CONSTRUCTION
ADVISORY
REPORT

HILL

The Most Current Construction Topics, Issues, and Advice

In this Issue:

Hill International, Inc.'s Claims & Consulting Group produces this newsletter to create a forum which addresses key issues related to the construction industry. The information contained herein is for general informational purposes only and should not be relied upon as legal advice. This information cannot be applied to specific facts and circumstances without the advice of legal counsel.

Legal Issues Involving Distressed Properties

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In today's real estate climate, many commercial transactions involve property that is subject to foreclosure, loan default, bankruptcy, litigation, property value decline, tenant problems or has experienced other significant difficulties. When dealing with distressed property, parties must be aware of certain issues and possible pitfalls that may not arise in normal transactions. This article will discuss some basic considerations that parties should consider when purchasing distressed property or in connection with receivership and workout situations.

FIVE ISSUES FOR PARTIES CONSIDERING THE ACQUISITIONS OF DISTRESSED PROPERTY

1. **Normal Due Diligence Activities:**

   In any real estate acquisition, due diligence plays a vital role. Thorough due diligence is even more important when purchasing distressed property. A complete investigation of the status of the property is critical to protect the buyer from unknown risks, but the issues and problems ascertained can also be used to negotiate a lower purchase price. Normal activities include the following:

   a. **Building Inspection:**

      If the property has been neglected due to abandonment or inability to pay for normal maintenance and repairs, a proper building inspection will help disclose these items and identify future expenses not factored into original valuations.

b. **Title Review:**

When conducting title review, the buyer should pay special attention to any development agreements, CC&Rs or similar encumbrances that impose assessments, development restrictions, timelines for construction, etc. The owner, due to financial inability or other constraints, may have failed to comply. If so, such failure could result in significant costs, potential litigation and/or have an adverse impact on the viability of the buyer's planned development or use of the property.

c. **Tenants:**

It is imperative to review the terms of all leases, operating contracts and similar documents. The length of the leases and viability of each tenant should be closely scrutinized. Lease defaults and lease expirations (that cannot be immediately renewed) will have a dramatic impact on the value of the property. Tenant estoppel certificates should be obtained from each tenant whereby the tenants and the existing owner certify the terms of the leases and that the instruments are in full force and effect without existing or potential defaults. The leases should be scoured thoroughly for any terms and conditions that would give the tenants an exit right or ability to reduce rent. For instance, a co-tenancy clause may allow a retail tenant to reduce rent or terminate a lease when an anchor tenant leaves the property.

d. **Other Standard Due Dilligence:**

Of course, an ALTA survey, Phase I environmental site assessment and other standard due diligence activities should also be considered.

2. **Existing and Potential Claims and Disputes:**

The buyer should ask its lawyer or a consultant to conduct a litigation search and have the seller to disclose all existing and potential claims and disputes. The lawyer may wish to consult with knowledgeable attorneys regarding real estate, environmental and bankruptcy issues that exist or may arise. In many distressed property cases, the owner not only has problems with its lender, but possible litigation may be looming between the investors, partners and members comprising the ownership itself. Beware of situations where the owner's prospective development or operations were funded by passive investors who are now disgruntled.

3. **Zoning Issues:**

A buyer typically should conduct a thorough investigation of the current zoning and land use of the property, including any pending approvals or outstanding zoning or site plan stipulations.

Owners of distressed properties often have obtained zoning or site plan approvals based on specific stipulations that must be fulfilled. Some of these stipulations may have time restrictions and these time restrictions may not have been met. Failure to conform to these stipulations within the required time could cause the entitlements to lapse. If the buyer fails to adequately investigate the land use and zoning requirements of the property, the buyer may find itself in a position where the recently acquired property is unusable for its prospective use.

4. **Valuations:**

The buyer should strongly consider obtaining multiple appraisals and/or professional opinions with respect to the valuation of the property. Accurate valuations are very difficult in the current economic market as there is little in the way of true arm's length transactions. By obtaining multiple appraisals, a buyer can obtain a better understanding of the fair market value.

5. **Surrounding Development:**

Determine whether all off-site improvements and infrastructure serving the development have been completed. In many cases, buyers acquire property only to learn that the master developer is unable to complete roads, utilities or other improvements that are necessary in order for the property owner to obtain building improvements and building permits for its parcel. If there is uncompleted infrastructure or improvements, the buyer should consider demanding a hold-back of the purchase price or other security to ensure that all improvements are made.

When buying a parcel within a larger development, the buyer should determine whether the center is viable and whether assessments from the other occupants are current. If the center is not being maintained, this can greatly impact the viability of the center and value of the property being purchased.

WORKOUT AGREEMENTS

Decreased property values and the lack of willing purchasers have made foreclosure a very unattractive option for many lenders in today's market. Because of the current economic conditions, many lenders prefer to provide loan extensions in hopes of receiving some repayment and eventually benefiting from a future economic turnaround. It is for these reasons that workout agreements have become a sought after alternative for many lenders.

Workouts are agreements between defaulting parties and the parties to whom they owe obligations that provide for payment of the obligation, while affording the defaulting party the opportunity to benefit from the value of the project. Since most real estate projects are owned by single asset entities, any security or assurance the lender or landlord would demand in the event of default is usually not available. The demand itself may increase the likelihood of bankruptcy, which is an unpalatable risk for most lenders or landlords. Therefore, the landlord and lender will sometimes seek some kind of resolution, known as a workout.

Common types of workouts include: (i) loan or lease renegotiation; (ii) redesign projects to a more manageable size; (iii) for loans, all or a portion of the property could be sold or refinanced while the lender forebears all or part of the regular payments; (iv) borrower or tenant could be recapitalized with a new partner contributing additional equity and possibly expertise which reduces risk to the lender; (v) deed in lieu of foreclosure in return for releasing borrower or guarantor; and (vi) termination of lease in exchange for a payment by the tenant.

