COMPLETION COMMITMENT

A BETTER TOOL FOR MANAGING TODAY'S CONSTRUCTION RISKS

BY JOEY BONIN

In today's market, amidst a proliferation of construction opportunities during the Great Recovery, there is a greater need than ever to minimize the financial risk of construction loans, especially in the wake of increasing oversight due to regulatory reform, the rise in cost of materials, and labor shortages that may contribute to project delays.

Managing Today's Risks with Yesterday's Tools

To reduce risks, lenders have traditionally looked to payment and performance (P&P) bonds. If a contractor is unwilling or unable to either pay project bills or perform the agreed-upon scope of work and a default occurs, the issuing surety company is obligated to pay the outstanding bills and ensure completion of the project up to the amount of the bond. As a result, most public projects require payment and performance bonds.

In the private construction and lending space, however, there are some limitations to using bonds for risk management. Some projects cannot be bonded. These might include: overseas projects; multiyear construction jobs (three+ years); projects with contractors deemed too inexperienced or where the owner is also the general contractor; and projects with groundwater contamination, among many others. The bond is linked to specific

project scope and contract amount—it does not cover other projects or cost discrepancies that may occur over a period of time. Furthermore, the beneficiary is the owner/developer, not the lender. Many lenders require bonds as a risk mitigant simply because it is a familiar tool, even though it may not necessarily be the best tool to protect their interests. It is important to note a bond can't be called in with an incremental problem or project delay. It can only be triggered by a default, at which point massive problems have already incapacitated the project. The resulting time for filing liens, adjudication, and final fiduciary resolution can drag on for months, sometimes years. Meanwhile, essential sub-contractors can be lost due to lack of payment, while the materials and unfinished site deteriorate, possibly endangering the project altogether.

A New, Proactive Toolkit

Thankfully, bonds are not the only safety net for lenders anymore. Proactive risk management tools, such as funds control, are becoming more mainstream and are increasingly acknowledged by lenders, the Small Business Administration[1] (SBA), and the U.S. Department of Agriculture (USDA)[2], as well as other various commercial construction programs as an acceptable alternative to a P&P bond.

One of the most comprehensive risk management approaches, called a completion commitment (CC), involves a series of proactive control measures implemented before and after closing to help to keep projects on budget and on schedule, and to minimize the risk of default. It includes four key risk management building blocks and an additional commitment of professional services to course-correct if needed.

ONE OF THE MOST COMPREHENSIVE RISK MANAGEMENT APPROACHES, CALLED A COMPLETION COMMITMENT (CC), INVOLVES A SERIES OF PROACTIVE CONTROL MEASURES IMPLEMENTED BEFORE AND AFTER CLOSING TO HELP TO KEEP PROJECTS ON BUDGET AND ON SCHEDULE, AND TO MINIMIZE THE RISK OF DEFAULT.

The Four Building Blocks of a Completion Commitment

Prior to closing, there are two key control measures to help lenders underwrite the project. A document and cost review (DCR) helps determine the feasibility of a project by evaluating, among other documents, the project's budget, schedule of values, plans and specs, owner/contractor agreement, appropriate permits, and the GC's full scope of work. During the same pre-closing period, a contractor evaluation (CE) helps determine not only the capabilities and experience of the GC but also its capacity to add another project to an active portfolio of ongoing work and still have access to appropriate resources, both human (labor) and materials.

After the loan has closed and once the project commences, construction progress monitoring (CPM), sometimes referred to as a draw inspection, and funds control/disbursement are critical tools for ongoing risk management to ensure successful project completion. At the time of each GC draw request, CPM consists of regular site observations (typically monthly) to evaluate construction completion as well as consistency with the original project plans and schedule.

The implementation of funds control and disbursement addresses all project-related payment issues, makes sure funds are disbursed on schedule, and prevents funds from being improperly diverted. As a compulsory feature, it allows the risk management firm to exercise full control over all project funds, conduct oversight of checks being issued by the GC, and, most importantly, to coordinate draw requests with ongoing onsite inspections that monitor milestone fulfillment. By assuring timely payment to subcontractors and suppliers, funds control encourages them to continue working on projects that may have been paused due to a default by the GC. Loss of key subs and suppliers is one of the most significant roadblocks to the successful completion of stalled projects.

All the above building blocks are required to obtain a completion commitment, but there is a fifth element that provides the commitment itself. This is an agreement at project inception that, in cases of performance-related contractor default or termination, stipulates that the risk management firm will step in to oversee management of the project completion, including the hiring of the replacement GC. The lender and owner both benefit from successful completion of

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the project. The product is requested by the lender, although the bank will usually require that the owner pays for the CC product and the rest of the risk management program as a contingency of the loan.

How Completion Commitments Work

Collectively, these control measures serve as an effective early detection system for potential project discrepancies and problem prevention. Therefore, it is far less likely for a project that has a completion commitment in place to experience the difficulties that result in personnel termination and/or payment-related default.

In extremely rare occasions, despite these proactive preventative measures or through unforeseen circumstances, the GC is terminated for proven non-performance. When a performance default triggers the completion commitment, the consultant is called in by the lender to assist in finding a replacement GC, perform a thorough budgetary and project documentation audit, and continue construction progress monitoring to seamlessly move forward and ensure project continuity. One of the notable mandatory items for a CC is that sub-contractors are assignable. In case of a default or termination, this helps keep the project team together—subs are less likely to walk out when they continue receiving checks and interfacing with an on-site project manager from the company on record.

