

# Buchalter

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## **AVOIDING LOSS OF LIEN PRIORITY: *CONSTRUCTION LOAN DISBURSEMENTS***

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

Buchalter  
12:00 Noon PST  
May 8, 2018  
Los Angeles, California

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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. 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 ABA's Title Insurance Litigation Committee.



**John L. Hosack**  
Shareholder  
Los Angeles Office

## Jason E. Goldstein—*Presenter*

Jason Goldstein is a Shareholder in the Firm's Litigation Practice Group in Irvine and Chairman of the Firm's Mortgage Banking Group. Mr. Goldstein specializes in real property related claims, litigation and private money, including defending lenders, brokers and servicers in court (negligence, fraud, TILA, RESPA, HBOR, wrongful foreclosure, lender/servicer liability, etc.) and before government agencies. Mr. Goldstein also regularly prosecutes misappropriation of trade secret claims, judicial foreclosures and conducts general civil litigation. He is a fellow of the American College of Mortgage Attorneys, an affiliate member of the California Mortgage Association and a member of the California MBA.



**Jason E. Goldstein**  
Shareholder  
Irvine Office

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## Joffrey Long —*Presenter*

Joffrey Long is President of Southwest Mortgage, a lender/broker that makes, arranges, and services non-consumer and consumer loans real estate loans including both private money and institutional loans. He has been licensed as a real estate broker and active in real estate lending since 1979.

He is a member of the California Mortgage Association (CMA) Education Committee, a Past CMA Education Chair and Past CMA President. He has been a member of CMA's Board of Directors since 2001.

Joffrey frequently serves as an expert witness, providing mortgage expert witness reports, declarations and expert testimony. He has testified in numerous depositions, arbitrations and trials relating to real estate lending, loan servicing, loan brokerage and trust deed investment matters.



**Joffrey Long**  
President  
Southwest Mortgage

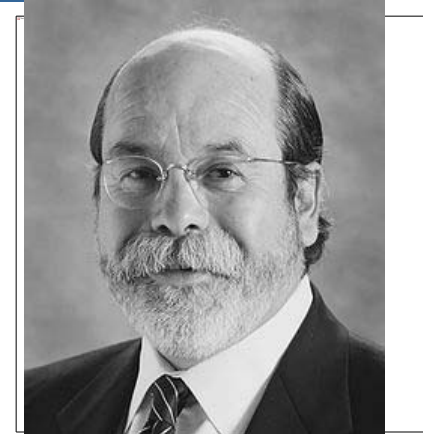
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## Rick Rodriguez

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**  
Principal  
Rodriguez Associates  
Advisory Group

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# I. INTRODUCTION

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## II. THE CONSTRUCTION LENDER'S ESCROW INSTRUCTIONS (1 of 3)

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- 1. Appropriate written escrow instructions should be addressed to the title insurer (underwritten title company/agent/approved attorney) and the escrow agent.**
- 2. The written escrow instructions must instruct that the deed of trust be recorded as a first priority lien on the borrower's property which is described in the lender's deed of trust. A separate instruction title insurance should be requested.**
- 3. The written escrow instructions must disclose that there "may" have been a commencement of the work of improvement on the property.**

## II. THE CONSTRUCTION LENDER'S ESCROW INSTRUCTIONS (2 of 3)

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4. The California Land Title Association (“CLTA”) Policy does not provide mechanic’s lien coverage.
5. The American Land Title Association (“ALTA”) Extended Coverage Loan Policy does provide mechanic’s lien coverage.
6. Beware of “regional exceptions” which may delete mechanic’s lien coverage (and turn an ALTA policy into a CLTA policy).
7. Beware: escrow instructions to your title insurer and escrow agent may not protect the construction loan from stop notice claims.
8. Tip: obtain a surety bond to keep mechanic’s liens from attaching to the property.

## II. THE CONSTRUCTION LENDER'S ESCROW INSTRUCTIONS (3 of 3)

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9. The written escrow instructions should prohibit the title insurer and escrow agent from using indemnities.
10. Matters to consider: Mello Roos, CC&R's, favorable leases and utility easements.

