

# WELCOME TO OUR SEMINAR

## MOTHBALLING A CONSTRUCTION PROJECT: WHAT HAPPENS TO CONTRACTS, FINANCING AND IMPROVEMENTS?

Wednesday, August 5, 2009 | 8:30 a.m. CST

*Presented by:*



# PRESENTATION OVERVIEW

## CURRENTLY SPEAKING



**Ty D. Laurie**  
Partner  
Practice Leader  
Construction  
Practice Group  
DLA Piper

- Strategic Assessments of Mothballing Projects
- Lender Negotiations
- Hidden Costs of Mothballed Projects
- Legal Issues Surrounding Mothballed Projects

# MOTHBALLING A CONSTRUCTION PROJECT

CURRENTLY SPEAKING



**Ty D. Laurie**  
Partner  
Practice Leader  
Construction  
Practice Group  
DLA Piper

## INTRODUCTION OF PANELISTS



**Dennis J. Powers**  
Partner  
Construction Practice Group  
DLA Piper



**James T. Schmid**  
Partner  
National Director of  
Construction Forensics  
Grant Thornton



**Melissa Dimitri**  
Manager  
Corporate Advisory &  
Restructuring Services  
Grant Thornton

# BACKGROUND

## CURRENTLY SPEAKING



**James T. Schmid**

Partner  
National Director of  
Construction Forensics  
Grant Thornton

## Why are projects being mothballed?

- Financing and equity has dried up
- Lenders are running from projects
- Future economic strength is unpredictable
- Overcapacity
- Real estate prices have dropped
- Projects were poorly conceived
- Partner financial incapacity

# WHAT EVERY DEVELOPER AND CONSTRUCTION PROJECT OWNER NEEDS TO DO NOW

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**James T. Schmid**

Partner  
National Director of  
Construction Forensics  
Grant Thornton

## Re-assess the feasibility of all your projects NOW

- Re-visit, scrutinize forecast revenue assumptions
  - Reasonableness
  - Source
  - Timing
- Reevaluate expected cost to complete project
  - Do not forget claims
  - Is original completion plan viable?
  - Are you getting the real story regarding percent complete?
- Is your source of debt funds secure?

# STRATEGIC ASSESSMENT

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**James T. Schmid**

Partner  
National Director of  
Construction Forensics  
Grant Thornton

- Evaluate strategic options:
  - Scale back construction
    - Consider breaking construction down into phases
    - Downgrade certain finishes to reduce costs
  - Conversion/adaptation
    - Apartments vs. condos
    - Convert retail space to residential space
    - If construction has not advanced significantly, consider adapting the land for a low-impact alternative (e.g., car wash, storage facilities)
  - Mothballing
  - Sale of all or portions of property
  - Bankruptcy
  - Foreclosure/termination

# NEGOTIATING WITH LENDERS

CURRENTLY SPEAKING



**Melissa Dimitri**  
Manager  
Corporate Advisory &  
Restructuring Services  
Grant Thornton

- Importance of communication
- Be prepared
  - Research current status of the property (title, appraisal, property condition, environmental assessment, leasing schedule, rent roll)
  - Know the range of strategic alternatives and the costs/benefits associated with each
  - Have a deep understanding of your loan agreement(s)
  - Know what you are asking of the bank (e.g., forbearance, payment modification, extension, etc.)
- Understand the lender's position and motivation
  - In general, lenders want to be highly compensated for and sufficiently protected against risk

# NEGOTIATING WITH LENDERS (continued)

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**Melissa Dimitri**  
Manager  
Corporate Advisory &  
Restructuring Services  
Grant Thornton

- Build a business case
  - If in default – how will you cure?
  - Assemble a scenario analysis for each strategic alternative
    - Include projected cash flows (both short- and long-term), P&Ls and balance sheets
    - Make your assumptions transparent (e.g., occupancy, maintenance, capital improvements, etc.)
    - Include loan balance projections
    - Perform sensitivities and covenant testing
- Have an exit strategy



# MOTHBALLING A CONSTRUCTION PROJECT

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Manager  
Corporate Advisory &  
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- Importance of Cost/Benefit Analysis
  - Cost benefit of mothballing the project (*e.g.*, carrying costs vs. sale vs. foreclosure)
  - Take into account potential future market conditions (*i.e.*, if you decide to mothball, you are essentially gambling the market will improve)
  - Take into account net present value of potential future cash flows

