# Construction Lending News

Volume 7, First Quarter 2004


## Quality Controlling Construction Inspections

By: Johnathon Morrissey[1]

In the constant quest to reduce risk in construction lending, one of the best tools is the construction inspection. A timely and accurate inspection can help ensure that a lender does not fund a construction loan in excess of work completed on site. The Federal Deposit Insurance Corporation is now focused on quality control of construction inspections, as inspections have become an audit point for construction lending compliance.

Below are some key items instrumental in quality controlling construction inspections and inspectors:

**Qualification of Inspectors:**
Inspectors chosen for construction inspection must be qualified. There are a wide variety of people that could be qualified to perform construction inspections: appraisers, contractors, engineers, architects, real estate professionals, etc. The most important factor is that the construction inspector understands the construction process, and is able to determine if work is complete or not. A series of questions or an exam on the construction process, even administered over the phone, will help to ensure that the prospective inspector is qualified to perform construction inspections.

**Diversification:**
A lender should avoid using the same individual inspector for all projects in a given area. A large inspector pool keeps a lender from having "all their eggs in one basket," and helps with the timeliness of inspection turn around. A sizeable inspector pool also allows a lender to quickly replace an inspector that is not meeting minimum requirements.

**Inspection Report:**
Lenders should require a detailed inspection report of all construction projects. This report should include the status of the construction project. Is the project progressing? Was the contractor or the project supervisor on site? The report should include a short narrative of the work that is completed and ongoing. The report should also include percentage of completion on the overall project, and on individual budget lines. The lender can greatly assist the inspector by providing a detailed budget and a set of plans, in order to allow the inspector to have full knowledge of what he is inspecting.

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## Avoiding Mechanics' Lien Problems in California

By: Mark Baker[2]

California is one of the most active states for residential construction. Therefore, it is also one of the most attractive states from a residential construction lending perspective. Through experience, lenders have learned that it is imperative to be well versed in California mechanics' lien law. However, following an initial review, unfortunately most lenders interpret the mechanics' lien law to be uncomplicated, which on the surface appears true. Under the surface lies a quandary of issues and if un-addressed, the lender may be exposed to mechanics' liens.

The California Constitution guarantees to "mechanics, persons furnishing materials, artisans and laborers of every class" lien rights (Cal. Const. Art. XIV, §3), and they have been broadly interpreted by the courts and legislature, to include essentially anyone that has contributed to a project.

Under the Constitution, any potential lienor has 90 days after completion of the work or improvement to file a lien (Cal Civ. Code § 3116). Make note however, that this is not

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[1] Johnathon Morrissey is the Assistant Vice President for Project Review and Contractor Acceptance for Granite Loan Management LLC. He can be reached at 888.456.4888, extension 248 or via e-mail at john.morrissey@graniteloan.com.

[2] Mark Baker is an attorney with Greenberg Traurig, LLP in Denver with an emphasis on commercial real estate. Mark has analyzed the lien laws of, and has interacted with local lien counsel and title companies in, more than forty states. Mark's practice includes representation in Colorado and nationally of construction lenders, developers, builders and owners, and Mark has extensive experience in all facets of real estate law. Greenberg Traurig is a multi-national firm which offers a full spectrum of the most sophisticated contemporary real estate services available. Mark can be reached at 303.572.6568 or at Baker@gtlaw.com.

## *Quality Controlling Construction Inspections*
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**Inspection Photographs:**
A picture is worth a thousand words. Lenders should require photos with all construction inspections. The pictures should include photos of the entire site, with particular attention paid to items requested for payment. Digital photos are usually best, as they can be sent quickly via email or the internet for review. If the photos do not support the draw request and a determination of the overall percentage of work complete cannot be determined, the inspection is not acceptable and should be re-inspected.

**Inspector Physical Plant:**
Lenders should ensure that inspectors possess an adequate physical plant to perform construction inspections. Computer, fax machine, internet access, digital photo capability, are all vital to proper communication and timeliness of construction inspections. An inadequate inspector physical plant can significantly reduce the quality and timeliness of construction inspections.

**Errors and Omissions Insurance:**
It is unusual for the individual inspector to bear the cost of Errors and Omissions (E&O) Insurance. However, a large regional or national inspection company should carry E&O insurance and provide the lender a certificate of such insurance.