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*Trends in financing, documentation and regulation*

*Building "fences" around potential problems*

John L. Hosack, Esq., Oren Bitan, Esq., Richard Ormond, Esq., Mr. Rick Rodriguez  
and Mr. Glenn Goldan

September 12, 2018 @ 12:00 Noon PST

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1000 Wilshire Boulevard, Suite 1500

Los Angeles, California 90017

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### III. IDENTIFYING AND DEALING WITH SUBORDINATE INTERESTS IN THE PROPERTY (1 of 2)

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- 1. Identify and prepare deal with all persons who have, or may acquire, a subordinate interest in the property.**
- 2. A construction lender cannot rely on the preliminary report, commitment for title insurance or loan policy of title insurance to inform it of who has a subordinate interest.**
- 3. Obtain a list from the borrower and general contractor of anyone who has been engaged to perform work, or who has performed work, on the property – and have the list constantly updated.**

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### III. IDENTIFYING AND DEALING WITH SUBORDINATE INTERESTS IN THE PROPERTY (2 of 2)

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4. **When loan advances are made obtain, among other things, lien waivers and/or subordination agreements.**
5. **Have the title insurance company plot the easements.**
6. **Obtain date-downs.**

## IV. THE LOAN POLICY OF TITLE INSURANCE (& Title Products) (1 of 2)

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1. The Loan Policy of Title Insurance should be an ALTA Extended Coverage Policy (2006).
2. The Loan Policy of Title Insurance should be in the amount: (1) the loan; (2) the anticipated value of the completed improvements; and (3) an additional 25% to cover any delay (125%).
3. Obtain reinsurance on larger loans.
4. Obtain co-insurance on larger loans.
5. “Underwrite” the title insurance company and escrow company.

## IV. THE LOAN POLICY OF TITLE INSURANCE (& Title Products) (2 of 2)

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6. Obtain a Trustee's Sale Guarantee before starting the foreclosure process.
7. Request that the title insurer issue an Owner's Policy of Title Insurance in the event the lender is required to foreclose its Deed of Trust.

## V. OBTAIN ALL APPROPRIATE ENDORSEMENTS TO THE LOAN POLICY OF TITLE INSURANCE (1 of 5)

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**A title insurance policy is similar to house.**



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## V. OBTAIN ALL APPROPRIATE ENDORSEMENTS TO THE LOAN POLICY OF TITLE INSURANCE (2 of 5)

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**But a title insurance policy with no endorsements is a house with a hole (or many holes) in the roof.**



## V. OBTAIN ALL APPROPRIATE ENDORSEMENTS TO THE LOAN POLICY OF TITLE INSURANCE (3 of 5)

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**Unless you like holes in your title insurance policy, you should consider endorsements.**



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## V. OBTAIN ALL APPROPRIATE ENDORSEMENTS TO THE LOAN POLICY OF TITLE INSURANCE (4 OF 5)

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1. ALTA 3.2-06 (zoning – land under development)
2. ALTA 6-06 (variable rate mortgage)
3. ALTA 8.2-06 (environmental lien protection – commercial)
4. ALTA 9.7-06 (private rights – stating “none”)
5. ALTA 9.7-06 (restrictions, encroachments, minerals – land under development)
6. ALTA 17-06 (access)
7. ALTA 17.2-06 (utility access)
8. ALTA 18-06 (single tax parcel)
9. ALTA 19.1 (contiguity)
10. ALTA 22-06 (location)
11. ALTA 24-06 (doing business)
12. ALTA 25-06 (same as survey)
13. ALTA 26-06 (subdivision)
14. ALTA 27-06 (usury)



