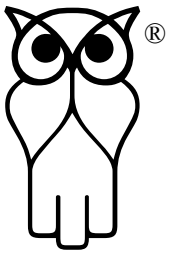

CONSTRUCTION RISK MANAGEMENT

MANAGING "DISTRESSED PROJECT" RISKS (PART 2)

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MANAGING "DISTRESSED PROJECT" RISKS (PART 2)

In the previous *Construction Risk Management Newsletter,* we examined the risks of holding or buying distressed projects, specifically real estate owned (REO) properties, from the perspective of lending institutions and construction companies. (Real estate owned properties are foreclosed properties that the lender is unable to sell at a price that covers the outstanding debt.) A key component of the REO transaction is the insurance program designed to manage both the current property and liability risks and the long-term construction defect litigation risks that may arise out of the REO assets. This article examines the various insurance issues involved in these transactions.

Because the 2009 recession's grip on the residential market has loosened somewhat in the fourth quarter, this article will consider not only distressed residential projects, but also the commercial REO properties roosting on banks' balance sheets as either nonperforming assets or outright foreclosed projects.

Bank REO Assets and Insurance: A Foundation Analysis

Risk management strategies and insurance solutions vary uniquely according to the project profile, including the specific building type, size, and occupancy. In the previous article, five categories of REO assets were identified with respect to residential properties, as summarized in Figure 1. Most banks have a combination of these assets in their REO portfolios. In this article, five commercial (property) asset types are also identified. The tenant type will also vary, including small single tenant, large single tenant, and multiple tenants.

In the life of a real estate project, the original developers and builders will generally know most about the asset (as they had a direct hand in its creation). Their perspective, however, is decidedly a short-term view, much like that of a sprinter. Lenders, on the other hand, have an intermediate term view having financed the acquisition, development and construction of the project, but without a substantive technical understanding of that process.

While insurance underwriters often do not completely understand all of the technical aspects of a project, they do have an understanding of the ongoing and completed operations risks. And when their insured builder "rides off into the sunset" for lack of a financial incentive to remain engaged in the project, the insurance company may be left to carry the longer-term burden of responsibility for construction defect claims. Many insurance companies also have large property and security portfolios. In these capacities, insurance companies have a much longer-term view, like that of a marathoner.

Figure 1
REO Asset Classes

Residential Properties	
Asset Type	**Description**
Paper Lots[1]	Tentative maps or preliminary plats approved by the appropriate planning commission, city council, or board of supervisors.
Blue-Topped Lots	Lots are rough graded to a stage of completion which is ready for installation of the infrastructure.
Finished Lots	Water, sewer, storm drain, and other street improvements are completed.
Partially Complete Homes	Partially complete homes, in various stages of construction.
Standing Inventory of Completed Homes	Complete except for finish flooring and utility meters. Sufficient for notices of completion and certificates of occupancy to be issued.
Office	Single- or multi-tenant office buildings ranging in size from 1- to 4-story suburban density garden style to mid-rise and high-rise downtown office towers.
Retail	Small strip retail centers; neighborhood centers anchored by grocery stores; in-line retail and free standing restaurant and/or gas station pads; and large regional shopping centers.
Industrial	Single purpose warehouse or manufacturing space, such as distribution centers and heavy industrial uses.
Research & Development	Small to medium sized front office space accessed through storefronts combined with rear high bay warehouse or lab research space served by large roll-up doors.
Other Specialty Uses	Semi-public and private buildings such as hospitals, hotels, churches, etc.

[1]A subsequent stage of paper lot development is the final recorded map or final plat, in which all improvement engineering plans have been completed, approved, and signed with the bond and fee letter issued by the government agency and bonds posted by the builder (for proposed public improvements). Final maps are a saleable commodity.

[2]The tenant type in any given asset category will also vary—e.g., small single tenant, large single tenant, and multiple tenants—which will influence the risk profile.

REO Asset Risks

Real estate projects have three primary risk components, as outlined in Figure 2. Development risk largely revolves around land use entitlement issues governed by local, regional, state, and some federal agencies. Normally there is a finite life for these entitlements. If they expire, the process of regaining governmental approvals can be long and costly. Fortunately, some states, California for example, have extended the subdivision mapping deadlines, thus allowing more time for approved tentative tract maps to become recorded final maps.

Figure 2
Primary Risk Components of Real Estate Projects

Development risk	Finite life of land use entitlements.
Construction risk	Liens on delayed or abandoned projects; construction defect litigation.
Operations risk	Ongoing building operation, performance, and maintenance.

Construction risk is more complex, possibly requiring direct construction of the assets, which may be partially completed and possibly abandoned. Multiple liens on the title by trade contractors are difficult to manage in a recessionary economy, and often exacerbate the lenders' desire to ensure a clear title. In addition, the risk of construction defect litigation varies inversely with the functionality of various building assemblies. Water intrusion (through leaky doors, windows, walls, and roofs, whether residential or commercial properties) is typically the first sign of potential problems which indicate marginal quality construction practices. Finally, once properties are fully constructed and leased-up, normal ongoing building operation and maintenance are then necessary to protect the assets' values.

