2023

CONSTRUCTION RISK MANAGEMENT

Journal

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Evaluating Stalled, Distressed Construction Projects

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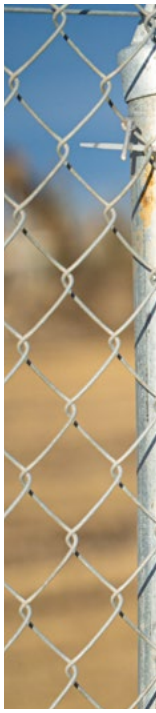

When a construction project has stalled, particularly when the borrower is unwilling or unable to complete construction, the lender, the investor contemplating acquisition of the project, or the court-appointed receiver stepping into the developer's shoes, will need to evaluate the construction in place, the underlying project approvals, and the cost and anticipated time to complete the project in order to make prudent business decisions.

A building or other construction project is not 'complete' until it has received a certificate of occupancy, or similar approval, from the public agency with primary jurisdiction over the project. Typically, it is the city or county where the project is located, although it could also be a state, federal, or even tribal agency. There may also be separate and significant tenant improvements or other project modifications necessary for the project to start generating income or otherwise be put into service for its intended use.

Unfortunately, time is the enemy on a stalled construction project: project permits and approvals may expire, key design and construction team members may leave, completed construction may deteriorate from weather, theft and vandalism, and security and insurance costs can soar.

The good news is that with sufficient time and money, almost anything can be fixed. However, the cost to complete a stalled project is almost invariably higher than if the project was completed without interruption.

Some Initial Issues and Considerations

A key consideration for evaluating distressed construction projects is that the lender cannot take any action that may be viewed as interfering with the borrower's operation and control of the project. The consequence of lender interference can be the involuntary conversion of the loan into a passive equity interest in the project – a bad outcome. To obtain project information, talk with project team members or access the project itself, it is important to first have the borrower's consent and cooperation.

At the first sign of borrower distress – and while the borrower is still cooperative – gather, organize, and review as much of the loan and project documentation as possible. Compile contact information for everyone involved in the design, approval, construction, and inspection of the project. Walk the project, preferably with consultants skilled in evaluating construction, and take as many photographs as possible. Determine what materials, if any, have been purchased and stored off-site or with suppliers. Confirm that the project jobsite is secure and that insurance policies are current. If all goes well, the borrower/developer will remain cooperative through the process of working out the loan and completing construction.

Once the borrower relationship becomes adversarial, the only way to obtain additional non-public project information is to seek the appointment of a receiver or wait until the foreclosure is complete. The fact that the borrower may

have abandoned the project is not sufficient reason by itself to access, secure, inspect, operate, or control the project.

'Invasive' inspections, such as assessment of potential soil and groundwater contamination, are often necessary and appropriate to fully evaluate the condition and status of construction. Those inspections may include mold, asbestos, structural, mechanical, electrical, low voltage, plumbing,

and roofing. However, unless the borrower consents in writing or a receiver is in place with the appropriate authority, invasive inspections – particularly environmental – can be problematic given the possibility that the results may have a negative impact on project value.

Borrowers in distress often cut corners and make poor decisions. They will use cheaper materials, less skilled and/or less supervised contractors, and overlook mistakes and substandard construction – all in an effort to complete the project as quickly as possible with whatever funds are remaining.

Below is a list of some of the typical construction issues that can arise on a stalled project:

- Expired project approvals and construction permits
- Incomplete plans and/or permit applications for design/build work
- Design professionals, subcontractors, or suppliers are no longer in business or uncooperative and/or restrict access to permitted plans due to nonpayment
- Long-lead materials, fixtures, and equipment are not yet ordered, significantly delayed, or unavailable
- Inadequate, improperly located or installed and/or delayed public utility installations
- Use of substandard, substituted, or uncertified materials and fixtures
- Substandard or improper construction
- Incorrect clearances, setbacks, building height, and other dimensional issues
- Construction extending past property lines, both above and below ground
- Low voltage electrical systems for access, communication, security, and fire/life safety not designed, installed, inspected, or operating properly
- Major building components damaged or compromised by prolonged exposure to weather such as wood framing, weather resistant barriers, insulation, drywall, and flooring
- Compromised or voided warranties
- Theft of high-value building materials and equipment stored on-site or installed, such as copper electrical wiring, electrical switchgear, heating and air conditioning equipment, and appliances

In addition, stalled projects often require 24/7 on-site security, and insurance policies must be extended or converted to 'vacant building' policies. As a result, both security and insurance can be unexpectedly costly.

Another consideration is that construction can involve potential long-term liability for construction defects – particularly condominiums and tract housing with homeowners' associations – so most lenders and many investors do not want to complete construction without some insulation from liability that can be provided by a court-appointed receiver and/or a construction defects insurance policy.