**Inspection Review:**
Lenders should closely review all construction inspection reports for quality. Is the percentage of work completion shown by the inspector backed up by the inspection photographs? Did the inspector indicate a percentage of completion on the items the contractor/borrower are requesting for payment? A review of each inspection is a continual audit of an inspector's work product. The timeliness of the inspections return should be included in the review.

**Annual Review of Inspectors:**
Lenders should review a construction inspector's qualifications on an annual basis. This review can also include an overall review of the inspection quality of the inspector over the past year.

**National Inspection Companies:**
Many lenders find it convenient to outsource their inspections to a national inspection company. If the lender is depending upon the services of one company it should be confident in the national inspection companies financial well-being. It is recommended the lender perform a financial review of the inspection company.

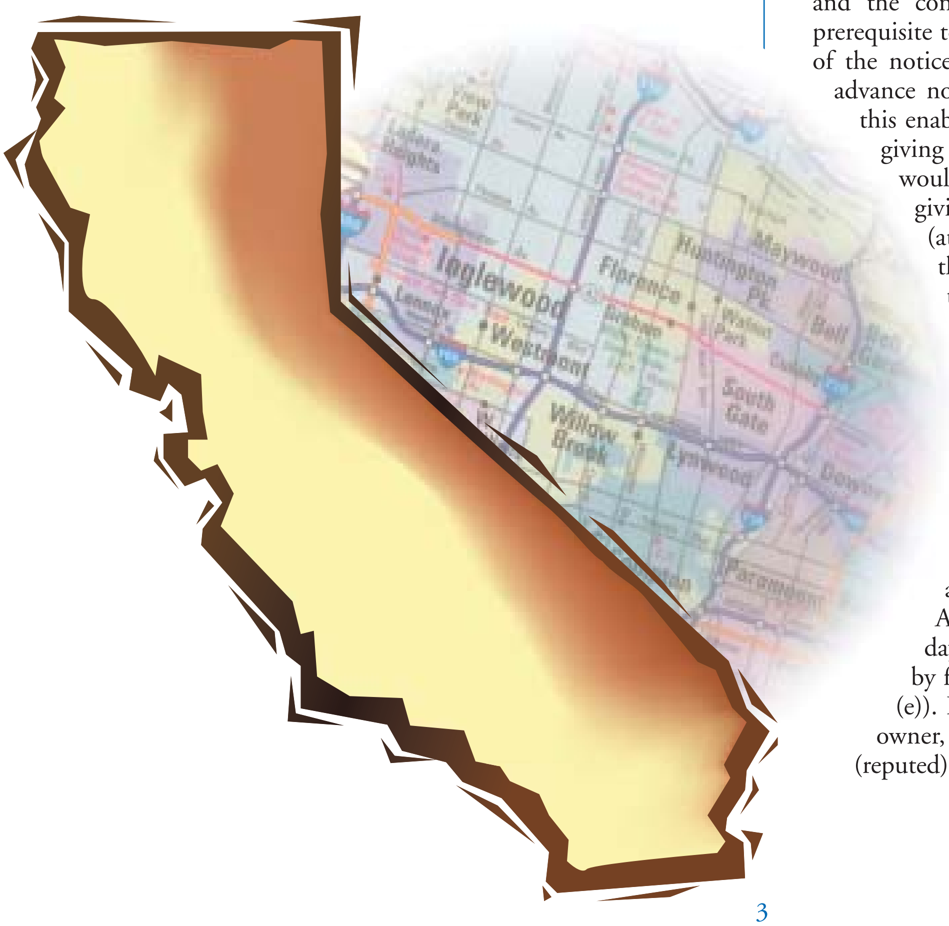
**Quality Control Inspections:**
In order to complete the quality review of an inspector, lenders should periodically review the work of an inspector or inspection company by sending a separate inspector to verify the assigned inspector's work. This quality control inspection should occur on the first project a new inspector is hired for and at least once a year for all inspectors. The quality control inspection should address the following three areas: (1) The quality control inspection should include the same narrative and photos as a regular inspection. (2) The quality control inspection should be reviewed in conjunction with the original inspection. (3) The quality control inspection should be very close to the original inspection findings. If the findings are different, it may be time to assign a new inspector to the project.

In conclusion, a construction inspector is the eyes and ears of the lender on a construction project. The lender depends on the construction inspection to ensure that funds are not dispersed in a disproportionate amount to the work actually complete. By following the aforementioned inspection management tips, the lender can not only significantly reduce construction lending risk but also put themselves ahead of the curve in regards to the audit and compliance departments.