## V. OBTAIN ALL APPROPRIATE ENDORSEMENTS TO THE LOAN POLICY OF TITLE INSURANCE (5 OF 5)

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15. ALTA 28-06 (easement – damage for enforced removal)
16. ALTA 28.3-06 (encroachments, boundaries and easements, described improvements – land under development)
17. ALTA 39-06 (policy authentication)
18. CLTA 100.19 (CC&R's – violations)
19. SPECIAL (deletion of arbitration provisions)
20. POST CLOSING: CLTA 122-06 (obligatory advance)
21. ALTA 32-06 (construction loan – loss of priority)
22. ALTA 32.1-06 (construction loan – loss of priority – direct payment)
23. ALTA 32.2-06 (construction loan – loss of priority – insured's direct payment)
24. ALTA 33.06 (construction loan disbursement)
25. CLTA 102.4-06 (03-09-07) (foundation endorsement)

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## VI. LOAN DOCUMENTATION FOR DISBURSING CONSTRUCTION LOAN FUNDS

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- 1. The construction loan documents should detail – with specificity – the exact circumstances under which the construction loan advances will be made (sole & absolute discretion).**
- 2. The construction loan documents should entitle the lender to inspect the borrower’s property and communicate with the general contractor and subcontractors and waive the any obligation to inform the borrowers and guarantors about the results of the inspection or communication.**

## VII. WHO WILL MAKE THE CONSTRUCTION LOAN DISBURSEMENTS

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- 1. Overview.**
- 2. Fund disbursement company.**
- 3. Title insurer.**

## VIII. TO WHOM SHOULD THE CONSTRUCTION LOAN FUNDS BE DISBURSED

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- 1. Borrower.**
- 2. Joint check payable to borrower and general contractor.**
- 3. Lender should be able to change the method of disbursement in its sole and absolute discretion.**

## IX. ARE THE CONSTRUCTION LOAN ADVANCES “OBLIGATORY” OR “OPTIONAL”

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- 1. Do the loan documents “automatically” make an advance “optional” if a default occurs?**
- 2. Do the loan documents require that a default be declared in writing by the lender before the borrower is in default?**
- 3. If the lender’s advance is “optional,” it will be subordinate to junior interest on the property.**
- 4. Protecting against “waiver” issues.**

## X. LENDER'S INSTRUCTIONS TO THE DISBURSING PARTY

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1. There should be clear instructions to the disbursing party if the lender is not disbursing the funds.
2. Funds should only be disbursed if the disbursement will be secured by a first priority lien.
3. Before a disbursement is made, it should be determined if there are any subordinate interests on the property.
4. If subordinate interests are identified, they should be requested to subordinate to the disbursement(s) – and if there is no agreement, no advances should be made until there is a satisfactory alternative.
5. An endorsement to the Loan Policy of Title Insurance should be obtained when each disbursement is made.

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## XI. AVOIDING THE LOSS OF LIEN PRIORITY (1 of 3)

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- 1. Determine if there are subordinate interests.**
- 2. Examples which may cause loss of lien priority:**
  - A. Change in interest rates.**
  - B. Extension of maturity date.**
  - C. Increase in loan amount.**
  - D. Change in security.**
  - E. Forbearance agreement (disguised extension request)**

## XI. AVOIDING THE LOSS OF LIEN PRIORITY (2 of 3)

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### 3. Potential adverse consequences for the lender.

- A. **Loss of entire lien priority. (See, *Gluskin v. Atlantic Savings & Loan Ass'n.* (1973) 32 Cal.app.3d 307)**
- B. **Loss of lien priority to the extent of the increased burden on junior lienholders (See, *Lennar Northeast Partners v. Buice* (1996) 49 Cal.App.4<sup>th</sup> 1576)**

## XI. AVOIDING THE LOSS OF LIEN PRIORITY (3 of 3)

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### 4. Lender's remedies to avoid the loss of lien priority:

- A. Record a Notice of Modification.**
- B. Obtain subordination agreements from subordinate interest holders.**
- C. Obtain modification endorsements to the Loan Policy of Title Insurance.**
  - 1. ALTA Form 11-06**
  - 2. CLTA Form 110.5-06**

