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# **Risk Management for Construction Loans Part II: *Avoiding Time and Cost Overruns, Construction Defects and Faulty Designs***

**John L. Hosack, Esq., Jason E. Goldstein, Esq., Mr. Rick Rodriguez and Mr. Matt Becica**

**12:00 Noon  
June 21, 2016**

**Webinar**

**Buchalter Nemer**

**1000 Wilshire Boulevard, Suite 1500  
Los Angeles, California 90017**

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## I. INTRODUCTION

- A. The Impact of the Economy on Construction Loans
- B. The Lender's Motivation to Make Construction Loans
- C. Lender's Due Diligence on the:
  - 1. Borrower
  - 2. Guarantor(s)
  - 3. Source of Funds
  - 4. Regulatory Issues
  - 5. Competition
  - 6. General Contractor
  - 7. Principal Subcontractors
  - 8. Architect
  - 9. Site

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## I. INTRODUCTION (CONT.)

### D. Causes of Construction Loan Defaults

1. **Insufficient Funds**
2. **Faulty Plans and Specifications**
3. **Construction Defects**
4. **Delay in Completion**
5. **Market Conditions**
6. **Loss of Key Tenant(s)**
7. **Loss of Takeout Financing**

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**Save The Date!**  
**RESIDENTIAL LOAN SERVICING:  
SEVEN MAJOR MISTAKES TO AVOID**

**John L. Hosack, Esq., Jason E. Goldstein, Esq., Mr. Joffrey Long**

**12:00 Noon PST**

**August 9, 2016**

**Webinar**

**Buchalter Nemer**

**1000 Wilshire Boulevard, Suite 1500**

**Los Angeles, California 90017**

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### **II. KEY PROVISIONS IN THE CONSTRUCTION LOAN AGREEMENT**

- A. Assignment of Plans and Specifications to the Lender**
- B. Assignment of Construction Contract to the Lender**
- C. Assignment of Permits and Entitlements**
- D. The Lender's Right to Communicate with the Architect, General Contractor, Subcontractors, Suppliers and Guarantor(s) and the Borrower's and the Guarantor(s) Waiver of Any Rights to be Informed of the Communications**

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### **III. PROHIBITION ON THE GENERAL CONTRACTOR ASSIGNING IT'S RIGHTS AND DUTIES UNDER THE CONSTRUCTION CONTRACT**

- A. Prohibition on the General Contractor Assigning its Right to Receive Payment**
- B. Time is of the Essence and the reasons why (i.e., Loss of take-out loan, Loss of tenant, etc.)**
- C. Dispute Resolution Provisions**
  - 1. The Borrower's Architect is the Person Who Determines Ambiguities, etc. in the Plans and Specifications and the Right to Compensation for Change Orders. The architect's decisions are only reviewable by binding arbitration.**

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## III. PROHIBITION (CONT.)

### 2. Mandatory Mediation

### 3. **Binding Arbitration**

- a. Retired Judge or Justice is the arbitrator
- b. The mediation/arbitration is preselected
- c. Only Receive Evidence Which is Admissible Under California Law
- d. Only Decide Dispute Based on Substantive California Law
- e. Issue a Reasoned Decision Based Only on Admissible Evidence and Substantive California Law

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## III. PROHIBITION (CONT.)

### D. Lender's Right to Complete Construction

1. **Mortgagee in Possession**
2. **Receivership**
3. **Bankruptcy Trustee**

### E. Payment Systems

1. **Progress Payment**
2. **Voucher System**
3. **Direct Payment to the Borrower**
4. **Joint Checks**

### F. The Contract Price to Construct the Project

1. **Fixed Cost Contract or Lump Sum Contract**
2. **Cost Plus Contract**
3. **GMAX**

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## III. PROHIBITION (CONT.)