## *Avoiding Mechanics' Lien Problems in California* *(cont'd from page 1)*

from completion of the lienor's work or provision of materials, but rather 90 days from the date the entire project is completed. For example, an unpaid foundation contractor may complete his work months prior to completion of a project. Nevertheless, he can file a lien claim at any time on or prior to the 90th day after the completion date of the entire project. This distinction is important as many other states with similar lien laws limit the period for a potential lienor to file a lien, to within 90 days after the date when the lienor's work is completed. This extended filing period however can be shortened to 30 days by recording a Notice of Completion within 10 days following the actual completion of the project (*id.* § 3093).

California's law dramatically increases the potential for the unexpected filing of mechanic liens at the end of the project. A lender though can take proactive steps to protect itself, and its borrower, from unexpected liens. This can be done either by paying the individual general contractor, subcontractors, and suppliers directly (rather than disbursing to the borrower) or by making recipients of funds provide lien waivers.




In California, lien waivers are only valid if they follow "substantially" the form lien releases contained in Civil Code § 3262, subdivision (d). This section sets out the precise language for four different lien waivers: (1) a conditional waiver and release upon progress payment; (2) an unconditional waiver and release upon progress payment; (3) a conditional waiver and release upon final payment; and (4) an unconditional waiver and release upon final payment. A conditional lien waiver and release is only valid if the waiving lienor actually receives payment. If payment is not received, the waiver is useless unless the lender directly issues the checks to the payees and the checks are negotiated. In addition, the lender should require its borrower to deliver executed unconditional lien releases in order to further document the process.

California contractors and material suppliers regularly use lien release forms that are not in accordance with the statute and may therefore be subject to legal challenge. Lenders should not accept any substitutions to the statutory lien waiver language.

The leading issue that often causes the most confusion for a lender developing construction lending procedures in California, is the Preliminary 20-day Notice. The statute sets out that every lienor is required to serve a "Preliminary 20-day Notice" on the project owner, the original contractor, and the construction lender (*id.* §3097 (a)). This is a prerequisite to the validity of any claim of lien. The purpose of the notice is to give the owner, contractor, and lender advance notice of potential lien claimants. Theoretically, this enables the recipients to obtain waivers from those giving notice. As a result, it would seem that the lender would not need to obtain any waivers from those not giving notice, as they would not have, lien rights (at least for work or materials furnished more than twenty (20) days prior to any later service of the notice). In fact, a lender originating construction loans in California will often hear from contractors that a contractor only needs to provide lien releases from those persons who have served a Preliminary 20-day Notice and no other person. Unfortunately however this is not the case.

In practice, the workings of the California mechanics' lien system are far different, causing a myriad of practical problems for lenders. According to California statute, a Preliminary 20-day Notice must be served by personal delivery or by first class registered or certified mail (*id.* § 3097 (e)). In addition, it must be served on the (reputed) owner, the original (reputed) contractor, and the (reputed) construction lender, if any (*id.* § 3097(a)).

### *Avoiding Mechanics' Lien Problems in California* *(cont'd)*

While the statute requires service to the owner, contractor and lender, in practice, service to only one will suffice for the courts. In addition, lienors may argue service was provided by "Personal delivery," a claim that is difficult to defend.

These practical problems with the law are further compounded by the fact that there is no mechanism for potential lienors to determine whether or not a construction lender is involved with the project and, if so, the lender's contact information. There is no practical or reliable way for a subcontractor or supplier to determine the name, address or proper contact information of a construction lender. Therefore, a lender cannot rely on receiving Preliminary 20-day Notices from the subcontractors and suppliers.

Finally, despite the statutory language, and regardless of the ultimate effect of failure to serve a Preliminary 20-day Notice, service of this notice is not a prerequisite to filing a lien. It is only a defense. The question of whether a proper Preliminary 20-day Notice was served only arises as a defense to the validity of the claim of lien. In practical terms, liens record against the project and the project comes to a halt while protracted litigation ensues. Experience suggests that rarely are lien claims thrown out of court on this issue because California Courts tend to be very liberal as to determining compliance with statutory notice requirements.

In summary, lenders cannot rely solely on Preliminary 20-day Notices to identify potential lienors. Instead, lenders should seek to avoid liens and problem projects by paying the contractor, subcontractors and suppliers directly, or by obtaining unconditional lien waivers.

