
MANAGING AGAINST CONSTRUCTION RISK

RISK # 1

The project's budget is understated and money runs out before the project is completed.

- 1) Develop a *detailed budget with a contingency*. The budget should provide a realistic estimate of all project costs, with construction costs based on a guaranteed price contract or bid, and with individual line items for each soft cost. The budget should include an allowance for any unforeseen occurrence during construction (usually 10% for new construction hard costs; 15-20% for renovation hard costs; 5% for soft costs).
- 2) Execute a *fixed-price contract (i.e., stipulated sum or guaranteed maximum price)*. The contract price is fixed, determined in advance of any construction, and based on defined construction specifications that are prepared by the architect and agreed to by the owner. Carefully review the GC's exclusions.
- 3) *Make monthly disbursements* to the contractor through the construction lender, based on an *application and certification for payment*. This is a generally accepted process for disbursing construction loan proceeds, whereby the general contractor (GC) requests payment from the owner (borrower), according to a schedule outlined in a construction contract. The applications for payment provide detailed information about how much work has been completed to date, and are signed off by the architect. The lender's inspector provides a separate report on payment applications. Do not sign a contract which allows for payments in equal monthly installments over the term of the contract.
- 4) Hire a *project manager* to oversee the development/construction project.

RISK # 2

The general contractor (GC) runs into cash flow problems. He/she doesn't have cash available to purchase supplies or pay subcontractors. Or, the GC diverts loan proceeds earmarked for the construction project to another purpose.

- 1) Make sure that the GC posts *payment bond and performance bonds*. These are bonds issued by a surety company. They are similar to an insurance policy that insures that if the GC does not pay his/her subcontractors or the GC is unable to complete the project, the borrower can make a claim to the surety company. For a smaller GC, have the GC obtain a letter of credit that equals 25% of the hard costs.
- 2) Require a *Lien Waiver and Release* upon each application for payment. By using this release, the GC, each subcontractor, supplier of materials, and mechanic acknowledge that upon payment, any right to place a lien on the property for work performed on the project to date will be waived.
- 3) Obtain a *satisfactory contractor's qualification statement*, which indicates the experience, availability, and capability of the proposed contractor. The statement should include financial statements, a resume of significant (and similar) work experience and references.
- 4) Check the GC's references for work on similar projects.

MANAGING AGAINST CONSTRUCTION RISK (CONTINUED)

<p>RISK # 3</p> <p>The GC (or a subcontractor) places a mechanic's lien on the property, thus placing the senior lender's first deed of trust (or mortgage) at risk.</p>	<ol style="list-style-type: none"> 1) Require a <i>release of lien</i> upon each application for payment (see Risk 2, #2 above). 2) Obtain <i>title insurance</i>. This is an insurance policy that assures that the senior lender will have a first deed of trust. Depending upon the state, "bring downs" or "bring to dates" may be required for each construction loan advance, so that the bank is insured only up to the amount advanced by that date.
<p>RISK # 4</p> <p>The GC has completed 95% of your project, but has started another large project, and doesn't show up to complete your project.</p>	<ol style="list-style-type: none"> 1) Obtain a <i>satisfactory contractor's qualification statement</i> (see Risk 2, #3 above). 2) Make sure that the GC posts <i>payment bond and performance bonds</i> (see Risk 2, #1 above). 3) Hire a <i>project manager</i> to oversee the development/construction project. 4) <i>Require Retainage</i>. This is a standard payment plan by which a certain percentage (typically, 10%) is withheld from the progress paid to the GC to ensure that the GC will not walk away from the project prior to 100% completion. This is standard practice for many construction lenders. 5) Contact the GC's <i>bond company</i>.
<p>RISK # 5</p> <p>An environmental problem is discovered on the property (e.g., contaminated groundwater due to a previous facility located on, or adjacent to, the property).</p>	<ol style="list-style-type: none"> 1) Obtain a <i>Phase 1 Environmental Site Assessment Report</i>. This is a report obtained by a third party (prior to construction, and usually required by your lender) that identifies any existing, potential, or suspect conditions that may pose an environmental liability to the property. 2) Hire a <i>project manager</i> to oversee the development/construction project.
<p>RISK # 6</p> <p>When the building is completed, the city inspector determines that it is not structurally sound, and will not issue a final permit.</p>	<ol style="list-style-type: none"> 1) Make sure that your architect has <i>Certificates of General and Professional Liability (Errors and Omission insurance)</i>. The architect's professional liability insurance covers negligent work performed by the architect and protects the owner (borrower) if there is damage due to such negligence. 2) Obtain an <i>Architect Qualification Statement</i>. This is a statement verifying the architect's qualifications and experience with projects similar to yours. 3) Check the <i>architect's references</i> for work completed on similar projects. 4) Require <i>Certificate of Occupancy</i> prior to release of final loan funds. This is a certificate issued by the appropriate government authority indicating that the project is ready and fit for occupancy, and that there are no building code violations. 5) A lender's <i>Construction Inspector</i> is appointed by the lender and serves as his/her representative to monitor construction progress on a monthly basis. This individual warrants the work on the lender's behalf only. 6) If possible, review a <i>Construction Inspector Pre-Construction Report</i>. This is a written report from the lender's construction inspector that provides an analysis of the feasibility of the project, specifically the reasonability of the price that the GC is bidding and the timeframe proposed. 7) Obtain <i>Satisfactory Contractor's Qualification Statement</i>. (See Risk 2, #3 above). 8) Hire a project manager to oversee the development/construction project.