Whatever type of workout is performed, it is important that the lender require the distressed party to fully disclose its financial condition, both at the time the agreement is executed and on a continuing basis during the term of the workout. A lender should typically have the borrower or tenant waive any claims against the lender or landlord, and the consideration for the accommodations made to the distressed party should be clearly explained. Parties should affirm the terms of the original agreement. Unlike normal transactions, if the negotiations concerning the workout fail, the parties usually cannot simply walk away from each other; litigation will be a probable outcome. Therefore, lenders are increasingly weary of workouts because, if the attempted workout fails, the lender faces the prospect of claims being brought by the borrower. One method of limiting a lender's risk of potential liability is through a pre-workout agreement.

PRE-WORKOUT AGREEMENTS

A pre-workout agreement can increase the likelihood of successful negotiations and limit the parties' liabilities as it sets the parameters of the negotiations and helps prevent misunderstandings.

The agreement should specify the intentions of the parties in their attempt to agree on terms for restructuring the loan. It is important that the agreement provide a statement allowing any party to terminate negotiations without risk of liability. A lender should insist that the pre-workout agreement mandate that the borrower continue to pursue other prospects during the negotiation, as the negotiations may not end in an agreement.

A poorly drafted pre-workout agreement, or even worse no agreement at all, puts the lender at risk that its statements will be understood (or at least argued by the borrower to be) default waivers or acceptance of the restructuring terms. Therefore, from the lender's perspective, the pre-workout agreement should explicitly require that any agreement resulting from the negotiations be in writing and signed by both parties. This should help prevent the borrower from claiming that during the negotiations the lender orally agreed to certain terms or waived various remedies.

Although a pre-workout agreement is not always necessary, it is important to consider the overall negotiations and what leverage a pre-workout agreement may provide. In many situations, a pre-workout agreement can serve as a means to limit lender liability during attempts to workout a loan.

RECEIVERSHIPS

Lenders need to be aware that taking title to distressed property through a deed in lieu of foreclosure will cause the lender to take the property subject to other existing liens, including mechanics' liens. Lenders also need to be aware that taking title to distressed property through foreclosure may cause the lender to take on unknown liabilities that are associated with the property. The liabilities greatly increase if the distressed property is in a construction phase as the lender will need to decide whether or not to complete construction. A lender will want to consider the appointment of a receiver to reduce exposure and preserve the collateral. When a party in interest in an asset demonstrates that the property is in need of protection or preservation, a court may appoint a receiver to take control of the property and administer the property, regardless of whether or not the debtor is present in the jurisdiction or gives consent to the receivership. The receiver (who is appointed by the court and therefore has quasi-judicial immunity) will insulate the lender from liability as it will allow the lender to delay taking title to the property. Additionally, the receiver will assume daily management and operation activities such as the collection of rents and property management.

The appointment of a receiver will not invalidate a mechanic's lien. Rather, the receiver takes the property subject to all valid liens, properties, and encumbrances. 1 Clark on Receivers § 272 (1959). However, it is important to note that although the appointment of a receiver does not invalidate a mechanic's lien, should the receiver get authority to borrow money during its control, that new loan may be considered a higher priority than any previously acquired mechanic's lien.

Asking a court to appoint a receiver will likely save the lender time and money as it will allow the lender to focus primarily on their area of expertise. Further, a receiver may increase the value of the property as the receiver will collect rents, pay for maintenance and improvements and prevent decay of the property. Most importantly, the receiver will likely protect the lender from liabilities and obligations associated with taking title to the property.

This article only provides a brief overview of the issues to consider when acquiring distressed property and the basic elements of receiverships, workout and pre-workout agreements. In today's market there are many opportunities involving undervalued land, but parties must be aware that distressed property carries many potential problems that are not found in normal transactions. Therefore, anyone interested in a deal involving distressed property should consult an experienced real estate attorney that deals with distressed property, along with experienced environmental and bankruptcy attorneys if appropriate.

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Distressed Assets and the Hospitality Industry Update in 2010: We're not out of the woods, yet…

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The sentiments going through each of our minds as we bid 2009 a "good riddance" and trek cautiously and more hopefully into 2010, emulate Franklin Roosevelt's famous quote: "We have nothing to fear but fear itself."

In response to the depressed state of the real estate and capital markets, large amounts of capital are now chasing opportunities to purchase defaulted hotels, as well as hotel real estate loans at a discount. Not since the savings and loan crisis in the late 1980's has the market expected a comparable volume of distressed hotels to be sold. For savvy buyers, this is a chance to earn enviable returns.

"This is like deja vu all over again." – Yogi Berra

Between 1989 and mid-1995, the Resolution Trust Corporation (RTC) closed or otherwise resolved 747 thrifts with total assets of $394 billion. When asked about what is the most exciting component of 2010 - Andrew Segal, president of Boxer Property in Houston said it well: "Unprecedented low priced buying opportunities." When asked about what are the biggest worries of 2010: "Unprecedented low priced selling opportunities."

THE STATE OF THE MARKET

Bloomberg: "Luxury Hotel Sales May Increase in 2010 as Property Values Drop". Luxury hotels will be among U.S. lodging industry's most traded real estate next year as buyers go after high-end properties that have slumped in value," said Arthur Adler, chief executive officer for the Americas at Jones Lang LaSalle Hotels. "The luxury hotel sector is among the top active sectors because there are more challenges…Luxury hotels have suffered the most. The possible discounts, if properties come to market and trade, will be greater in this sector than in others."