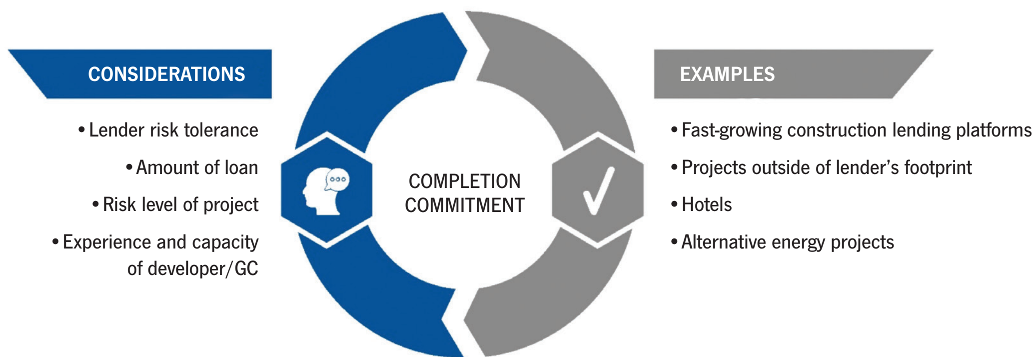
As project and contractor evaluations get underway, the CC consultant notifies all essential collaborating and administrative parties that the GC is no longer on board, ensures all retained subcontractors are paid, and is in constant communication with project stakeholders to make sure funding and completion milestones are in place to resume construction work. As a result, there is generally far less project downtime, typically ranging from days to weeks, as compared to months or even years, for similar projects with triggered P&P bonds.

When to Use a Completion Commitment

When the only construction risk management in place is a bond, the sole beneficiary is usually the owner/developer, but the lender's potential liability is still significant. Upon default, a surety ultimately restores funding based on the original estimate to complete the project, but it could take a protracted amount of time to adjudicate liens and follow up through proper channels during the investigation. In some cases, it takes years to restore funds. Unfortunately, by that point, a derelict construction site, subcontractors that are long gone, and the potentially higher costs for labor and materials to complete the project might force the developer or owner to walk away, leaving the lender with a foreclosed and devalued project.

With a rapidly changing construction landscape and an evolving array of lending sources, managing default risk depends on many complex interweaving factors. The graphic illustrates some key considerations and

FIGURE: COMPLETION COMMITMENTS AT A GLANCE



PAYMENT AND PERFORMANCE BONDS VS. COMPLETION COMMITMENTS: AN OVERVIEW		
	P&P Bond	**Completion Commitment**
Beneficiary	Usually owner	Usually lender
Typical cost	1-3% of hard dollar construction budget	0.4-0.5% of hard dollar construction budget
Includes proactive control measures	No	Yes
Triggered by	Performance or payment default	Any ongoing discrepancy
Typical project downtime	Months to years	Weeks to months

circumstances where a completion commitment is a more effective proactive risk mitigant than a traditional P&P bond.

So, how does the CC work under real circumstances? Below is a case study from a company we'll call "Company One."

A Better Story: Completion Commitment Saves Hotel Construction

Company One was engaged as a completion commitment consultant for a major hotel construction project in Tennessee. From the outset of the project, as part of the full suite of risk management services, the Company One team worked closely with the GC, subcontractors, and developer to re-evaluate the budget, make payments to subcontractors and vendors, and monitor adherence to major completion milestones. Company One discovered the GC had asked the borrower (developer) to pay him all the money upfront, rather than disbursing through scheduled funds control. He claimed to be self-performing much of the work and was trying to stay ahead of the funds. Had strict funds disbursement oversight not been implemented on this project, the GC could have ultimately absconded with most of the construction budget, resulting in an enormous loss for the developer and lender.

Despite regular site inspection visits, real-time progress monitoring, and meetings with individual stakeholders, multiple liens were placed on the project and the GC was ultimately terminated for cause (repeated delays, quality of workmanship), triggering a performance default. Company One then stepped in to fulfill the completion commitment, starting with evaluating the project's status at the time of the dismissal. The hotel was 50% complete—the roof was on and building envelope was dried-in—an excellent starting point for a new GC to take over.

The Company One team traveled to the site to review the outstanding scope of work. Company One worked closely with the borrower to interview the most capable replacements and assist in getting a new GC on board. There was little to no delay in replacing the GC, and subcontractors and vendors continued to be paid as work progressed. Company One's construction risk management team instituted weekly meetings for construction progress monitoring while collaborating with the developer and new GC to help with assignment of subcontractors. Company One worked with the developer and new GC to revise the project schedule, update site materials deliveries, and establish milestones based on reasonable deliverables. Some vendors were even replaced. Company One saved the developer money by taking non-essential contract administration out of the new scope of work and resumed stringent funds control and disbursement oversight, including monitoring of buyouts to make sure contracts awarded were not greater than the scope of work required.

In the end, the hotel construction was finished without any additional liens and largely on schedule. By contrast, waiting for a bond payout on this project would have delayed completion significantly.

FOR ANY LENDER OR DEVELOPER, UNDERTAKING A MAJOR CONSTRUCTION PROJECT INVOLVES SIGNIFICANT FINANCIAL RISK.

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For any lender or developer, undertaking a major construction project involves significant financial risk. While bonds may have been considered the industry standard for many years, they are not necessarily the best solution for all business objectives in today's market. The completion commitment product, together with a sound full-service construction risk management program including funds control and disbursement, helps ensure the lender and borrower can proactively manage their project from inception all the way through completion, with little or no disruption if problems occur. ®

Notes

1. SBA SOP 50 10 5 K, Subpart B (pages 216-217) https://www.sba.gov/document/sop-50-10-5-lenderdevelopment-company-loan-programs
2. USDA RD Instruction 4279-B, Subpart B – Business and Industry (B&I) Guaranteed Loans (page 63) https://www.rd.usda.gov/files/4279b.pdf

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