Construction Lending News

Volume 9, Third Quarter 2004

Mitigating Pre-Closing Construction Lending Risk

Review of the Contractor—Part Two

By John Morrissey [1]

Construction lending, while highly profitable, also includes a vast number of risks. Many of those risks exist prior to the loan ever closing, and it has been estimated that a substantial portion of a lender's risk can be mitigated through proper review of the project and contractor. Part One of this article, as noted in last quarter's newsletter, addressed the proper techniques for reviewing a project and Part Two, included here, will evaluate the proper techniques for reviewing a contractor's qualifications.

On the whole, no one person affects a construction project more than the general contractor. He/she is often the first person to enter into a construction contract with the homeowner and will often obtain all of the construction materials and labor to build the homeowner's project. The general contractor also will schedule and supervise all of the work being performed on the project from start to finish. Often, all of the money to pay the subcontractors and material suppliers will flow directly through the contractor's account. This places a tremendous amount of responsibility on the general contractor, and therefore, it is prudent for the construction lender to be aware of the contractor's

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Utah's Mechanics' Lien Law

By Marc Stewart Metzgar, JD [2]

Based upon legal research conducted by Elizabeth S. Whitney [3], Attorney at Law, Parsons Behle & Latimer

In creating this series of articles on state-by-state lien laws, GLM has noticed a trend in some states to limit a subcontractor's rights to lien residential properties. Or to compensate homeowners who have had losses due to contractors not paying subcontractors. In almost every state in the United States, lien laws have arisen from English Common Law, where a laborer on a home had rights to lien the home if he was not paid. Hundreds of years ago, there was really no concept of a general contractor not paying the subcontractors and suppliers after receiving payment from the homeowner. However, today's laws, while protecting subcontractors and suppliers, place homeowners at risk for paying twice: once to the general contractor and then a second time to the subcontractor who was not paid for his work by the general.

As remodeling and construction complaints have risen to the number-one consumer complaint in America, state legislatures have attempted to protect homeowners from unscrupulous contractors. Some states, like Arizona and Pennsylvania, have been very successful in these efforts, while others have only added to the typical complexity and confusion of the existing lien laws. Utah has joined the states that have compounded the confusion in their existing lien laws.

In 1994 Utah passed the Residential Lien Restriction and Lien Recovery Fund Act (§38-11-101 through §38-11-302), or, as we like to call it, the Real Estate Attorney Full Employment Act. It was adopted to protect homeowners from paying twice for residential improvements. In summary, the Residential Lien Act details the following:

Residential Lien Act Summary:

1. Persons who have contracts directly with the owner ("original contractors") may file liens on residential projects and sue to foreclose such liens and to assert any other available claims.

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Mitigating Pre-Closing Construction Lending Risk

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qualifications. A review of the general contractor's credentials is typically referred to as Contractor Acceptance or Builder Review. For lender liability reasons, the term "approval" should be omitted from any and all conversations or written materials provided to the borrower and/or contractor. To ensure that a general contractor has the qualifications and experience to build the project and deliver the home free of mechanics' liens, the following steps should be taken:

Obtain an Authorization to Release Information:

Prior to beginning any type of review on a contractor, a lender should obtain a signed authorization to release information from the contractor. This authorization gives permission to the lender to check into the qualifications, credit, and background of the contractor. The National Association of Residential Construction Lenders has created a contractor questionnaire that is quite thorough and is available through their website at www.narcl.com.

Review the Contractor's Insurance:

The general contractor should carry Commercial General Liability Insurance. This insurance covers third party liability claims that can occur on a job site and also covers any construction defects on the property. The liability insurance policy should provide a general aggregate amount of at least $1,000,000, although larger projects may require higher coverage limits. Lack of this insurance could cause claims to be levied against the borrower or the lender. After all, the claimant will look to the person or company with the deepest pockets, which is typically the lender.

The general contractor should also carry Workers' Compensation Insurance if the contractor has direct employees. This insurance covers any claims against the contractor for job site related injuries to the contractor's employees. The contractor should carry this insurance even if he only employs office staff, as they may visit the job site. Many states require that a contractor carry this coverage and will not issue a license to the contractor without proof that the insurance is in force. Lack of this insurance could also lead to claims being levied against the borrower and/or lender.