Reuters: "Global hotel deals to rise 40 percent in 2010". Global hotel transactions are forecast to rebound by up to 40 percent in 2010, boosted by Asian and Middle Eastern investors, after sales volumes plunged to a decade low this year. Between $11 billion and $13 billion worth of hotels are expected to change hands next year, recovering from the market's 64 percent year-on-year decline of $9 billion in 2009, investment services firm Jones Lang LaSalle Hotels said."

"You've got to be very careful if you don't know where you're going, because you might not get there."
– Yogi Berra

Previously, during the RTC debacle in the '90's, at least there was some capital available. This time lack of capital is the problem. We are seeing lenders cautiously getting back into the market, but at debt coverage ratios at more historic levels. Interest rates are pegged to Prime versus LIBOR that better reflect the risk of these investments. Over the years, the benchmark DCR or Debt Coverage Ratio (the debt coverage ratio is calculated by dividing the Net Operating Income (NOI) by a property's annual debt service. Annual debt service equals the annual total of all interest and principal paid for all loans on a property. A debt coverage ratio of less than 1.0 indicates that the income generated by a property is insufficient to cover the mortgage payments and operating expenses.) For hospitality properties, DCR has historically been approximately 1.40. When we look at upcoming commercial mortgage-backed securities (CMBS) and other loans rolling over, there is a "high water mark" based on real time stressed occupancies and ADR's (average daily rate) – in other words, how many properties today are achieving that DCR?

Per the Urban Land Institute's December 2009 newsletter, hotel occupancy rates (a moving 12-month average) stood at 58.7 percent in third-quarter 2009, down from 60 percent in the first quarter of 2009, and 680 basis points below the same quarter a year ago. Completions were up slightly as a percentage of rooms, from 2.6 percent in third-quarter 2008 to 3.2 percent. Revenue per available room (RevPAR) fell in the third quarter of 2009 compared to the same quarter a year ago, off by 23.1 percent.

According to PKF Hospitality Research's (PKF-HR) December 2009 report: "The year 2010 will continue to be a tough one for U.S. hotel owners and operators. PKF-HR is forecasting that, on average, properties will continue to suffer year-over-year declines in revenue and profits from an already dismal 2009. However, given the deceleration of room rate discounting observed during the third quarter of 2009, the severity of the losses incurred in 2009 and 2010 will be less than previously forecast. In addition, year-over-year growth in important measurements, such as occupancy, RevPAR, and demand, will be realized a full quarter earlier than thought three months ago.

"Accordingly, this year's annual ADR forecast has been reduced to a decline of 8.8 percent, and the 2010 ADR forecast is now a minus 1.5 percent. These compare to declines of 10.4 percent and 3.1 percent that we forecast last quarter.

"The steep declines in RevPAR and the resulting historic contraction in Net Operating Income at the property level have severely undermined the ability of many owners to meet their debt service obligations. This difficulty has been compounded by the economic reality that many hotels that are serving as the sole source of collateral for the mortgage holders of these assets are no longer worth the face amount of the debt. Data from Trepp LLC illustrates how rapidly this situation has deteriorated. At the beginning of the financial panic in September 2008, only 0.55 percent of the roughly 3,700 CMBS hotel loans were in some form of delinquency or default. By June of 2009, this number had increased to 4.31 percent. As of December 10, 2009, the volume of non-performing CMBS hotel loans had sky-rocketed to 13.47 percent."

According to Moody's Investors Service: "Although the pace of decline has continued to slow in recent months, commercial property prices have fallen nearly 44% since their peak two years ago, and now look more like what the industry saw in 2002."

"The pace of declines has tapered off since the large drops measured in April and May; however, further declines are anticipated," the report states. With the 43.7% drop in the Moody's/REAL National All-Property Aggregate since the October 2007 peak, "it is now necessary to look to properties purchased in 2002 to find positive price appreciation."

In particular, the report notes the effects of price drops on loan to values are especially pronounced with more recent acquisitions. "On average, loans originated at a 75% LTV in 2005 or later are now under water" with an average LTV today of 108%, says the report. Although most of the loans will not mature for several years, thus giving values a chance to recover, "later vintage loans are in a deep hole" and face increasing risk of short term default as property fundamentals continue to erode.

"When it comes to the rate of recovery for commercial real estate, federal policymakers are setting the pace more so than market fundamentals," say experts in a report based on Pricewaterhousecoopers' quarterly Korpacz Real Estate Investor Survey.

Dr. David Kelly of J.P. Morgan Asset Management recently reported: "Unemployment always goes up more quickly than it comes down. We may not reach that level (full-employment is defined by most economists at an unemployment rate of about 5%) until some time in 2014." The United States was at 10.0 percent unemployment in December, the highest unemployment rate since 1983.

According to Bloomberg, "The delinquency rate (in commercial real estate) will not improve until the unemployment rate drops and consumer spending revives."

"Baseball is 90% mental -- the other half is physical." – Yogi Berra

The gravity of the real time problem is staggering. Approximately 1,341 commercial properties in California and 8,393 commercial properties across the United States, that have maturing CMBS debt in the coming 18-months, almost $7 billion dollars of hotel debt alone, matures in the next 18-months. By example:

California hotel loans: $6.959B

Number of CMBS loans maturing by property type in next 18-months:

Hotel and Resort, California: 195

Hotel and Resort, United States: 1,484

But then consider that CMBS debt is only approximately 25% of all commercial real estate debt which is based on $3.47 trillion in commercial real estate and multifamily mortgage debt outstanding.