### G. Duties of the Lender's Agents, Including its Inspectors and/or Consultants

- 1. Borrower and Guarantor(s) agree that any Inspection or Knowledge possessed by the Lender is for the Sole Benefit of the Lender**
- 2. Borrower and Guarantor(s) Waive Any Right to be Informed of Any Knowledge possessed By the Lender or the Lender's Agents**
- 3. Substandard Status Reviews and Misreporting**
- 4. Failure to Identify and Report Denied, Disputed and Pending Changes**
- 5. Failure to Properly Forecast Final Completion Costs**

### H. Waiver of Bonds

- 1. Written Request of Borrower and Guarantor(s) to save them money**
- 2. Right of Lender in the future, in its sole and absolute discretion, to require bonds**
- 3. Borrower's failure to provide requested bonds is material breach of loan agreement which impairs Lender's security which justifies termination of loan disbursement and foreclosure**

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## **III. PROHIBITION (CONT.)**

### **I. Completion of Construction**

#### **1. Certificate of Completion**

#### **2. Certificate of Occupancy**

##### **a. Temporary Certificate of Occupancy**

##### **b. Final Certificate of Occupancy**

#### **3. Release of Retainage**

### **J. Progress Payments by Lender do not Constitute Approval of Contractor's Work**

### **K. The Borrower's Obligation to Immediately Eliminate any Mechanic's Lien, Stop Notice on Other Lien(s) on Claim(s).**

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## IV. LOAN ADMINISTRATION

- A. The Implied Covenant of Good Faith and Fair Dealing
- B. The Risk of Fiduciary Duty Being Imposed on the Lender
- C. Communication and Miscommunication
- D. Dealing With Loan Participants
- E. Lender's Initial Review of the Borrower's Proposed Plans, Specifications and Budget
- F. Scheduling and Monitoring Progress, etc.
  - 1. **Substandard Scheduling Causes Misreporting Progress**
  - 2. **Best Practices – examples**

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## IV. LOAN ADMINISTRATION (CONT.)

### **G. Lender's Review of Borrower's Payment Applications**

- 1. Problems with overpayment**
- 2. Front end loading**
- 3. Nuances of a GMP Contract**

### **H. Documentation of the Borrower's (General Contractor's) Defaults and the Impairment of the Lender's Security**

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### **V. TIME FOR PERFORMANCE/LIQUIDATED DAMAGES**

#### **A. Importance of a Liquidated Damages Clause**

#### **B. Extension of the Original Date of Completion**

- 1. Consent of Participants and Guarantor(s)**
- 2. Modification endorsement to Loan Policy of title insurance**

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### VI. DELAYS OF THE COMPLETION OF CONSTRUCTION

#### A. Borrower Caused Delay

1. Change orders
2. Lack of money

#### B. General Contractor Caused Delay

1. Change orders
2. Labor shortage
3. Lack of payment

#### C. Architect Caused Delay

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### **VII. PROBLEMS CAUSED BY SITE CONDITIONS**

#### **A. Type of construction**

##### **1. New**

##### **2. Rehabilitation of Existing Structure (e.g., Office Building to Condominiums)**

#### **B. Adequacy of Lender's Inspection**

#### **C. Competency and Financial Strength of Inspectors**

#### **D. Communication of Information Obtained by from Lender's Inspections**

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## **VIII. COST OVERRUNS**

### **A. Cause of Cost Overruns**

- 1. Defective plans and specifications**
- 2. Bid mistakes**
- 3. Site conditions**
- 4. Construction defects**
- 5. Governmental Requirements**
- 6. Labor Issues**
- 7. Extra work**
  - a. Extra work which was not required by the construction contract**
  - b. Extra work which was required because of defective plans and specifications**
  - c. The general contractor's right to compensation for extra work**

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## VIII. COST OVERRUNS (CONT.)