Review the Contractor's License:

Licensing requirements vary from state to state. Some states require contractor licensing on a state level, others leave licensing to the cities and counties. If the state requires a valid general contractor's license, the lender should obtain a copy from the general contractor. The license should be reviewed to ensure that it is in force and active. Lenders should also contact the state or municipality issuing the license to ensure that it is active and in good standing. Many

states also provide web-based information concerning the status of a contractor's license. States that require a license do not allow a contractor to enter into a construction contract without an active license.

Obtain Positive Identification of the Contractor:

In order to ensure that a third party isn't trying to obtain acceptance as a contractor by using someone else's credentials, it is prudent to obtain positive photo identification from the contractor. A driver's license, passport, or any other positive form of identification can be matched to the contractor's license and other information listed on the contractor acceptance submission.

Review Contractor's Gross Sales over a Three-Year Period:

Most small contractors do not produce audited financial statements. The construction lender, by reviewing the contractor's gross sales over the last three years, can gain a better understanding of the size and trends of the builder's business.

Contact Contractor's References:

Lenders should require that a contractor submit a list of previous client and subcontractor/supplier references. Lenders can then contact these references to ensure that the contractor is in good standing with his subcontractors/ suppliers and that he/she has satisfied previous clients. It is also important to determine whether or not the contractor has built a similar size home.

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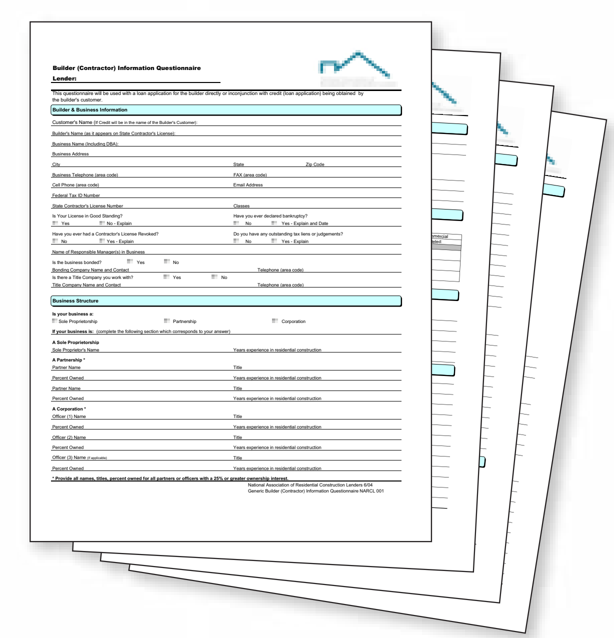
Development of the NARCL Builder (Contractor) Information Questionnaire (Form 001)

By Richard W. Nirk [4]

The National Association of Residential Construction Lenders (NARCL) provides education, information and is devoted to developing procedural standards for the benefit of the construction lending industry. The group is comprised of borrowers, lenders, builders, investors, and other professionals in the residential construction lending community. The focus within NARCL provides a broad direction to lenders in the area of commercial lines of credit, which also provide consumer products, such as construction to perm loans. A number of key initiatives are in process with NARCL, but the most important to date is the recent development of the new Builder (Contractor) Information Questionnaire (NARCL Form 001).

After some concentrated research with various builders throughout the country, it was determined that one of the most common issues frustrating builders nationwide, was the inconsistency of standards within the lender community. When a consumer obtains a construction loan or if a builder applies for credit, the builder on the project is often reviewed based on his/her qualifications and creditworthiness. The application process can drastically vary from lender to lender, thus leading to considerable frustration by the builder and their unwillingness to provide documentation.



Builder (Contractor) Information Questionnaire

Lender:

This questionnaire will be used with a loan application for the builder directly or inconjunction with credit (loan application) being obtained by the builder's customer.

Builder & Business Information

Customer's Name (If Credit will be in the name of the Builder's Customer):

Builder's Name (as it appears on State Contractor's License):

Business Name (Including DBA):

Business Address

City State Zip Code

Business Telephone (area code) FAX (area code)

Cell Phone (area code) Email Address

Federal Tax ID Number

State Contractor's License Number Classes

Is Your License in Good Standing? Yes No - Explain

Have you ever declared bankruptcy? No Yes - Explain and Date

Have you ever had a Contractor's License Revoked? No Yes - Explain

Do you have any outstanding tax liens or judgements? No Yes - Explain

Name of Responsible Manager(s) in Business

Is the business bonded? Yes No

Bonding Company Name and Contact Telephone (area code)

Is there a Title Company you work with? Yes No

Title Company Name and Contact Telephone (area code)

