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Construction Lending: Downturns and Defaults

John L. Hosack, Esq., Mr. Joffrey Long and Mr. Rick Rodriguez

12:00 Noon (Pacific Time)

January 23, 2018

Webinar

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1000 Wilshire Boulevard, Suite 1500

Los Angeles, California 90017

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Presenters

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John L. Hosack—*Presenter*

John L. Hosack is a Shareholder in the firm's Litigation Practice Group in Los Angeles and a member of the firm's Mortgage Banking Group. Mr. Hosack represents mortgage brokers, secured lenders and property owners at trial and on appeal in real property disputes including, broker liability, lender liability, fraud, breaches of contract, mechanic's liens, stop notices, judicial foreclosures, receiverships, escrow claims and title insurance claims. His transactional practice includes commercial real property loan documentation, loan workouts, REO sales and foreclosures. He is an Affiliate Member of the California Mortgage Association and a member of the Los Angeles Mortgage Association, a Fellow of the American College of Real Estate Lawyers and a Fellow of the American College of Mortgage Attorneys and the Co-Chair of the Title Insurance Committee of the American College of Mortgage Attorneys. He is the author of "California Title Insurance Practice (First Ed., Calif. Cont. Ed. Bar), the first book on title insurance, and is a past Chair of the American Bar Association's Title Insurance Litigation Committee.



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Shareholder
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Joffrey Long —*Presenter*

Joffrey Long is President of Southwest Mortgage and has worked in loan servicing and origination of institutional loans, as well as the making, arranging, and servicing of private investor real estate loans for 40 years. He is past president and education chair, and a present member of the board of directors of the California Mortgage Association.

He frequently serves as an expert witness, providing litigation consultation, mortgage expert witness reports, declarations, and expert testimony. He has testified more than 35 times in depositions, arbitrations and trials relating to loan servicing, loan origination, the sale of real estate loans and loan brokerage.



Joffrey Long
President
Southwest Mortgage

Rick Rodriguez —*Presenter*

Mr. Rodriguez is the founder and principal of Rodriguez and Associates Advisory Group (“R&A”), a Los Angeles based consultancy firm that has provided a unique array of services to its clients since 1992. For the past 24 years, R&A has successfully formulated creative workout and loan restructure resolutions to complex multi-party debtor-creditor transactions in judicial and non-judicial settings.

Having spent approximately 20 years as a banker, primarily with Security Pacific National Bank, Mr. Rodriguez has personal experience in due diligence, loan administration and workout of all types of loans, from consumer credit to large commercial complex syndicated credits. Mr. Rodriguez is a seasoned expert witness in banking, finance and real estate matters who testifies at jury trials, bench trials, arbitration proceedings, and mediation sessions; both by deposition and declaration. Mr. Rodriguez has testified equally for plaintiffs and defendants.



Rick Rodriguez
Founder
Rodriguez & Associates

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I. INTRODUCTION

- This webinar is based, in part, on two webinars which were presented in mid-2016. During the year and a half since these two construction loan webinars were originally presented, much has occurred and the purpose of this webinar is to build on those two previous webinars and inform you as to how to prepare for the next downturn in construction lending and the attendant defaults.

I. INTRODUCTION (CONT.)

- 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

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

II. UNDERWRITING THE REQUEST FOR A CONSTRUCTION LOAN

- A. Introduction
- B. The Borrowing Entity
- C. The Proposed Construction Project

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TAKE OUT LOANS: CONSIDERATIONS FOR CONSTRUCTION AND PERMANENT LENDERS

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III. UNDERWRITING THE PROPOSED
BORROWER'S TEAM, INCLUDING, BUT
NOT LIMITED TO, THE BORROWER'S
ARCHITECT, GENERAL CONTRACTOR
AND THE PRINCIPAL
SUBCONTRACTORS