# DON'T FORGET HIDDEN COSTS OF SHUTTING DOWN OR SUSPENDING A DEVELOPMENT

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**Melissa Dimitri**  
Manager  
Corporate Advisory &  
Restructuring Services  
Grant Thornton

- Weatherproofing/security costs
- Demobilization and (hopefully) remobilization costs
- Lender penalties and personal guarantees
- Contractor claims
- Continuing costs (time dependent)
  - Debt service
  - Insurance
  - Security
- Lost revenue

# MOTHBALLING A CONSTRUCTION PROJECT



# MOTHBALLING A CONSTRUCTION PROJECT



# WHAT TO DO WITH CONTRACTORS

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- Two ways to handle contractors
  - Suspend work
  - Terminate the contractor
    - For convenience
    - For cause
  - Will be liable for contractor's anticipated profit for complete project if you do not have the right to terminate for convenience
    - *O'Connor Construction Co., Inc. v. Belmont Harbor Home Dev., LLC*, 2009 Ill. App. LEXIS 660 (June 16, 2009)

# SUSPENSION OF THE WORK

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- AIA A201 General Conditions provides:
  - §14.3.1. The Owner may, without cause, order the Contractor in writing to suspend, delay or interrupt the Work in whole or in part for such period as the Owner may determine.
  - §14.3.2. The Contract Sum and Contract Time **shall** be adjusted for increases in the cost and time caused by suspension, delay or interruption as described in Section 14.3.1. Adjustment of the Contract Sum shall include profit.

# TERMINATION FOR CONVENIENCE

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- AIA A201 General Conditions termination for convenience provision:
  - §14.4.1. The Owner may, at any time, terminate the Contract for the Owner's convenience and without cause.
  - §14.4.2. Upon receipt of written notice from the Owner of such termination for the Owner's convenience, the Contractor shall
    - .1 cease operations as directed by the Owner in the notice;
    - .2 take actions necessary, or that the Owner may direct, for the protection and preservation of the Work; and
    - .3 terminate all existing subcontracts and purchase orders and enter into no further subcontracts and purchase orders.

# TERMINATION FOR CONVENIENCE

CURRENTLY SPEAKING



**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- §14.4.3. In case of such termination for the Owner's convenience, the Contractor shall be entitled to receive payment for Work executed, and costs incurred by reason of such termination, **along with reasonable overhead and profit on the Work not executed.**

# TERMINATION FOR CAUSE

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- AIA A201 General Conditions termination for cause provision:
  - §14.2.1. The Owner may terminate the Contract if the Contractor:
    - .1 repeatedly refuses or fails to supply enough properly skilled workers or proper materials;
    - .2 fails to make payment to Subcontractors;
    - .3 repeatedly disregards applicable laws, statutes, ordinances, codes, rules and regulations, or lawful orders of a public authority; or
    - .4 otherwise is guilty of a substantial breach of a provision of the Contract Documents.

# TERMINATION FOR CAUSE

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- §14.2.2. When any of the above reasons exist, the Owner, upon certification by the Initial Decision Maker that sufficient cause exists to justify such action, may without prejudice to any other rights or remedies of the Owner and after giving the Contractor and the Contractor's surety, if any, seven days' written notice, terminate employment of the Contractor...

# PROPERLY EXERCISING RIGHT TO TERMINATE

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- Termination for cause
  - Often litigated
    - Judges sympathetic to a contractor not performing the work or performing it slowly if it has not been paid
  - Notice requirements
    - Must strictly comply with time requirements
  - Certification by the initial decision maker (often the architect) is necessary

# CONTRACTOR'S RIGHT TO TERMINATE

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- AIA A201 General Conditions gives the contractor the right to terminate the contract
  - §14.1.1. The Contractor may terminate the Contract if the Work is stopped for a period of 30 consecutive days through no act or fault of the Contractor ... for any of the following reasons:
    - .3. because the Owner has not made payment on a Certificate of Payment within the time stated in the Contract Documents; or
    - .4. The Owner has failed to furnish to the Contractor promptly, upon the Contractor's request, reasonable evidence as required by Section 2.2.1.