### B. Response to the Need for Additional Funds Required by Cost Overruns

1. Borrower
2. Guarantor(s)
3. Bonding company
4. General contractor
5. Lender

### C. Consequences of Cost Overruns

1. Delay in completion
2. Mechanic's Liens
  - a. Escrow claim
  - b. Title Policy claim
3. Stop Notice
  - a. Foreclosure
  - b. Litigation
  - c. Bankruptcy

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### IX. CONSTRUCTION DEFECTS

- A. Cause(s) of Construction Defects**
- B. The General Contractor's Responsibility for Construction Defects**
- C. The Subcontractor's Responsibility for Construction Defects**
- D. Who Pays for Construction Defects**
- E. Remedies of the Lender for Construction Defects**

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## **X. FAULTY DESIGN**

### **A. Cause(s) of Faulty Designs**

### **B. The Lender's Remedies for Faulty Designs**

### **C. The Architect's Responsibility for Faulty Designs**

### **D. Who Pays for Faulty Designs**

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### **XI. CHANGE ORDERS**

**A. Requests by the Owner**

**B. Requests by the General Contractor**

**C. Review and Approval of the Change Order Requests by the Owner's Architect**

**D. Lack of Objections to the Change Order by the Lender because There Are Sufficient Funds which Remain in the Budget to Pay for the Work**

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### **XII. INSURANCE COVERAGE FOR FAULTY DESIGN AND CONSTRUCTION DEFECTS**

- A. Insurance for Faulty Design**
- B. Insurance for Construction Defects**
- C. Certificates of Insurance**

**“A certificate of insurance is merely evidence that a policy has been issued. (Ins. Code, § 384.) It is not a contract between the insurer and the certificate holder.” *Empire Fire Ins. Co. v. Bell* (1997) 55 Cal.App.4<sup>th</sup> 1410, 1423.**

- D. Additional Insured Endorsements**
- E. OCIP/Wrap Policies**

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### **XIII. REPLACEMENT OF THE GENERAL CONTRACTOR**

- A. Grounds for the Owner to Terminate the General Contractor**
- B. The Owner's Notice to the General Contractor of Deficiencies in Performance**
- C. The General Contractor's Right to Cure the Alleged Deficiencies in Performance**
- D. The Owner's Right to Require the General Contractor to Post a Performance Bond**
- E. The Time and Expense Required to Secure a Replacement General Contractor**

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### **XIV. THE LENDER'S SALE OF AN INTEREST IN THE CONSTRUCTION LOAN**

- A. Sale of Participation Interests**
- B. Sale of the Whole Loan**
- C. The Borrower and the Guarantor(s) Express Consent that the Loan may be sold in whole or part**
- D. The Borrower and the Guarantor(s) Waiver of any right to be informed that the Loan is being sold in Whole or Part**
- E. The Borrower and the Guarantor(s) Waiver of any right to purchase the Loan, whether in whole or part**

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## **XV. CONSTRUCTION LENDER'S POTENTIAL LIABILITY**

- A. Breach of the Construction Loan Agreement**
- B. Breach of the Implied Covenant of Good Faith and Fair Dealing**
- C. Lender Activities beyond the Scope of a Traditional Lender of Money and the Potential to Create Fiduciary Duty**
- D. The Lender's Active Participation in the Construction as Opposed To Normal Activities**
- E. Improper Disbursement of Loan Funds**
- F. Termination of Loan Disbursement**
  - 1. Conditions for disbursement not satisfied by the Borrower**
  - 2. Borrower's breach of loan agreement**
- G. Failure to Extend the Date of Completion**
- H. Failure to Modify the Loan Terms**
- I. Lender Taking Control of the Borrower**

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### XVI. CONSTRUCTION LOAN RISK MINIMIZATION RECOMMENDATIONS

- A. Train Employees**
- B. Review and Update Loan Documents**
- C. Write for the Jury (Plaintiff's Exhibit "1")**
- D. Supervise Employees**
- E. Workout Specialist vs. Loan Officer**
- F. Experienced Counsel**
- G. Protocol ("Pre-Workout") Agreement**
  - 1. Release**
  - 2. No Release**

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## XVII. CONCLUSION

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# Conclusion

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