The California Mechanics' Lien Law is an interesting case study in the technical aspects of the law verses real life application. The law in California, like that in many other states, is fraught with contradictions and practical problems, and reliance on specific statutory provisions may not be enough to protect the lender.

When sourcing mechanics' lien legal counsel in any state, this writer would recommend trying to find an attorney who knows the law, has litigation experience with mechanics' lien claims, and can answer questions clearly in layman's terms. It is incumbent upon lenders to ask questions and to communicate the bottom-line needs for each project, and it is incumbent upon counsel to anticipate the concerns of their clients, particularly where statutory law and practical experience may conflict.

# *Alternatives to General Liability Insurance*

*By: Jim McErlean[3]*

"If we write one dollar of General Liability Insurance premium for any Homebuilder, it will be one dollar too many," states an Insurance Company Executive who used to write millions of dollars of Homebuilder insurance premiums. So why is he concerned about exposing his company to the liability exposures of Homebuilders?

Plaintiff attorneys and the court system of America have always sought the deep pockets of the insurance industry when fighting for the "rights" of the consumer. In recent years, due to a combination of accelerated construction schedules that potentially compromise quality, and a growing cottage industry of lawyers specializing in Construction Defect litigation, the cost of insurance claims and settlements from the Homebuilding industry have skyrocketed. Claims from Radon, Synthetic Stucco (EIFS), Soil Movement, Construction Defects and Mold have eradicated the profit margins of the Homebuilding insurers. Such claims have reduced the surplus or the asset base in which insurers pay claims. Carriers who previously provided General Liability (G/L) coverage to Homebuilders have also either withdrawn from this 'class of business' or have severely restricted their insurance coverage offerings thus, increasing the gap.

If you looked at a map, circa 1995, for availability and/or affordability of G/L insurance for Homebuilders, the map would resemble today's United States, circa 2004. But, if you looked at today's map for available and/or affordable G/L insurance, it would resemble the United States before the Lewis & Clark expedition (circa 1804, when only the East and some Midwestern states had been discovered!) that's how little G/L insurance is being represented. Reason being is that G/L insurance is designed to protect the policyholder's legal liability from 3rd party claims of "Property Damage" or "Bodily Injury" caused by the policyholders operations. Claims to the General Public, such as injuries while visiting homes under construction or Model homes would be covered under a Homebuilder's G/L policy. Or claims from Construction Defects that damaged property or physically harmed the homeowner would also be covered. However, G/L insurance is not intended to be the builder's warranty policy, and historically, this is one of the main factors the G/L insurance industry has constricted.

For example, if the builder has faulty work that needs to be repaired in order to make their customer happy, the G/L

[3] Jim McErlean has a six-year career in the Insurance Industry, most notably in Regional Management positions spanning the past nine years. Currently working for HBW Insurance Services (since 1999), a Managing General Agency specializing in the Residential Construction field, Jim heads up their national Risk Management operations as well as their Midwestern & Western Marketing efforts. Most of his current time is spent working with HomeBuilders or HomeBuilder Associations locally and nationally on the Risk Management and Insurance needs of the Residential Construction Industry. Jim can be reached at 480.816.9559 or jmcerlean@hbwis.com.

## *Alternatives to General Liability Insurance*

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policy is not the rescue net for these costs. Builders have often believed they were buying a comprehensive policy to respond to all their claims, complaints, and disputes from homeowners, i.e., just file the claim and make the insurance company provide the appropriate Customer Service response. The G/L insurance industry however is primarily set-up for catastrophic losses where the policyholder could not have foreseen the claim occurring, triggering an "occurrence." Unfortunately, over the years builders have continually submitted operational or warranty type claims for shoddy workmanship and construction quality problems rather than true unforeseen losses. This has since become the norm for Builders' G/L Insurers, consequently driving them away due to the mounting losses. And now left with few insurance options, Builders have to assume much more risk than in the past. They also have to purchase insurance with much higher deductibles or with a multitude of exclusions. This requires the Builders to invest in sound Risk Management practices in order to protect their companies' assets and profits.