The vast majority of this hotel debt coming due was:

- Underwritten between 1999 and 2003;
- Before peak valuations in 2007; and
- Today's valuations are probably higher than they were at time of the origination of the loans.

The question becomes, "How much of this debt will present with a minimum of a 1.20 to 1.4 debt coverage ration at roll-over time?"

Moody's Investors Service reported during the Christmas week that multifamily delinquencies rose by nearly a full percentage point between October and November 2009. In fact, multifamily ranked second only to hotels in terms of the month-to-month increase in the amount of delinquent loans.

Data from Trepp LLC illustrates the highest delinquency rates in CMBS loans so far have been:

- **Hospitality:** 13.47%
- **Multifamily:** 13.0%
- **Retail:** 9.7%
- **Other:** 7.2%
- **Office:** 4.9%

Two of the larger CMBS portfolios that exhibited stress in 2009 were:

- A $967.2 million mortgage on a hotel portfolio controlled by CNL Hotels & Resorts
- A $344.6 million loan on a hotel portfolio owned by Beanie Baby investor Ty Warner

"You can observe a lot just by watching." – Yogi Berra

Coming out of the Holiday season, a Charles Dickens story seems appropriate: A Tale of Two Cities. These are two real time case studies evolving at this time with branded hotels in established markets:

Hotel Default of Week One - Baird/Baird Real Estate

Hyatt Columbus Capitol Square. The 400-room Hyatt Capitol Square in Columbus, Ohio was purchased for $38.7 million ($96,750/key) in 2007 and funded with a $32 million ($80,000/key), 10-year CMBS loan originated by LaSalle Bank. Today the loan is in special servicing with LNR Partners after the hotel generated only $3.2 million of NOI in 2008. At last report the hotel was covering debt service, but below the 1.15x covenant which triggered special servicing for the loan. The hotel was built in 1984 and is reportedly in good condition, but suffering from overall weak demand in the Columbus market. Bloomberg reports that the borrower is seeking a restructuring of the loan terms.

Hotel Default of Week Two - Baird/Baird Real Estate

Springhill Suites Seattle. The 234-room hotel's $32.7 million ($139,743/key) CMBS mortgage has been transferred to CW Capital's special servicing group. The mortgage is 60 days delinquent as its debt service shortfall hasn't been funded by the current owners since October. The 6.4% fixed rate mortgage was originated in November 2006 by CGM. Debt service has dropped under 1.0x, despite hotel occupancy of 71% YTD. Built in 2001, the hotel on Yale Avenue in Seattle was purchased in 2006 for $50.7 million ($217,000/key).

Both of these examples go to the core of our previously stated concerns: well located hotels, have just been hammered by local market conditions with debt coverage ratio issues to match. The good news is that we are quoting non-recourse debt for hospitality with a preferred loan size of $10M - $30M (however the lender will consider larger on a case-by-case basis); LTV's of 60% - 70%; with interest rates between 7.5% - 9.5%, subject to the perceived risk of the borrower and the site; and terms of 5 – 7 years. This includes new-build construction on a case-by-case basis. We are quoting full-recourse programs in hospitality ranging in preferred loan size of $15M up, with virtually no ceiling; LTV's to 70%; pricing at Prime + 2.5%, so 5.75% today; interest only; and terms of 2 – 6 years. We also have entitled land loan programs ranging in preferred loan size of $3M to $50M.

We have active lenders who will look at new-build hotels and resorts as well as review broken projects but on a case-by-case basis.

"A nickel isn't worth a dime today." – Yogi Berra

In closing:

- 1,484 hotel and resort CMBS loans come due in the coming 18-months
- CMBS debt is only approximately 25% of all commercial real estate debt
- The delinquency rates in CMBS loans so far have been 13.47% for hospitality, the highest of all
- Unemployment will not get back to normal levels until 2014
- Nobody knows what debt will look like when it returns in abundance other than it will be far more conservative and it will be far more expensive.
- Finally, one Anonymous banker 's outlook was that "Probably the worst deals are done during good times, so I supposed some of the best deals will be done during these times."

Stop Notice Risks for Construction Lenders

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Construction lenders face myriad challenges in the plunging economy and real estate market. The difficulties include handling a heightened number of borrower defaults, deciding whether to continue disbursing construction loan funds in a declining market, and determining how to weigh the risks of foreclosing and completing construction on an incomplete project. While navigating these obstacles, lenders should always evaluate their potential liability to contractors and suppliers for bonded stop notices. Meanwhile, claimants should recognize the full extent of the stop notice remedy. While this article is predicated upon California law, to the extent the stop notice laws of other jurisdictions follow or mirror California law, the following discussion may be pertinent and is these issues should considered.

By serving a bonded stop notice claim on the lender, contractors and suppliers can effectively lien any undisbursed construction loan funds. The failure of a construction lender to honor a proper stop notice can result in substantial exposure. Construction lenders that ignore a bonded stop notice claim on a private work of improvement do so at their peril.(1)

A stop notice is a written and verified statement served by a claimant owed money on a work of improvement. The statement must identify the claimant and describe the nature of the labor, materials, or services provided; the name of the party to whom these were furnished; the dollar value of what was furnished; and the amount claimed as due.(2) By serving a valid stop notice on a construction lender, a stop notice claimant creates a claim or lien on undisbursed construction funds in the hands of an owner or lender for the benefit of the claimant. This remedy allows contractors, subcontractors, and materialmen to reach undisbursed construction loan proceeds as security against nonpayment.(3) Once a bonded stop notice is served, the lender must withhold from available construction funds an amount sufficient to pay the stop notice claim and may not use that withheld amount to pay down the principal amount of the loan or to pay interest, fees, or other costs.(4)

"A bonded stop notice" is defined as a stop notice given to a construction lender that is accompanied by a bond in a penal sum equal to 1.25 times the amount of the claim.(5) A construction lender is only obligated to withhold funds from an owner/borrower if properly served with a bonded stop notice. Indeed, a construction lender is not obligated to honor a stop notice that is not bonded.(6) The construction lender must withhold funds pursuant to a bonded stop notice served by an original contractor, subcontractor, or first-tier supplier.

