

HYPOTHETICAL PROBLEM FOR ABA  
PRESENTATION ON APRIL 4, 2003

Lakeside Development, L.L.C. ("Lakeside") is the fee owner of 25 acres of real estate located in the City of Grand Rapids, Michigan, that is commercially zoned. Lakeside determined to construct a mixed-use, high-rise building on the site, which would contain retail space, offices and some condominiums. The construction financing for this project has been provided by First State Bank ("Bank") and draws under the loan are being made through a title company. As security for repayment for the construction loan, Lakeside granted to Bank a first mortgage on the real estate and buildings being used for the project. Bank, however, neglected to obtain an assignment of the construction contract and design services agreement entered into by Lakeside and Architectural Specialists, Inc. ("ASI").

A commitment for take-out financing has been obtained by Lakeside from Gotham Insurance Company ("Gotham"). Pursuant to a tripartite agreement involving Lakeside, Gotham and Bank, Gotham will provide this financing only upon fulfillment of the following conditions: (i) Gotham receives written evidence that all contractors, subcontractors, materialmen and laborers on the project have been fully paid; (ii) forty percent (40%) of the project is occupied; and (iii) appropriate certificates of occupancy have been issued.

The construction contract for the project was drafted so as to permit the general contractor, Killefer Construction Company ("Killefer") to be the overall manager of work on the site. The contract provides that Killefer's compensation for its work will be on a "cost plus" basis with a guaranteed maximum amount. Killefer has provided a performance bond to Lakeside, which has been issued by American Surety, Inc. ("Surety").

Due to recent economic downturn, Lakeside has not been able to sell and lease space in the project in accordance with its earlier projections. In addition, there have been significant cost overruns. Killefer contends that the majority of these overruns have been caused by changes to the project requested by Lakeside. This is disputed by Lakeside, which argues that the overruns are due to poor estimation practices by Killefer. On one issue, however, Killefer and Lakeside agree—that some of these overruns were caused by drawings and specifications submitted by ASI that are ambiguous and lack sufficient detail. ASI, in turn, denies these charges.

Faced with this situation, Bank has decided that it will not fund any more draws being made on the construction loan. The remaining availability under the loan will be insufficient to pay the cost to complete the project, based on current estimates. Various subcontractors have not been timely paid and are clamoring for attention. To date, Surety has refused to honor its commitments under the performance bond for the stated

reason that Surety has not received sufficient evidence that Killefer has failed to perform its obligations under its contract with Lakeside.

**QUESTION #1:** Is it advisable for the various parties involved to attempt to solve these problems and finish the project through workout negotiations outside of bankruptcy? If this approach is taken, what are the negotiating strategies of the parties?

**QUESTION #2:** In the event that Lakeside becomes the subject of a case under Chapter 11 of the Federal Bankruptcy Code, what options and strategies are available to the parties?