# CONTRACTOR'S RIGHT TO TERMINATE

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- §14.1.2. The Contractor may terminate the Contract if, through no fault of the Contractor...repeated suspensions, delays or interruptions of the entire Work...constitute in the aggregate more than 100 percent of the total number of days scheduled for completion, or 120 days in any 365-day period, whichever is less.
- §14.1.3. If one of the reasons described in Section 14.1.1 or 14.1.2 exists, the Contractor may, upon seven days' written notice to the Owner and Architect, terminate the Contract and **recover from the Owner payment for Work executed, including reasonable overhead and profit, costs incurred by reason of such termination and damages.**

# THE ARCHITECT

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- Termination
  - AIA contract provides that if owner suspends project for more than 90 cumulative days, architect can terminate.
  - Owner may terminate for convenience, but owner is responsible for termination expenses and architect's anticipated profit.
- Ownership of Drawings
  - AIA contract gives owner a nonexclusive license, provided owner pays architect. License terminates upon contract termination.
  - Retaining ownership of drawings upon termination important.

# CONTRACTOR'S RIGHT TO OWNER'S FINANCIAL INFORMATION

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- AIA General Conditions provide that the contractor has the right to request, prior to commencement of the Work, reasonable evidence that financial arrangements have been made to fulfill Owner's obligations under the contract.
- Thereafter, the Contractor may request evidence of financial arrangements if the Owner fails to make payments to the Contractor, the Contract Sum changes materially, or the Contractor identifies a reasonable concern regarding the Owner's ability to make payment when due.

# IDENTIFYING AND RESOLVING CLAIMS

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- Who are the potential claimants?
  - General contractor
  - Architect
  - Engineers and consultants
  - Subcontractors
  - Sub-subcontractors
  - Suppliers to subcontractors

# IDENTIFYING AND RESOLVING CLAIMS

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- Identify the universe of claimants
  - Start with payment applications and sworn statements
    - But do not rely on them exclusively
  - Sometimes necessary to contact all potential claimants to verify the amount due
    - Send out a form that requests:
      - Original contract amount
      - Change orders
      - Extras that are not reflected in change orders
      - Payment amounts and dates
      - Contract balance
      - Any unpaid suppliers or sub-subcontractors
      - Percent completion of its work or materials supplied

# IDENTIFYING AND RESOLVING CLAIMS

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- **Contractors**
  - Relevant time periods to make claims
    - Contract provisions
    - Mechanics Lien Act
      - Ninety days for subcontractors and sub-subcontractors to send notice of claim for lien
      - Four months to record lien claim to be effective against lender and subsequent owners
      - Two years to record lien claim to be effective against owner
      - Two years to file suit to foreclose lien claim
  - Other Mechanics Lien Act Provisions
    - Ten percent interest
    - Attorneys' fees to claimant if payment withheld without just cause or right.
    - Section 34 right to demand claimant foreclose its lien

# IDENTIFYING AND RESOLVING CLAIMS

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- Sales obligations
  - Notice to purchasers
    - Purchasers may argue that notice that will not complete on time is an anticipatory repudiation
      - However, anticipatory repudiation requires a clear and unequivocal statement that seller cannot comply with the contract
  - Termination of sales agreements
    - Limitation of liability provisions in sales agreements important
      - Generally enforceable in Illinois (but not other jurisdictions, such as Florida)

# IDENTIFYING AND RESOLVING CLAIMS

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- Leasing obligations
  - Failure to timely deliver project can lead to exposure to tenants and brokers
    - Limitation of liability or break-up provision important
    - Must strictly comply with notice provisions

# COMPLETION GUARANTEES

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- Generally requires
  - property be kept lien free
  - guarantor completes improvements
- Construed by the courts as a security interest
- Guarantor often not required to complete improvements if the lender is fully secured
- If lender forecloses and sells property, it may lose the benefit of the completion requirement

# COMMON AREA MAINTENANCE IN VERTICALLY SUBDIVIDED BUILDINGS

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- Absence of project will have an impact on sharing of operating expenses
- Other owners in the building may seek common area maintenance expenses as if project were completed

# PRESERVING ENTITLEMENTS

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- Building permits
  - Will expire if no work being performed
- Zoning
  - Legislative – will not expire
- Planned Unit Development
  - Probably will have commencement and completion dates and sometimes phases
- Entitlement obligations
  - Will run with the land if the project is sold

# PHYSICAL PROTECTION OF THE PROPERTY

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**Dennis J. Powers**  
Partner  
Construction Practice  
Group  
DLA Piper

- US Army Corps of Engineers guidelines
  - Differ by construction style and locale
  - Security, maintenance and monitoring
  - If enclosed, will require ventilation
    - Cannot simply board it up
- Heating Ventilating Contractors Association guidelines