The stop notice claimant also may demand in its stop notice that the lender provide a copy of any payment bond.(7) If there is a payment bond recorded for the project, different rules apply. When a payment bond has been recorded, the lender is not required to withhold funds but may do so at its option.(8) This applies to all proper claimants other than the original contractor. Similarly, an owner served with a stop notice is not required to withhold funds when a payment bond has been recorded but may do so at its option.(9) If an owner declines to withhold funds in response to a stop notice because a payment bond has been recorded, then the owner must furnish the claimant with a copy of the payment bond.

A valid stop notice can be a highly effective remedy for a claimant seeking to obtain payment for its work. A lender that improperly disburses funds subject to a stop notice is personally liable for the amount due to the lien claimant under the contract with the owner (but not exceeding the maximum amount of unexpended construction funds).(10) Further, the stop notice remedy is independent and cumulative of a claimant's rights to a mechanic's lien, to enforce any payment bond, and to pursue a writ of attachment.(11) Thus, a claimant may avail itself of all prejudgment remedies simultaneously.

Like mechanic's liens, stop notices are nonconsensual and do not require prior judicial approval. Moreover, lien and stop notice rights may not be waived by contract, reflecting a strong public policy favoring payment for those who improve property. Similarly, no assignment by the owner or contractor of construction loan funds—whether made before or after service of a stop notice on a construction lender—has priority over the stop notice claimant. Assignments cannot defeat the rights of stop notice claimants.(12)

Stop notices differ from mechanic's liens in that they attach to the funds of the owner of the property, or the construction loan proceeds from a lender, rather than to the real property being improved.(13) As a result, a stop notice survives a foreclosure of the property. Thus, stop notices do not give rise to the priority issues regarding the construction lender's deed of trust that emerge with mechanic's liens.(14) If several stop notices have been filed and not enough money exists to pay them all, stop notice claimants share pro rata in the available funds.15

LIMITATIONS AND REQUIREMENTS

Statutes limit who can assert a stop notice. In general, California law provides that all persons and entities qualified to record a mechanics' lien, with the exception of the general contractor, may serve a stop notice on the owner. This includes materialmen, subcontractors, first-tier suppliers, equipment lessors, licensed design professionals, union trust funds, and those who make improvements to the site.(16) These same classes of claimants, plus the general contractor, may serve a stop notice on the construction lender. Only when the stop notice is bonded is the lender required to withhold funds.

Stop notice claimants need not wait until their work is complete to serve a stop notice. This is in contrast to mechanic's lien claimants, who must wait until their work or the overall work of improvement is complete. Nevertheless, stop notice claimants must take numerous technical steps to ensure that their stop notices are valid. They must serve a proper 20-day preliminary notice in a timely manner. Service must take place "prior to the expiration of the period within which [the claimant's] claim of lien must be recorded under [Civil Code] Section 3115, 3116, or 3117."17 These sections calculate the expiration of the service period as a specified number of days after the completion of the work of improvement or the recordation of a notice of completion.

In most cases, owners or lenders do not record or serve valid notices of completion for completed projects. In the absence of a validly recorded and served notice of completion, claimants have 90 days from completion of the project to serve a stop notice. That period is shorter when a valid notice of completion has been recorded and served, or when a valid notice of cessation has been recorded.(18) Claimants must pay careful attention to these prerequisites to perfect their stop notice rights.

If owners or lenders dispute the validity of the stop notice, they must post a stop notice release bond in an amount 1.25 times the amount of the stop notice. Only upon the filing of the bond, which has the effect of providing substitute security for the claim of the stop notice claimant, can the withheld funds be released.(19)

Similar to a mechanic's lien claimant, a stop notice claimant must take prompt legal action to enforce the stop notice. An action to enforce the stop notice may be commenced at any time after 10 days following service of the stop notice but no later than 90 days following the period in which a mechanic's lien could be recorded. If no action is commenced within the prescribed period, the stop notice ceases to be effective, and withheld funds may be paid to the person to whom the funds are owed. If an action is commenced, notice must be given within five days. (20) When multiple actions to enforce a stop notice are filed, a motion to consolidate may be filed so that the actions will be adjudicated together in one proceeding.(21)

A significant distinction between a mechanic's lien foreclosure action and a stop notice enforcement action is the right of bonded stop notice claimants to recover their attorney's fees if they are determined to be the prevailing party.(22) By statute, prevailing party claimants also will be awarded interest at the legal rate. Interest accrues from the date of service of the stop notice.(23)

Construction lenders facing a stop notice claim should understand that the statutes governing stop notices are remedial and are liberally construed to effect their objectives and to promote justice. Therefore, while certain deadlines are strictly enforced (such as the deadline for a claimant to commence legal action to enforce a stop notice), other requirements are liberally construed in favor of the claimant.(24) Stop notices are designed to protect materialmen who furnish labor and materials that enhance the value of the property and are supposed to be paid out of the construction fund.(25)

As one court reasoned, a lender's senior deed of trust usually protects the lender from the risk of default.(26) Meanwhile, a lender may protect against the risk of nonpayment of claimants by requiring the owner or developer to post a payment bond. Also the lender can inspect the progress of the construction, issue joint checks, or institute other funding controls. The court further noted that permitting a claimant to recover against the lender for materials and labor contributed to the property is appropriate because those contributions increase the value of the property and therefore enhance the lender's security. In addition, the court declared that strong policy reasons support requiring commercial lenders to police the building industry—and the stop notice remedy encourages this as well.

