

STALLED CONSTRUCTION PROJECTS: HOW TO MINIMIZE LOSSES

By William W. Weisner



As of February 2010, the New York City Department of Buildings listed more than 500 sites in the five boroughs as projects at which construction had stalled. The reasons for so much stalled construction varied, and included:

- The construction lender stopped funding because the loan was “out of balance.”
- The construction lender stopped funding because of its own financial difficulties.
- Equity sources did not meet their capital contribution requirements, either because of their own financial difficulties or because they did not want to put money into projects that appeared to be “under water.”
- Changed market conditions led to an inability to secure financing.
- Crane collapses or other construction problems at the site led to stop work orders.
- Litigation caused delays – e.g., in the case of Forest City Ratner’s Atlantic Yards project.
- Disputes with contractors, including demands for additional compensation, stalled construction.
- Inexperienced developers failed to manage their projects properly, leading to one or more of the above issues.
- After construction commenced, city agencies determined that a project did not conform to its permits or to zoning restrictions.

Among the many adverse consequences of stopping construction are:

- Increased construction costs resulting from demobilization, remobilization and extended general conditions.
- Increased project costs resulting from the extension of the construction period, including loan interest, default interest, real estate taxes, insurance premiums and implementation of a safety monitoring plan.
- Costs associated with procuring additional equity and/or debt required to restart and complete construction. The cost of this capital is typically significantly higher than the terms of financing available at the project’s inception.
- Legal fees incurred to analyze and address the consequences of defaults under financing documents and construction contracts and the expiration of building permits or other permits or entitlements.
- Disputes among partners and disputes with lenders, contractors and other vendors.
- Prospective buyers and tenants avoiding commitments to buy or lease space in the project.
- Risks to the general public if the site is not properly secured and a site safety plan implemented.
- Impact on the surrounding community.

Tarter Krinsky & Drogin has recently represented many clients involved with stalled projects. These matters raise many legal, business, tax, financial and other issues. Unfortunately, the solutions to these situations almost invariably result in a significant impairment of the owner’s equity in the project. The solutions also often result in architects, contractors, subcontractors, suppliers and other vendors receiving reduced payments. Lenders usually have to choose between foreclosing on the property securing their loans, which in most cases will result in recovery of less than

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the full amount due on their loans, or working with the owners to restructure the debt and allow the introduction of new capital at some level in the capital stack to finance completion of construction and sale or lease-up of the project.

We have seen a variety of resolutions for these distressed site situations, including:

- The lender agreed to increase its loan on the condition that the owner engage a new construction manager recommended by the lender and raise additional equity as well, diluting the equity of the existing partners of the owner. The construction manager issued a guaranty of completion to the lender in return for the right to receive additional compensation if it meets completion targets and the property achieves certain revenue targets.
- The owner transferred its property to a new developer identified by the lender. In exchange, the lender released the existing owner and guarantors from liability for the loan.
- The existing owners teamed with a new partner to purchase the existing construction loan from the lender at a discount and then raised new capital in the form of a preferred equity investment to finance future development costs.
- A stalled construction site was sold to a new owner, in exchange for the right of the selling owner to receive a share of proceeds after the new owner completes construction and achieves certain levels of financial returns.
- The modification of an existing construction loan was combined with closing of a mezzanine loan that will bring the project's sources and uses back into balance.

The prospects of significant positive financial returns are low in most of these cases, but the losses likely to be incurred by the lenders, investors, contractors and others have been greatly reduced from the losses that would have

been incurred in a foreclosure or owner bankruptcy. In cases where the owner has invested significant equity, the resumption and completion of construction preserve the possibility of recovering at least some of that equity.

In many projects reported in the press, the lenders have foreclosed on their collateral after a project stalled and a negotiated resolution could not be achieved. The new owners generally have reported that they intend to complete construction eventually and then sell or lease the properties. Investors should be aware that some municipalities outside of New York are threatening to revoke entitlements unless construction is promptly recommenced and completed.

LOCAL LAW ASSISTS DEVELOPERS

In contrast, New York City has taken some steps to assist developers of stalled sites. In October 2009, Local Law No. 70 was enacted in New York City. This law provides, among other things:

- All permits issued by the Commissioner of the Department of Buildings (DOB) will expire if the permitted work or use is not commenced within 12 months from the date of issuance of the permit (six months for work in an area of special flood hazard), or if the work is commenced but is thereafter suspended or abandoned for a period of 12 months.
- However, the Commissioner was authorized to establish a program under which permits for such sites can remain in effect and even be renewed if the owner applies for inclusion in the program and complies with the program requirements, which are primarily focused on maintaining the safety of sites where work has not commenced or is suspended.
- On January 15, 2010, the DOB issued Buildings Bulletin 2010-001, which established such a program. An owner applying for the program must submit a "Safety Monitoring Plan" for DOB review and approval and

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request a site meeting with the DOB. If the plan is approved, the owner must continuously apply for renewal of permits, maintain proper insurance, submit monthly monitoring reports, make the site accessible to the DOB for periodic inspection, and comply with the Safety Monitoring Plan and other requirements of the program.

- It is important to note that renewal of DOB permits does not necessarily include renewal or vesting with respect to landmarks, zoning and other entitlements.

The cessation of construction prior to completion leads to numerous complex business, legal, financial, marketing, construction and safety issues. However, with proper planning, prompt action and the development of a plan that takes into account the many issues involved, losses to all parties involved can be minimized.

About William W. Weisner, Partner

Bill is a Partner in the Real Estate, Construction, and Banking and Finance Practice Groups. He handles a wide variety of commercial real estate and finance matters for lenders, developers, investors, landlords and tenants nationwide. Bill focuses on designing creative yet practical and efficient solutions to real estate issues and client needs. He has been repeatedly named as a leading real estate lawyer in the New York Metro edition of Super Lawyers magazine and has been recognized by Chambers USA since 2008. Bill can be reached at 212.216.8095; wweisner@tarterkrinsky.com.