Business Structure

Is your business a:

Sole Proprietorship Partnership Corporation

If your business is: (complete the following section which corresponds to your answer)

A Sole Proprietorship

Sole Proprietor's Name Years experience in residential construction

A Partnership *

Partner Name Title

Percent Owned Years experience in residential construction

Partner Name Title

Percent Owned Years experience in residential construction

A Corporation *

Officer (1) Name Title

Percent Owned Years experience in residential construction

Officer (2) Name Title

Percent Owned Years experience in residential construction

Officer (3) Name (If applicable) Title

Percent Owned Years experience in residential construction

*** Provide all names, titles, percent owned for all partners or officers with a 25% or greater ownership interest.**

National Association of Residential Construction Lenders 6/04
Generic Builder (Contractor) Information Questionnaire NARCL 001

The mortgage industry is now stronger then ever due in part to the consistency and standardization of the mortgage process. FannieMae and FreddieMac have driven this process with standardized applications, credit requirements, and analytical tools that inform lenders of the standard and provide consumers with a uniform process. Since one of NARCL's goals is to deliver a platform for consistency in the area of construction lending, the NARCL Form 001 is now available and will be implemented on a voluntary basis by a number of construction lenders.

The lenders who have assisted in the development of NARCL Form 001 have agreed to implement it within the 4th quarter of 2004. This initial group of lenders includes WAMU, CitiGroup-CitiMortgage, Affinity Bank, IndyMac Bank, and JPMorgan Chase. Discussions are in process with many other lenders who also recognize the benefits of consistency in this area.

The form itself has two available formats (8½ × 14 @ 2 pages or 8½ × 11 @ 4 pages) and can be formatted based on each lender's needs. NARCL requests that the form be used as presented, and any specific areas not needed by the lender be listed as optional. The lender may add their logo and the form is formatted by key areas of information from the builder, to include: Builder & Business Information, Business Structure, Business Experience, Gross Sales, Warranty Information, References and requests key documentation, like a copy of their State Contractors License. The form also allows the lender the ability to request other key information like financials and includes a Declaration & Authorization Section to Release Information.

As the first consistent residential construction credit application developed specifically for the builder the use of NARCL Form 001 will lead toward a consistent process for the builder and consumer. As acceptance is gained, the NARCL Form 001 will give builders a consistent process to follow and lenders a consistent process evaluation, thus ultimately improving the risk management process in the construction lending industry.

The NARCL Form 001 will be discussed in many of the upcoming NARCL membership conference calls and will be highlighted at the 2004 Strategies for Success in Construction Lending seminar, held December 7–8 in Orlando, Florida. If you would like more information about NARCL, regular membership conference calls, programs available, the NARCL Form 001 and/or activities, please contact Richard W. Nirk at www.rwnirk@narcl.org.

[4] Richard W. Nirk has over 20 years of commercial, construction and mortgage lending experience. He has been employed by a number of firms such as CitiGroup, American Express and for many years was the National Construction Program Manager for JPMorgan Chase. He currently is the Executive Director for the National Association of Residential Construction Lenders and is a National Construction Advisor for the Excell Management Group, Ltd.

Utah's Mechanics' Lien Law

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2. Persons who do not have direct contracts with the owner are "barred" from liening residential property and from recovering a civil judgment against the owner if the following conditions are met (the "statutory criteria"):

   - The owner and the original contractor entered into a written contract;
   - The original contractor was properly licensed; and
   - The owner paid the original contractor in full "in accordance with the written contract and any amendments."

In plain English, it would appear if one hires a licensed general contractor to build a house and pays him in full, subcontractors cannot file liens. For this reason, many Utah residential construction lenders do not ask for lien releases from the subcontractors and suppliers.

Unfortunately that is not how the law works. A subcontractor that we'll call "Joe the Electrician" finishes his electrical contract and bills the general contractor $10,000. The residence is half completed, and the general contactor submits a draw to the lender and receives the payment but does not pay Joe. Can Joe lien the job? One would think not, because the general contractor has been paid in full for Joe the Electrician's work in accordance with Joe's subcontract. This would seem to comply with the statute as detailed above wherein the licensed general contractor has been paid in full for Joe's work. But that is not the case. Joe can still file a lien for the unpaid $10,000. Let's explore why this is the case.