The purpose of Risk Management is to identify and control loss exposures so a company may maintain a continuity of their operations. There are four Risk Management techniques to protect a business: (1) Avoid; (2) Minimize; (3) Shift; (4) Insure. A business can choose not to participate in a dangerous activity, such as buying a mountainside parcel of land that could become part of a mudslide (Avoid), or purchase the same parcel of land, but hire a Geo-Technical Engineer to properly test the soil conditions and instruct the Structural Engineer on how to build a solid foundation (Minimize). The business could also implement properly worded Subcontractor Agreements that will indemnify and hold the builder harmless for actions of Subcontractors (Shift) or purchase a third-party, insurance backed warranty (such as 2-10 Homebuyers Warranty) that provides structural coverage to the Builder, with the Homeowner deemed the beneficiary of this coverage (Insure). These are just a few of the many options and solutions within the four techniques of Risk Management that Builders can implement to protect their business from the gaps left from by their G/L insurance policy.

Other alternatives to traditional G/L insurance, which are becoming 'in vogue' in today's challenging climate, are Risk Retention Groups (RRG's) and Owner Controlled Insurance Programs (OCIP's). RRG's are forming across America to pool capital and similar business operations (including a few RRG's for Homebuilders). They stem from the Product Liability Risk Retention Act of 1981, later changed and renamed the Federal Risk Retention Act of 1986, and are designed for similar business operations to join forces in order to insure their unique and similar exposures. RRG's have the same success/failure rates as traditional Insurance companies, therefore, can be good alternatives during time of insurance crisis, such as what Builders face today.

Owner Controlled Insurance Programs (OCIP's), better known as "Wrap-Up" programs, are also gaining favor as alternatives to traditional G/L coverage. Wrap-Ups allow the Builder and all Subcontractors to join together "under" one policy to insure typically higher hazard operations, such as a Condominium project. They are designed to eliminate cross-claims among contractors since there is only one insurance carrier providing the liability coverage, i.e., the deep pockets are reduced to a single pocket!

A final option for the world of Homebuilders' insurance is Builders Risk Coverage, also known as Course of Construction Insurance. Many lenders require proof of this coverage before funding construction loans, but also sell it via relationships with affinity insurance programs. Like any issue outside a Builder or Lender's area of expertise, they should have a sound understanding of the coverage offered by Builders Risk/Course of Construction. The first issue is insurable interest or who has a financial stake at risk? Usually, the answer is the Builder and the Lender, but sometimes the homeowner who purchases the policy is also at risk.

The Builder and Lender need to understand that the coverage only responds to "hard costs" (sticks and bricks) and

### Alternatives to General Liability Insurance
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not "soft costs" (builders profits, overhead, interest, designs/plans, etc.) — Builders Risk/Course of Construction is "property" coverage only. For example, it would not afford liability coverage to the Builder, if say, for example, the soft costs were significant enough, that if not paid, the Builder or Lender would not be able to afford to rebuild the home after the loss. The same applies if children playing at the site on evenings or weekends are injured. If the Builder only obtained a Builders Risk policy for this project and failed to obtain a G/L policy, the Builder would not have any coverage for this accident. If a Lender did not insist on proof of G/L coverage, solely concentrating on the Builders Risk coverage, they may find that the Builder does not have the ability to finish the project. Thus, forcing the Lender to repossess the land and incur extra costs on the loan.

So as you can see, there are a number of options out there for Builders who continue to face skyrocketing insurance costs to protect their businesses. And while ultimately all will require a bit more groundwork from the onset, it surely makes a better alternative than mitigation and/or repossession. As the saying goes, "an ounce of prevention is better than a pound of cure" — builders must start to implement additional Risk Management techniques in order to protect their assets and profits and Builders, Lenders, and Homeowners alike should continue to educate themselves on proper G/L coverage and never accept just the "bare minimum" on any project.

For more information visit:
www.graniteloan.com

## In This Issue:



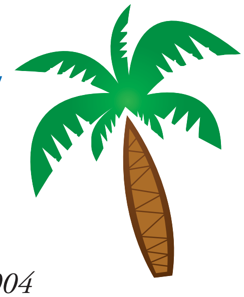
### Construction-at-a-Glance

| | Dec. 03 | Dec. 02 |
|---|---|---|
| Monthly Housing Starts* | 2,061 | 1,815 |
| Permits-Single Family* | 1,443 | 1,321 |
| Monthly New Home Sales* | 1,111 | 1,052 |
| Unemployment Rate | 5.7% | 6.0% |

**Thousands of Units*

*Mark Your Calendar:*

### "Strategies for Success in Construction Lending"



JW Marriott, Grande Lakes Resort
Orlando, Florida
**December 7–8, 2004**

*Register on-line beginning May 15, 2004*


GRANITE
LOAN MANAGEMENT
10770 E. Briarwood Ave.
Suite 280
Centennial, CO 80112