## XII. LENDER ALTERNATIVES IN THE EVENT OF DEFAULT

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1. Events of default, e.g., recordation of mechanic's lien, stop payment notice, etc.
2. **Immediately notify borrower and guarantor - *in writing* - of default and request that they cure.**
3. **Depending on nature of default, immediately inform in writing the title insurer, escrow agent and/or surety.**
4. **Determine if the borrower(s)/guarantor(s) can increase their equity contribution to the project.**
5. **Determine whether borrower can obtain additional financing.**
6. **Determine whether borrower can obtain additional investors.**
7. **Determine whether the borrower can reduce the scope of the construction project.**
8. **Determine whether the borrower can sell the property in its "as-is" incomplete current condition.**
9. **Determine if the construction loan can be sold at an acceptable discount.**
10. **Multi-beneficiary loan issues.**

## XIII. THE LENDER'S RIGHTS AGAINST THE BORROWERS AND GUARANTORS

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1. The loan documents should expressly provide that the borrower and guarantor have liability for the default(s).
2. The borrower and guarantor should have executed and delivered to the construction lender “completion guarantees.”
3. No modifications of the loan should be made without the prior written consent of borrower, guarantor and the title insurer.
4. Keep borrowers and guarantors informed of the good news – *and the bad news.*

## XIV. AVOIDING THE LOSS OF LIEN PRIORITY BY PARTIAL RECONVEYANCES

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- 1. Partial reconveyances may subject the construction lender's lien to a loss of lien priority.**
- 2. Obtain a CLTA Series 111 endorsement in conjunction with any partial reconveyance.**
- 3. Consider the skill level of the person giving the partial reconveyance.**
- 4. Confirm that the documentation of the loan was proper from the outset.**

## XV. THE CONSTRUCTION LENDER'S RESPONSE TO MECHANIC'S LIENS AND STOP NOTICES (1 of 8)

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### 1. Principal Mechanic's Lien Defenses

- **Immediately tender to borrower, guarantor, title insurer, escrow agent and surety.**
- **Lack of the required license “. . . at all times . . . .” during performance. [See, California Bus. & Prof. Code Section 7031(a)]**
- **Failure to serve a preliminary notice on both the lender and the owner [See, California Civil Code Sections 8200 and 8416(c)-(d)].**
- **Obtain and record a payment bond, which makes the lien of the lender's Deed of Trust superior to work performed after recordation of the payment bond [See, California Civil Code Section 8452].**

## XV. THE CONSTRUCTION LENDER'S RESPONSE TO MECHANIC'S LIENS AND STOP NOTICES (2 of 8)

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### 1. Principal Mechanic's Lien Defenses (cont.)

- Did the claimant record a claim of lien within the time required [See, *California Civil Code Sections 3412, 3414 and 8448*]
- Did the claimant timely file the foreclosure action [See, *California Civil Code Section 8460*]
- Did the claimant record a *lis pendens* within 20 days of filing the foreclosure action [See, *California Civil Code Section 8461*]
- The equitable defense of “unclean hands” can invalidate the mechanics lien claim [See, *Burton v. Sosinsky (1988) 203 Cal.App.3d 562*]



## XV. THE CONSTRUCTION LENDER'S RESPONSE TO MECHANIC'S LIENS AND STOP NOTICES (3 of 8)

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### 1. Principal Mechanic's Lien Defenses (cont.)

- Estoppel and laches may bar a claimant who exercises its rights in disregard of others [See, *A.A. Baxter Corp. v. Home Owners & Lenders* (1970) 7 Cal.App.3d 725]

## XV. THE CONSTRUCTION LENDER'S RESPONSE TO MECHANIC'S LIENS AND STOP NOTICES (4 of 8)

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### 2. Principal Stop Payment Notice Defenses

- **Immediately tender to borrower, guarantor and title insurer.**
- **Was it served on the lender before expiration of the time to record a mechanic's lien. [*See, California Civil Code Section 8508(b)*]**
- **Did the claimant give a timely preliminary notice [*See, California Civil Code Section 8200*]**
- **Was the stop payment notice accompanied by a bond equal to 125% of the claim amount [*See, California Civil Code Section 8536(b)(1)*]**

## XV. THE CONSTRUCTION LENDER'S RESPONSE TO MECHANIC'S LIENS AND STOP NOTICES (5 of 8)

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### 2. Principal Stop Payment Notice Defenses (cont.)