The purpose of a stop notice is to provide materialmen with protections when they extend their resources in return for a future payment from a construction fund. Most often smaller companies are the ones who file stop notices—companies that have provided labor or materials to a project without the resources to litigate. When balancing the protection of claimants expending their labor and materials against owners or lenders receiving the benefit of those goods and services, the equity scale usually tips in favor of claimants.

Because the stop notice remedy is so highly effective for stop notice claimants, construction lenders have made several attempts over the years to structure a construction loan that effectively circumvents it. In light of the policies in support of the remedy, lenders have not met with much success in trying to defend against stop notices. For example, in a case involving a borrower/owner that assigned to the lender the loan fund under an agreement to make specified progress payments to the contractor, the lender could not defeat a stop notice claim by asserting a right to retain the assigned fund as security for repayment of the loan.(27)

Furthermore, if a lender could eviscerate the purpose of the stop notice statutes by simply not creating a separate construction fund, then every set of construction loan documents in California would do the same, and bonded stop notices would become ineffective. This result would be contrary to the purpose of stop notices as defined by California courts. To permit lenders to do otherwise would allow them, upon foreclosure of a property, to have the benefits of the provided materials and labor without payment—and deprive lien claimants of any effective remedy.

Courts have also held that a stop notice will reach an undisbursed loan fund even following a default by the borrower terminating the borrower's right to obtain further disbursements from the loan fund.(28) Stop notice priority extends to all loan funds that remain subject to disbursement—even those that may not be due under the lender/borrower construction agreement because disbursement conditions have not been satisfied. This priority is unchanged even if the borrower is in default.(29) As a consequence, a lender may not properly defeat a stop notice by insisting that no undisbursed funds exist because the borrower is in default and the lender is therefore not obligated to disburse those funds. Private agreements between lenders and borrowers may not serve as a defense to a stop notice claim.

In a seminal decision, Familian Corporation v. Imperial Bank,(30) the court refused to allow a lender to pre-allocate construction loan funds to an interest reserve and thereby effectively subordinate perfected stop notice claims to the interest reserve. The court held that the lender may not pay itself fees, points, and interest in preference to stop notice claimants at the inception of the loan, thus reducing the loan fund and achieving priority over liens or stop notice claimants. This practice violates the anti-assignment edict of the stop notice statutes.(31) Lenders also are judicially prohibited from attempting to achieve priority by 1) applying the loan balance to reduce the amount due under the construction note, and 2) depositing unexpended construction loan funds into a general fund or separate escrow account.(32)

CONSTRUCTION FUNDS AND LENDER LIABILITY

Conflicts sometimes arise over what constitutes a construction fund. In part this controversy stems from the fact that the California Civil Code does not currently contain a provision specifically defining a "construction fund" for purposes of stop notice claimants. However, former Code of Civil Procedure Section 1190.1(h)—the predecessor to Civil Code Section 3166—defines "construction fund" as the amount either "furnished or to be furnished by the owner or lender…as a fund from which to pay construction costs" or "arising out of a construction or building loan."(33) Civil Code Section 3087 defines a "construction lender" as any mortgagee lending funds to pay for the cost of the work of improvements on a property or a "party holding funds furnished or to be furnished by the owner or lender or any other person as a fund from which to pay construction costs."

The plain language of the Civil Code and its predecessor in the Code of Civil Procedure broadly treat a construction fund as any amount of money designated to be used to pay construction costs. In both Civil Code Section 3087 and former Code of Civil Procedure Section 1190.1(h), the only requirement for establishing a construction fund is that an amount must be designated as "a fund from which to pay construction costs." Therefore, a construction loan agreement that specifies the loan proceeds as the money for paying construction costs would qualify as a construction fund for the purposes of stop notices.

The amount retained by the lender in response to a bonded stop notice should not be used to pay down the principal amount of the loan or to pay interest, fees, or other costs owed to the lender. A lender that fails to properly withhold undisbursed loan proceeds following a bonded stop notice is personally liable for the amount due to the lien claimant. Nevertheless, the lender will not be liable for more than the amount of the undisbursed loan proceeds at the time the bonded stop notice was served.

FOLLOWING FAMILIAN

The Familian decision should guide lenders in their response to bonded stop notices.(34) In Familian, a construction lender received bonded stop notices that far exceeded the undisbursed loan balance. Meanwhile, the lender had paid itself interest and fees from a reserve account specifically set up to pay interest on the loan and other fees owed to the lender as those amounts accrued. The claimant contested the right of the lender to pay itself from the reserve account before the stop notice was served, and the court agreed with the claimant.

According to the Familian court, the practice of making payment from an interest reserve constitutes a statutorily prohibited assignment under Civil Code Section 3166. The court held that the lender may not pay itself fees and interest in preference to stop notice claimants. To do otherwise would permit the lender a double recovery by allowing it to capture fees and interest as well as the enhanced value of its property. That enhanced value is created by the construction work performed by the claimants.

The effect of the Familian decision is huge, because it can lead to lenders being required to disgorge amounts they have paid to themselves in earned interest and expenses. It also follows under Familian that construction lenders with fully disbursed loans remain at risk.

In addition, when a construction loan is sold, a preexisting bonded stop notice claim is not defeated by the transfer. The original construction lender served with an effective bonded stop notice remains obligated to comply with stop notice withholding requirements. Therefore, construction lenders should procure appropriate indemnities or take other actions to safeguard against this risk when selling a loan subject to a bonded stop notice.