Commercial properties carry the same development and construction risks as their residential counterparts. It is the operation risk which varies from property to property, as a function of the inherent building construction type (per codes) and internal control systems specific to the type of occupancy and tenant mix. Examples of internal control systems include heating, ventilation, air conditioning equipment, smoke and fire protection assemblies, elevator conveyances, etc. Current functionality reviews of these FF&E items (fixtures, furniture, and equipment) and detailed risk assessments are important measures of asset performance and weigh heavily in the lenders' decision process relative to disposition strategies. Property condition assessment reports (PCARs), which provide this type of risk analysis, are as important to lenders in assessing a property's value as current MAI appraisals. (MAI is a professional designation which demonstrates that the appraiser is a member of the Appraisal Institute, a trade association that monitors appraisers and holds them to a higher professional standard than is required by licensing organizations.)

Likewise, mixed-use properties—which combine office, retail, and a rental or for-sale residential component of medium or high density—pose a complex set of issues above and beyond those of a pure residential use. The development, construction, and operation risks are more intricate and pose multiple challenges to lenders. For example, the ownership and maintenance of common areas in the project, which are frequently shared between multiple tenant

types, require thoughtfully prepared HOA governance documents and service contracts. The success or failure of these projects often goes back to the original developers/builders and their architects and engineers who created the original building programs, which are frequently three-dimensional puzzles of interlocking ownerships and construction assemblies. Clearly, a comprehensive assessment of the development, construction, and operation risks and liabilities flowing from them requires team expertise in all facets of these real estate projects.

Insurance Coverage and Stakeholders

Coverage for liabilities arising out of construction defects is provided by way of completed operations coverage in the commercial general liability (CGL) policy. (Professional errors and omissions insurance provided by design professionals may also come into play.) Ideally, the completed operations coverage will extend across the entirety of the "tail" exposure—i.e., until all claims are barred by the applicable statutes of limitation or repose, which can extend out 10 years or more beyond substantial completion of a real estate development project. However, if the builder is no longer viable, the lender may be left with the entire burden and promise of property ownership.

In that scenario, a new set of risk management strategies is necessary. In the short term, this may include seeking an extension of existing policies or a refund of unearned premium as a source of capital for completing the project. For example, in lieu of refunding premiums on an existing, prepaid wrap-up insurance policy, the insurer may agree to extend the policy for a new builder following the original builders' exit from the project, subject to a full underwriting review. Alternatively, an insurer may issue a refund of premium to a residential builder whose unit production volume is lower than what the policy was written to include. In the long term, however, these options would not likely provide sufficient protection for the stakeholders. (In a typical commercial project build-out, there are at least four stake-holders: the new developer, a new general contractor, the lender, and the insurance company.)

A more typical approach is to develop a new wrap-up insurance program for the incoming builder that provides coverage for the resurrection of the project. In that transaction, one of the key coverage issues will be coverage for construction work completed by the original builder.

To the extent liability for prior work attaches to the new stakeholders, there will be opposing interests with respect to liability coverage. The insurer will be inclined to exclude the prior work (invoking the prior work exclusion) in the build-out policy so as to avoid taking on the prior builder's and prior insurer's liability for poor workmanship. The new builder, however, may resist a prior workmanship exclusion in an attempt to avoid responsibility for the prior builder's mistakes. The degree of resistance will likely vary according to (1) the asset type, (2) the extent of construction work necessary to complete the asset to a saleable condition, and (3) other coverage options available. For example, if a residential community of 25–30 homes is largely complete except for finish flooring and "punching out" the interior and exterior details, *and* the original builder enjoyed the benefit of a third-party quality assurance program providing plan reviews and course of construction oversight, then the risk of litigation is expected to be minimal. Accordingly, a prior work exclusion may not be as big of a concern for either the new builder or the insurance company. However, if the original builder did not have the benefit of a third-party quality assurance program, the litigation potential may be more of a concern. In that case, the builder is likely to be more adamant that the policy contain no prior work exclusion and the insurance company to be more adamant that it does contain this exclusion.

Another strategy for lenders in avoiding construction defect litigation risk is to request that the court appoint a receiver prior to taking title. A receiver can effectively isolate the lender from the prospect of downstream construction defect litigation. Alternatively, the lender can create separate limited liability companies for single assets or small groupings of like assets. Both of these options are effective in avoiding litigation from prior work, as well as the new work in completing the build-out. The success of these strategies will vary with the size, type, and complexity of the asset(s). For each of these options to be successful, expert legal advice must be obtained by the lender *before* taking title to nonperforming assets and begin the process of converting them into REO properties.

In addition to prior work exclusions, lenders should address the issue of who takes responsibility for the customer service or warranty work that was performed by previous trade contractors. Unsophisticated lenders may not realize that they have already taken on that (customer service or warranty) risk through their foreclosure of the asset or by way of accepting a deed in lieu of pursuing a foreclosure action.