- If a payment bond had been recorded before the lender is given a stop payment notice, the lender may disregard the stop payment notice unless it is given by a direct contractor [See, *California Civil Code Section 8536(b)*]
- Determine whether the individual sureties are sufficient [See, *California Civil Code Section 8534*]
- Was the stop payment notice served on “. . . the manager or other responsible officer or person at the office or branch of the lender administering or holding the construction funds . . .” [See, *California Civil Code Section 8505(b)*]

## XV. THE CONSTRUCTION LENDER'S RESPONSE TO MECHANIC'S LIENS AND STOP NOTICES (6 of 8)

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### 2. Principal Stop Payment Notice Defenses (cont.)

- Was the construction loan for a work of improvement located in California [*See, Mechanical Wholesale Corp. v. Fuji Bank, Ltd. (1996) 42 Cal.App.4<sup>th</sup> 1647*]
- Does the stop payment notice seek payment for work performed after the date of the notice [*See, California Civil Section 8502(c)*]
- The conflict between *Familian Corp. v. Imperial Bank (1989) 213 Cal. App.3d 681* and *Steiny & Co. v. Citicorp Real Estate, Inc. (1999) 72 Cal. App.4<sup>th</sup> 199*

## XV. THE CONSTRUCTION LENDER'S RESPONSE TO MECHANIC'S LIENS AND STOP NOTICES (7 of 8)

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### 3. Additional Due Diligence

- Once a month have title checked for mechanics liens and other recorded matters (*i.e.*, unauthorized conveyance, encumbrance, etc.).
- Once a month conduct a litigation search on the borrower, general contractor and subcontractors.
- In the event of the recordation of a mechanics lien or the service of a stop notice immediately notify in writing the title insurer, escrow agent and surety company (assuming that a mechanics lien bond was obtained).
- In the event a mechanics lien is recorded or a stop notice is received immediately make written demand upon the borrower and the guarantor to eliminate the same and hold you harmless.

## XV. THE CONSTRUCTION LENDER'S RESPONSE TO MECHANIC'S LIENS AND STOP NOTICES (8 of 8)

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### 3. Additional Due Diligence (cont.)

- **Do not stop construction loan disbursements even if there is a default, until after you have consulted with the title insurer to determine what effect, if any, termination of construction loan disbursements would have on policy of title insurance coverage for mechanics liens.**

## XVI. THE CONSTRUCTION LENDER'S RIGHTS OF EQUITABLE SUBROGATION

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- 1. Equitable subrogation considerations when the construction lender satisfies an existing lien as part of its construction loan.**

## XVII. IF THE CONSTRUCTION LENDER STOPS DISBURSEMENTS, WILL IT HAVE “CREATED” THE MECHANIC’S LIENS

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1. Concerns with stopping disbursements: **creation** of mechanic’s liens and the **loss** of title insurance coverage.
2. Exclusion 3(a) – the basis for title insurer’s to claim that the termination of construction loan advances “created” the mechanic’s liens. See, e.g., *Bankers Trust Company v. Transamerica Title Ins. Co.* (10<sup>th</sup> Cir. 1979) 594 F.2d 231 **and its progeny**.



## XVIII. REQUIREMENTS FOR FINAL ADVANCES

1. Determine whether the project has been completed in accordance with the plans, specifications and all government requirements (permits, etc.)
2. Obtain an “as-built” survey showing the location of the improvements.
3. Record a “valid” notice of completion (don’t be the “*soap dish case*”).
4. Obtain appropriate endorsements to the Loan Policy of Title Insurance (CLTA 101.5 / CLTA 101.6).
5. Holdback disbursements.

## XIX. CONCLUSION

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