Many question the rationale of the Familian decision and consider it poorly reasoned. For example, in Steiny v. Citicorp Real Estate, Inc., another appellate court disagreed with Familian (35) and ruled that a lender was entitled to keep payments made to itself from the loan fund to the extent those amounts were earned prior to service of the stop notice. However, the Steiny case was decertified from publication and, as a consequence, may not be cited as authority. Familian, warts and all, remains existing law. While lenders must heed this decision, bonded stop notice claimants have been handed a powerful sword.

Lenders seeking to defend against a stop notice claim should first evaluate whether the prerequisites for a stop notice have been met, such as verifying that the claimant obtained the appropriate bond, gave a proper and timely 20-day preliminary notice, and timely served the stop notice. They should further ascertain that the claimant is among the categories of claimants that possess stop notice rights. Moreover, in the appropriate circumstances, lenders should discern if the claimant was properly licensed. Also, a lender should work with the borrower to determine the merits of the amount claimed to be due and attempt to compel the borrower to resolve the dispute with the claimant. A lender should consider demanding that the property owner secure a stop notice release bond if a legitimate dispute exists.

Lenders who sell distressed construction loans retain any existing stop notice liability.   Merely transferring a note does not rid a lender of the obligation to honor an existing bonded stop notice.   Provisions to protect against this risk, including indemnities, should be made part of the loan sale agreement.

Ultimately, owner/borrowers and lenders share a strong incentive to keep stop notices from interfering with timely project completion. An incomplete and delayed project increases construction costs and undermines the value of a lender’s security. In addition, if a lawsuit is filed to enforce the stop notice and is accompanied by a mechanic’s lien foreclosure action, the lender should consider whether to tender the lawsuit to the title insurer. Finally, lenders may need to consider whether to file an interpleader action, in which they may be entitled to recover their attorney’s fees.

REFERENCES

1. Stop notices on public works projects are governed by different rules.
2. Civ. Code §3103.
3. Civ. Code §3083 (defining “bonded stop notice”)and §3103 (defining “stop notice”); Black’s Law Dictionary 1432 (7th ed. 1999).
4. A-1 Door & Materials Co. v. Fresno Guarantee Sav. & Loan Ass’n, 61 Cal. 2d 728 (1964).
5. Civ. Code §3083.
6. Civ. Code §§3159, 3162.
7. Civ. Code §3159(a)(3).
8. Civ. Code §3159(a)(2).
9. Civ. Code §3161.
10. Calhoun v. Huntington Park First Sav. & Loan Ass’n, 186 Cal. App. 2d 451 (1960).
11. Civ. Code §§3158 et seq.
12. Civ. Code §3166.
13. Connolly Dev., Inc. v. Superior Court, 17 Cal. 3d 803 (1976).
14. Mechanical Wholesale Corp. v. Fuji Bank, Ltd., 42 Cal. App. 4th 1647 (1996).
15. Civ. Code §3167.
16. Civ. Code §3158.
17. Civ. Code §3160.
18. Civ. Code §§3115, 3117.
19. Civ. Code §3171.
20. Civ. Code §3172.
21. Civ. Code §3175.
22. Civ. Code §3176.
23. Id.
24. Hendrickson v. Bertelson, 1 Cal. 2d 430 (1934); Familian Corp. v. Imperial Bank, 213 Cal. App. 3d 681 (1989).
25. Rossman Mill & Lumber Co. v. Fullerton Sav. & Loan Ass’n, 221 Cal. App. 2d 705, 709 (1963).
26. Miller v. Mountain View Sav. & Loan Ass’n, 238 Cal. App. 2d 644 (1965).
27. A-1 Door & Materials Co. v. Fresno Guarantee Sav. & Loan Ass’n, 61 Cal. 2d 728 (1964).
28. Id.
29. Id. at 734.
30. Familian Corp. v. Imperial Bank, 213 Cal. App. 3d 681 (1989).
31. Civ. Code §3166.
32. Familian, 213 Cal. App. 3d at 686.
33. See, e.g., A-1 Door, 61 Cal. 2d at 734 (quoting former Code of Civil Procedure §1190.1).
34. Familian, 213 Cal. App. 3d 681.
35. Steiny v. Citicorp Real Estate, Inc., 85 Cal. Rptr. 2d 38 (1999) (unpublished).

Risk Management and the Distressed Property

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The concept of Risk Management is well established, though not always well followed in management plans, especially on construction projects. The Project Management Institute's a Guide to the Project Management Body of Knowledge defines Risk Management as the "systematic process of identifying, analyzing, and responsing to project risk. It includes maximizing the probability and consequences of positive events and minimizing the probability and consequences of adverse events to project objectives." Potential cash flow problems of owners, contractors, and subcontractors has always been one of the risks considered in these plans but in the current economy, the risk is far greater and the effects much more significant. These financial risks can strike from a number of directions as the owner, the lender, the designer, the general contractor, subcontractors, and even material suppliers can call and declare they are done, "sorry".

PREVENTION

Like most risks, financial risk management starts early with the development of contract(s). Some questions to consider at this stage would include:

- Who in the chain is responsible for the failure of another party?
- Are payment and performance bonds, largely avoided in commercial projects, a requirement to reconsider in today's climate?
- What contracts are assignable upon default?
- Who owns stored materials and offsite work-in-progress?
- What is a sufficient retainage percentage or amount to restart work with a replacement contractor/subcontractor?
- What reporting requirements or other procedural activities can be used to demonstrate current and ongoing financial health?