Disposition of REO assets significantly relies upon "as is, where is" warranties (i.e., what you see is what you get) provided to builders acquiring partially completed assets from the lender on a wholesale, discounted value basis, as well as for consumers acquiring the newly completed assets from either the new builders or from the lenders selling standing inventory they have foreclosed upon. These "as is, where is" warranties provide significant protection to the lender. To implement this provision, expert legal advice is recommended to properly draft the warranty documents.

Clearly, the warranties which lenders implement will vary with the type, size, and complexity of the project. In horizontal residential subdivisions, divided into separate and distinct construction phases, with a new wrap-up insurance policy applying to the next phase in sequence, the warranty would be reasonably simple to create and roll out. Not so, however, with a large, partially built mixed-use (commercial or residential) vertical project, unless a bright line can be established between the prior work in place and the new work just completed. For commercial properties, while the mechanics of these warranty, customer service, and litigation risks are similar to residential properties, the dynamics of construction defect litigation is a lesser risk overall, due to the single or concentrated ownership of a single asset (such as an office building), rather than a class of multiple owners of similar assets (such as condominiums).

A number of proactive strategies for engaging the original builders, trade contractors, and affiliated consultants to assist in managing and correcting deficiencies are provided through "privities of contract." For example, trade contractors and consultants of record often have proprietary knowledge about the design, construction, and warranty service needs of a project or distressed asset by virtue of their position on the development team. Knowledgeable lenders can use this information to their advantage. Similarly, liens, unrecorded easements, encumbrances and similar clouds on title can be more efficiently managed by the original development team, even without the original developer/builder in the lead. In this regard, the civil engineer can often be the most helpful party. Further, lenders may seek to engage the services of the original developer/builder to coordinate the customer service and warranty obligations in the early years of a new asset since they will have a closer relationship with the original buyers and/or tenants. (The latter suggestion assumes the lender pursued a deed in lieu of foreclosure to control the property, and that the business relationship between the lender and builder is still intact. If the lender becomes the outright owner of the asset through an adversarial foreclosure process, there are no privities of contract between the foreclosing lender and the original trade contractors or consultants of record.)

Further complicating the asset completion and disposition process is the lack of direct relationship between the foreclosing lender and the myriad professionals involved in the transaction, such as financial intermediaries, wholesale insurance brokers, and retail brokers. Lenders who understand how these parties connect the builders, third-party quality assurance firms, and wrap-up insurance administrators to effect a comprehensive insurance solution will proactively engage these stakeholders to assist in managing the liability risks in their REO portfolios.

Toolbox Solutions: PCARs, QA Programs, and Appraisals

A surgical approach to analyzing the portfolio of asset risks and underwriting replacement policies (or extending existing policies) is to produce the "Level A" PCAR, which clearly delineates existing conditions of the project, asset by asset. Supplemental "Level B" or "Level C" PCARs also address legal, entitlement, costs to complete, and other risk evaluations of the assets. The content of these reports was discussed in detail in our previous article. In addition, separate MAI appraisals establishing accurate valuations (based upon market, income, and cost approaches) round out the list of important tools in the lender's toolbox. The value of these toolbox solutions is in creating a bright line of responsibility to guide lenders and insurers in evaluating the asset, distinguishing work which had been completed to date from work that remains to be completed, including the quality of the work in place.

Ongoing quality assurance ("QA") programs are an integral component of the PCAR process. They can include qualitative and quantitative benchmarking across multiple locations, and encompass preconstruction, during-construction, and post-construction risk evaluations in a lender's portfolio of REO assets. These elements, knit together as part of the insurance-related risk management program designed initially to assist builders and insurers, can now also benefit the lending industry and its regulators.

For large lenders, known as money center banks, with an extensive nationwide portfolio of REO assets, comprehensive rolling wrap-up insurance programs are available and offer economies of scale in their scope and coverage (including protection of 10-year liability tail, discussed earlier). One needs to think on a large scale to successfully manage the potential liability in a portfolio containing dozens of assets in different states found in these large money center banks.

Underwriting and pricing a new rolling wrap-up for such a lender's REO portfolio seeks to manage the risk of multiple assets and determine the overall risk of the portfolio. Critical drivers in the underwriting process will become the stage of completion and duration of exposure for each asset. Attaching a numerical score to such an evaluation would provide a way of evaluating each asset. These quality measures can be applied to a single REO asset, a collection of REO assets within a single community bank, or across the national portfolio of a large money center bank. These toolbox solutions are both simple and elegant, serving to help measure and manage a lender's REO risk.

Concluding Thoughts

To mount a successful REO insurance strategy specific to one asset or a portfolio of assets, a proactive and complementary team approach is best. The "four horsemen" necessary to shoulder the burden of this responsibility typically include: (1) legal counsel to assist with isolating project risks and negotiating new insurance policy terms; (2) risk assessment expertise with extensive construction knowledge for proper implementation of the benchmarking tools; (3) comprehensive insurance solutions (specific for the mixed-use and residential assets) to cover the 10-year tail for latent construction defect litigation risk; and (4) experienced land and new homes sales brokerage for successful project dispositions. With this assistance, large money center banks and smaller, regional community banks will be adequately equipped to manage the myriad of issues surrounding the disposition of their REO assets.