A. Introduction

III. ANALYZING THE PROPOSED BORROWER'S TEAM (cont.)

- B. Lender Due Diligence on the Architect and Preparation, if Necessary, to Terminate the Architect
 - Assignment to the Lender of the Plans and Specifications
- C. Lender Due Diligence on the General Contractor and Preparation, if Necessary, to Terminate the General Contractor
 - Assignment to the Lender of the Construction Contract

IV. UNDERSTANDING THE RISKS IN CONSTRUCTION LOAN APPRAISALS

A. Introduction

While much has been said and written about construction loan appraisals, it is important for the lender to bear in mind that even the best construction loan appraisal is an “educated guess” based upon current conditions. Unfortunately, any major construction project will take longer from the loan request to the completion of construction than it is possible for the appraiser to accurately gauge. Accordingly, the construction lender is compelled to bring to its underwriting an appreciation, among other things, of the economy and to be alert for an unduly optimistic appraisal.

IV. UNDERSTANDING THE RISKS . . .

(cont.)

B. Understanding the appraiser's assumptions.

1. All appraisals contain various assumptions which the appraiser has made. Those assumptions may or may not be consistent with the lender's assumptions. It is important for the lender to thoroughly understand the basis of the appraiser's assumptions and to make an independent determination as to whether the appraiser's assumption are realistic.

IV. UNDERSTANDING THE RISKS . . .

(cont.)

- C. The appraiser's estimated time to complete construction and obtain a certificate of occupancy and achieve occupancy (and rent flow) is one of the more important assumptions.
- D. The appraiser's assumption of the income which may be generated from the property, once the construction is completed, is the most important assumption.

V. 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

V. 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 Lien
 - a. *Escrow claim*
 - b. *Title Policy Claim*
 - 3. Stop Notice
 - a. Foreclosure
 - b. Litigation
 - c. Bankruptcy

VI. THE CONSTRUCTION LENDER'S EXIT STRATEGIES

- A. Introduction
- B. Have the borrower obtain a commitment take out loan from a different lender
- C. Have the borrower sell the property
- D. Have the construction lender make the take out loan
- E. The construction lender has a receiver sell the property
- F. The lender forecloses and sells the property

VII. ALTERNATIVE DISPUTE RESOLUTION PROVISIONS

A. Jury Waiver

B. Mediation

C. Arbitration

1. Administration of Arbitration
2. Procedural Rules for the Arbitration
3. Location of Arbitration Hearing
4. Arbitrator's Powers
5. Provisional Remedies (i.e., appointment of a receiver, writ of attachment, etc.) and Injunctive Relief

VII. ALTERNATIVE DISPUTE RESOLUTION PROVISIONS (CONT.)

6. Selection of the Arbitrator
 - a) Limit time for selection
 - b) “Automatic” Selection in the Event of an Impasse
 - c) Preemptory Challenge
 - d) For Cause Challenge
7. Limits on discovery
8. Require the Arbitrator to rely only upon admissible evidence
9. Require the Arbitrator to apply California law
10. Time Limit to Conduct the Arbitration
11. Time Limit to Issue the Award
12. Require a “reasoned” award based only admissible evidence and California law

VII. ALTERNATIVE DISPUTE RESOLUTION PROVISIONS (CONT.)

D. Judicial Reference (As an alternative to Arbitration)

1. The need to file a Complaint
2. Selection of the Arbitrator

E. Parties to the ADR Agreement

1. Lender
2. Borrower(s)
3. Gurantor(s)
4. Surety
5. Loan Broker
6. General Contractor (For Construction Loans)

VIII. CONSTRUCTION LOAN ADVANCES: OBLIGATORY AND OPTIONAL

- Can the construction lender disburse loan funds, without the risk of a loss of lien priority, if there is a “technical” default in the loan (i.e. absence of a financial statement)?
- Can the construction lender disburse loan funds without the risk of a lack of lien priority if the Lender has commenced foreclosure?
- Obtaining advance endorsements to the loan policy for each advance. [ALTA Forms 14-06, 14.1-06, 14.2-06 and 14.3-06 and CTLA Forms 111.14-06, 111.14.1-06, 111.14.1-6, 111.14.2-06 and 111.14.3-06