The ability of the owner to pay has long been a common question, and historically, evidence of a construction loan has been the necessary proof. But it is important to remember that having a construction loan in place doesn't guarantee payment if the developer defaults. But it's not just owners to think about. What about the financial health of the other entities, contractors, designers, manufacturers? In today's challenging economy, many are so focused on winning work that they fail to consider the precarious nature of today's project teams.   Parties should consider making proof of the financial health of all parties a periodic requirement just like one would verify proof of insurance. Look at financial statements and credit reports with an advisor that can interpret the risks involved as even a subcontractors' cash crisis can hobble the forward progress of a job. Make the reporting requirements and the financial health requirements specific to avoid disagreements later in the project as to how healthy is healthy.

At the time of letting the contracts, look carefully at the Schedule of Values ("SOV"). Front loaded SOV's, or "unbalanced" bids can lead to problems. If the contractor or subcontractor needs a mobilization payment beyond its immediate cash costs of the project, consider a loan that is recouped over the course of the project. At a time when the economic pressure on contractors is to get cash early in the project, good business practices, as well as economic pressures on owners/developers is to pay for only the pro-rata portion of the project in each payment application. The proposed Schedule of Values or Milestone Payments needs scrutiny to avoid unintentionally paying for more work than actually has been completed.

MONITORING

The monitoring part of a Risk Management plan is largely self-perpetuating if the payment procedures are set up appropriately. The objective is to maintain the proper balance between what has been paid for and what has been delivered or performed. As such, the ongoing invoicing and payment process is critical in these difficult times. Whereas before, one could relax somewhat in the knowledge that being “paid ahead” was only a moderate timing issue on a lump sum contract, the prospects of financial failure of a contractor or subcontractor today, have made it critical to not only limit progress payments to real progress, but to make sure you own what you just paid for. Some specific procedures to consider:

- Make Progress Payment checks to both the prime contractor and the subcontractors (i.e. dual payees), payments made direct to subcontractors, as well as enforceable lien releases are a way to be sure that the chain of cash flow does not break down.
- Lacking dual checks, have a required schedule for the payment of invoices down the chain of suppliers and the receipt of lien releases and aggressively enforce that schedule. If the schedule starts to slip take action immediately to determine the cause of the problem and ensure it’s not the beginning of a downhill slide. The contractor/subcontractor who is slowing payments to subcontractors not only is not making you friends on the project, but puts the payer at risk if the contractor were to quit unexpectedly.
- Consider making contractor payments tied to completion milestones or specific activities in the project schedule. This is a common procedure that encourages proper monitoring of the project schedule and incentivizes the team to watch the actual project progress and manage the schedule appropriately.
- Consider the use of independent warehouses and bill of sales for stored materials. The material supplier who has possession of paid-for, but undelivered project materials can be a significant risk to both the cost and schedule of the project
- Have the owner keep at least 60 days of construction cost in an escrow account and check that the balance is maintained properly. Stop work if the balance dips below the costs incurred to date, the retainage balance, and the cost to demobilize.
- Watch the progress of the architects design work to ensure that the usable completed work is at least roughly equal to the amount paid to the architect and its sub-consultants.
- Get pending change orders resolved, on the schedule of values, and paid in a timely manner. If someone goes under, a long list of unresolved change orders is always a problem.

MITIGATION

Despite all the planning and monitoring, there is still a risk of someone going under. The final step of a risk management strategy is to have a plan in case the worst case scenario occurs. When this happens, the project team often reacts in a very symptomatic manner, i.e. fix the current issue and move on. Unless one addresses the causational issue(s), a quick fix, such as a cash advance or release of retainage, is likely to just push back the time when the entity will get in trouble again. Be very suspicious of vague explanations such as “bank error” or “administrative glitches” that might tempt you to proceed on hoping for the best. Like the frog that gets used to the hot water a few degrees at a time, it’s tempting to let late payments slide a little rather than stepping in quickly. Rarely has anyone said they wish they had taken action later than they did. If formal bankruptcy is involved, there are procedures to be followed and the advice of an attorney is invaluable. But until then, consider the following to protect yourself:

If you are the owner where a contractor, subcontractor, or supplier below you has stopped working:

- Read the contract and follow all specific and required procedures.
- Contact the surety if there is one.
- Take control of the site and any off-site assets you have paid for. Protect yourself from the creditors who will also be trying to grab what they can.

- Inventory the site and the actual completion stage of the project. Also look also for completed, but deficient work to limit what you may find yourself paying for twice. Create a record by taking pictures, including a video of the site and materials.
- Look to your ability to assume lower tier entities to cut out the problem and keep the project moving.
- To the extent possible, communicate with everyone to keep the team together and the project moving forward if at all possible. Stopping and restarting is an expensive proposition.
- Take a few extra days though and see if you can get a replacement contractor/supplier for a fixed price to completion. Commonly, the replacement companies don't want the risk of a lump sum when doing a takeover, but even the mules know when the work is T&M.
- If you are a contractor and one of the parties above you has quit:
- Read the contract and follow any specific procedures.
- Contact the surety if there is one.
- Take control of anything you have completed and not been paid for.
- Inventory the site and the actual completion stage of the project. Take pictures to document the work and materials in place.
- Take control of your equipment and uninstalled materials.
- Communicate with any entities below you.
- Send an invoice for any work you have completed, but have not been paid for to-date.
- Don't complete any more work until you know how you are to be paid.
- Don't hesitate to file a lien where appropriate.

CONCLUSION

Unexpected events have always occurred on construction projects. The industry as a whole is good at reacting, correcting, and completing a project despite its challenges. The distressed project, though still rare, has a unique ability to surprise the unaware and leave affected parties with no viable corrective actions to take. A Risk Management Plan, including considerations for financial risk, is the best way to minimize the impact of these unfortunate circumstances.