their appropriateness to the specific project.

Once you've completed steps 1-12, you will be in a much better position to address the non-performing loan. If you lack workout experience, or your workout department is overburdened, consider working with a construction loan workout consultant, who will not only guide the process, which is usually adversarial, but will also act as a management tool to both shield the bank from potential causes of action and enhance their negotiating position during Phase III, fighting over the project.

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