IX. DEFAULT INTEREST

- A. Introduction
- B. Types of Default
- C. Nature of Clauses
- D. Disclosure and Enforceability

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X. LOAN ACCELERATION PROVISIONS

A. Acceleration on Default Provision

1. Should the acceleration be “automatic” or should it be required to be declared by the lender?
2. Should the lender be required to give the borrower notice of an intent to accelerate the loan?

B. “Due-on” Provisions

1. Due on sale or transfer of an interest in the property

X. LOAN ACCELERATION PROVISIONS .

.. (cont.)

2. Due on further encumbrance

XI. REQUIRE THAT THE CONSTRUCTION DEED OF TRUST BE RECORDED BY THE TITLE INSURER (OR ITS AGENT) AS A FIRST PRIORITY LIEN ON THE BORROWER'S PROPERTY

A. Introduction

X. REQUIRE THAT THE CONSTRUCTION ... (cont.)

- B. Lender's knowledge of the potential commencement of the work of improvement
- C. Lender's written disclosure to the escrow agent and the title insurer before the recordation of the Deed of Trust that there may have been a commencement of the work of improvement

XII. 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

XII. 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 Security

XIII. DISBURSEMENT OF CONSTRUCTION LOAN FUNDS

- A. Introduction
- B. Should construction loan funds be disbursed directly to the borrower?
- C. Should construction loan funds be disbursed jointly to the borrower and the general contractor?
- D. Should construction loan funds be disbursed jointly to the borrower, general contractor and sub-contractor?

XIII. DISBURSEMENT OF CONSTRUCTION . . . (cont.)

E. Potential lender liability for wrongful disbursement of construction loan funds

XIV. CONSENSUAL MODIFICATION OF A NON-DEFAULTED CONSTRUCTION LOAN

Modification Endorsement for the Loan Policy of Title Insurance. [ALTA Forms 11-06, 11.1-06 and 11.2-06 and CLTA Forms 110.11-06, 110.11-06 and 110.11.2-06]

- Inclusion of all necessary parties. [First California Bank v. McDonald (2014) 231 Cal.App.4th 550]
- The “Protocol” Agreement.

XV. BORROWER DEFAULTS AFTER THE COMMENCEMENT OF CONSTRUCTION

- A. Introduction
- B. Understand the nature and extent of the defaults
- C. A complete construction project is better than an incomplete project
- D. Involve all of the “interested” parties (i.e. guarantor, general contractor, title insurer, etc.) in a confidential mediation

XVI. IF THE CONSTRUCTION LENDER STOPS DISBURSEMENT, BECAUSE THE BORROWER IS IN DEFAULT, HAS THE LENDER “CREATED” ANY MECHANICS LINES WHICH MAY ARISE

- A. Introduction
- B. Exclusion from Coverage 3(a) of the ALTA Loan Policy

XVII. MITIGATING THE RISKS TO THE LENDER OF “OVER BUDGET” CONSTRUCTION LOANS

- A. Guaranties
- B. Additional Security
- C. Payment Bond
- D. Completion Bond
- E. Loan Provisions
- F. Change Orders

XVIII. DEFECTS IN DESIGN OR CONSTRUCTION

- A. Whose fault is it?
- B. What can be done?
- C. Who will pay for the correction of the defects?
- D. Have you identified all of the defects?

XIX. STOP PAYMENT NOTICES AND MECHANICS LIENS

- A. What caused the problem?
- B. Immediate demand upon borrower, guarantors, escrow agent and title insurer
- C. Who is responsible?
- D. How does the construction get completed?
- E. The role of tolling agreements
- F. The lender's obligation to withhold funds upon receipt of a Bonded Stop Notice

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XX. CONCLUSION

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