MANAGING AGAINST CONSTRUCTION RISK (CONTINUED)

<p>RISK # 7 An accident occurs during construction and a worker is seriously injured. The worker sues the GC, thus tying up the GC and impeding completion of your project.</p>	<ol style="list-style-type: none"> 1) Increase the charter school's <i>General Liability Insurance</i>. Make sure that the school's insurance policies cover the value of the new property (with proposed improvements). 2) If the borrower is purchasing a new site, make sure the new property is added onto the charter school's existing insurance policies. 3) Confirm that the GC has sufficient <i>Workers' Compensation Insurance</i>. Ensure that the GC has sufficient insurance to cover workers in case of an accident.
<p>RISK # 8 A flood, fire, or other disaster occurs on the construction site, causing serious damage to construction in progress.</p>	<ol style="list-style-type: none"> 1) <i>Confirm</i> that the GC (or the owner) has obtained Builder's Risk Insurance in an amount that is at least equal to the GC's contract. 2) <i>Determine</i> whether the property is in a flood zone and do a search for Flood Compliance (usually performed by lender).
<p>RISK # 9 Real estate market conditions take a downturn, and once the building is completed, it is appraised for less than what it cost to construct it. The senior lender's loan-to-value is insufficient, and requires additional collateral coverage.</p>	<ol style="list-style-type: none"> 1) Obtain an <i>as-built appraisal reflecting adequate collateral coverage</i>. This is a third party estimate of the property's value, once constructed, based on plans, specifications and current market conditions. Lenders typically allow a maximum of loan-to-value percentage of the property's value to be in the form of senior debt so as to make sure that the property can be sold to cover the outstanding loan in a liquidation scenario. The lender providing the loan typically orders the appraisal. 2) If possible, obtain a <i>Construction Inspector Pre-Construction Report</i>. (See Risk 6, #6 above). 3) Ask your lender for <i>construction inspector's</i> reports throughout the project, if possible.
<p>RISK # 10 The charter school's current operations suffer because management is focused on the new development project and "no one is minding the store".</p>	<ol style="list-style-type: none"> 1) Hire a <i>project manager</i> to oversee the development/construction project.
<p>RISK # 11 The building is constructed with a small portion encroaching on a neighbor's property.</p>	<ol style="list-style-type: none"> 1) Obtain an <i>Architect Qualification Statement</i>. (See Risk 6, #2 above). 2) Review a <i>Construction Inspector Pre-Construction Report</i>. (See Risk 6, #6 above). 3) If possible, obtain an <i>A.L.T.A./As-Built Survey</i>. This is a survey prepared by an independent, third party surveyor showing the precise location of all improvements, encroachments, and rights of way on the property. Lenders may also require an updated survey once the building's footprint (e.g., footings and foundations) is laid to avoid this problem.