If the borrower/developer is 'self-performing' as the project architect and/or the general contractor – and to the extent that the borrower/developer has close relationships with the project's subcontractors – it is likely that these related project team members will, at a minimum, be reluctant to talk, and often will be uncooperative and adversarial.

The Construction Evaluation Process

This is the time to engage a third-party consultant who specializes in construction evaluation, unless this capability already exists in-house. When construction has stalled, the existing project team will expect a third-party construction evaluation consultant to be involved in the lender's or the investor's due diligence process.

First – and to the extent that this information is available – compile and review the project's approvals, the construction and consultant contracts, the building department inspection record card comments, other inspection reports (i.e. architect, structural engineer, accessibility, building envelope, acoustical, insurance carrier, deputy inspectors, and loan disbursement inspector), the contractor's pay applications and logs, and a current title report to identify mechanics liens and other documents of record. Look for issues that may have arisen during construction, and to what extent the architect, the general contractor, and their respective insurance carriers, may be contractually obligated to resolve those issues.

Next, walk the project. This is likely to be one of several job walks. However, the initial review of project documents and reports will provide some indication of what to initially focus on. Each subsequent job walk will further inform the assessment of the status of the project.

Talk with the architect, the other design and engineering consultants, the deputy inspector(s), the general contractor, subcontractors, and major material suppliers. A great deal can typically be learned from the people actually working on the project. This includes whether they are interested in and/or capable of completing the project, the remaining issues, as well as who will need to be paid and how much they will need to be paid before restarting work. Ask about upcoming decisions, alternatives, and the cost and time to complete the project. If possible, it is better to do separate job walks, first with the design and inspection teams, followed by the construction team. The design team often has a different perspective than the construction team. Project team members may be reluctant to be candid when both the design and construction teams are together in the same room.

Once it is clear what is known and what is unknown about the project from the existing project team, it is time to separately talk with one or more third-party architects and general contractors who are experts in this specific type of construction in the same city as the project is located. They may identify issues that the existing team may be reluctant to talk about or may not be aware of. Assume that the existing project team will find out about discussions with new consultants and contractors, since subcontractors all tend to travel in the same circles.

If the project has been stalled for some time and many of the team members are gone, uncooperative, or adversarial, it may be necessary to pay a third-party general contractor to prepare a cost-to-complete estimate and a completion schedule. Unless there's a strong existing relationship with the contractor, they will often be reluctant to do this work without compensation.

It's often best to delay talking with the city or any of the other public agencies involved with the oversight and approval of the project until the end of the evaluation process. These conversations are certainly important, and often critical, but better to have after becoming fully informed as to the condition and status of the project – including the potential need to reinstate expired project and construction approvals and/or eliminate or modify conditions of approval, including costly required off-site construction requirements.

At this point it should be possible to develop a reasonably accurate 'best-guess' project completion budget and schedule, relative to the original project costs and status of completion, bearing in mind that material and labor costs have probably escalated from initial pricing. There may be

significant additional costs and schedule delays to account for protective measures, corrective work, material lead times, and soft costs incurred in evaluating and completing the project.

Conclusion

Regardless of how much due diligence is performed beforehand, with construction comes surprises – the 'unknown unknowns' that inevitably arise in any construction project. This is particularly the case in a distressed, incomplete project, where it is probable that the quality, fit, and finish of the work has suffered as project funding has run out. Moreover, once things have become adversarial, existing team members no longer have the incentive to help identify and solve construction issues. The best insurance against surprises is a thorough assessment, healthy contingencies for both budget and schedule, and a great deal of persistence and patience.▪

PROJECT COMPLETION CHECKLIST

- ☐ Public Agency Project Approvals & Permits
- ☐ Building Permit Inspection Record Card
- ☐ Permit Set of Construction Drawings
- ☐ Architect
- ☐ Civil Engineer
- ☐ Structural Engineer
- ☐ Mechanical, Electrical, & Plumbing Consultants
- ☐ Waterproofing Consultant
- ☐ Acoustical Consultant
- ☐ ADA Access Consultant
- ☐ Utility Consultant
- ☐ Elevator Consultant
- ☐ Low Voltage Electrical Systems for Access, Security, & Emergency Communications
- ☐ Other Consultants
- ☐ Special / Deputy Inspector Reports Deputy Inspector Reports
- ☐ Insurance – Property & Liability / Owner or Contractor Controlled
- ☐ General Contractor – 3rd Party or Self Performed
- ☐ Loan Draw Inspections
- ☐ Loan Draw Applications – Payment Status & Change Orders
- ☐ Subcontractors
- ☐ Stored Materials
- ☐ Status of equipment, finishes and fixtures not yet installed
- ☐ Environmental Reports – Phase 1 & 2
- ☐ Asbestos & Mold Inspection
- ☐ Utility Status – Electricity, Water, Sewer, Gas, Storm Drains, Internet, Telephone
- ☐ Mechanics Liens
- ☐ Stop Notices