Procedures for Removing Liens on Residential Property Under Utah Law:

Although the Residential Lien Act bars "wrongful" liens, lien claimants may nevertheless record such liens even if there may be a question as to whether the statutory criteria have been met. What this means is any unpaid subcontractor or supplier may file a lien. It is then up to the courts to determine whether or not it is a "valid" or "wrongful lien."

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Mitigating Pre-Closing Construction Lending Risk

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Obtain Contractor's Personal or Business Credit:

One of the biggest risks of construction lending is a lien placed on the property. Since the general contractor is normally responsible for paying all of the subcontractors and suppliers on a project, it is important to understand the credit rating of the contractor. A business credit report from a reputable agency can provide lenders with information about how the contractor pays his/her business bills. Sole proprietors and closely held corporations often will not have a business credit rating. In these cases, obtaining a personal credit report on the main principal of the company can be beneficial. If the contractor is paying his/her personal bills on time then more than likely he/she will pay the subcontractors and suppliers on time.

In conclusion, while the aforementioned steps may seem simple, they are all an important part of mitigating a lender's construction risk. A qualified general contractor is an integral part of realizing a completed asset. Reviewing the general contractor's qualifications will ensure that the builder is capable of constructing the asset in addition to paying the bills associated with the project. Thus, this review combined with a comprehensive project review will help to ensure a complete, lien free property for the borrower while leaving the lender with a successful and profitable construction lending program.

Utah's Mechanics' Lien Law

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Once a lien is recorded there are only three available remedies in Utah to remove the lien:

1. Bond Around:

As in most states a bond for 150% of the amount of the lien can be posted to remove the lien from title. But residential lien bonds are expensive and difficult to obtain. Often borrowers cannot qualify or obtain one. Additionally, even with the lien released, the lien claimant is entitled to litigate his or her entitlement to the alternate security.

2. Summary Proceedings:

Utah's wrongful lien laws provide for an expedited procedure whereby a party can attempt to have a "wrongful" lien removed by filing a Petition for Summary Relief to Nullify Wrongful Lien. A "wrongful lien" is defined as "any document that purports to create a lien or encumbrance on an owner's interest in certain real property at the time it is recorded or filed" and is not expressly authorized by law. A hearing on the lien is held within 10 days and if the lien is wrongful, it will issue an order declaring the lien void *ab initio,* releasing the property from the lien.

Unfortunately, the wrongful lien statutes, including the summary proceeding, do *not* apply "to a person entitled to a lien under Section 38-1-3 who files a lien pursuant to Title 38, Chapter 1, Mechanics' Liens" (see § 38-9-2(3) (1999)).

Remember Joe the Electrician? Would he have a "wrongful" lien that could be removed with the summary proceeding? The answer is no. The Utah courts have interpreted the law to mean the general contractor has to have been paid in full for the entire job under the terms of the contract, not just a portion. In other words, the residence has to be completed for the statutory defenses to work and summary proceeding to apply. Joe has a valid lien.

3. Litigation:

The owner must defend the lien claimant's lien foreclosure action in costly and lengthy legal proceedings.

Conclusion:

Despite the legislatures' efforts to protect homeowners, for all practical purposes Utah's mechanics' lien laws function like most other states insomuch as unpaid subcontractors and suppliers can file liens that can only be removed by payment or litigation. Regardless if the general contactor has already been paid, the borrower may be forced to pay twice.

Bad things happen when liens record on a construction project, and frequently the project comes to a halt. The general contractor who is not paying the subcontractors and suppliers has either disappeared or is insolvent. The project sits dormant, exposed to the elements and vandals, and a new general contractor typically wants more to complete the project than what's left in the budget. The homeowners, who are often incapable of making up any budget shortfalls, default and often sue the lender.

In close, regardless of what other construction lenders are doing in Utah, the protections against liens provided by the Residential Lien Act are limited. During construction, it would be judicious for all parties involved to ensure the subcontractors and suppliers are being paid by having the general contractor provide lien releases or paying the subcontractors and suppliers directly.

CORRECTION NOTICE:

The copyright line for "On Great Clients," by Joe Berkeley in the Second Quarter 2004, Volume 8 edition of the Construction Lending News, was incorrectly detailed. The copyright should read: Reprinted with permission © 2004, The Taunton Press, Inc.

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Construction-at-a-Glance

	July 03	July 04
Monthly Housing Starts*	1,893	1,980
YTD Permits-Single Family*	839.2	944.9
Monthly New Home Sales*	1,156	1,082
Unemployment Rate	6.2%	5.5%

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