

## **Construction Lending in the New Millennium: What A Lender Needs To Know Before Making A Construction Loan**

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Construction lending is highly complex and sophisticated. It requires cooperation among a variety of people, such as the borrower, the construction lender, their respective counsel, the permanent lender, the contractor, their representatives, architects and engineers, appraisers, title companies and others. The ultimate aim of all parties is the successful completion of a project having both social value and economic viability.

With the possible exception of a recourse construction loan made to a high quality and creditworthy U.S. corporation, there is an element of market risk in every construction loan. That is, there is a possibility that the project itself will not be successful as a hotel, office building, condominium development, apartment complex, shopping center or other type of building or complex. This may result in the project's not being completed, and therefore the borrower may not be able to repay the loan or the permanent lender will not fund its permanent loan. The better a construction lender can limit the non-market risks inherent in construction loans, the more likely the construction loan will have a successful outcome.

There are other factors that can make the project attractive to the construction lender since it is not possible for every construction loan to be made to such high credit corporations or be made on commercial and industrial properties fully leased to lessees of credit standings or with appropriate long term take-out financing in place at the closing of the construction loan. For example, the owner of a particular project may have such a substantial investment in the project that the construction lender may conclude that it is very well covered against a possible loss due to poor acceptance of the project in the market. Further, situations may arise where the owner has such an excellent track record with prior projects and/or is so well and favorably known to the construction lender that it may decide to make the loan regardless of apparent weaknesses of the project or the borrower at that time. In these and other similar situations, there will undoubtedly be market risk. The project itself may be bad; the borrower's own equity investment may not be substantial enough or the borrower's past track record of success may have already begun to break down. It is important, therefore, that the construction lender identify the market and other risks which may be associated with the potential construction loan and adopt a course of conduct aimed at achieving timely payment of each construction loan, including periodic interest payments during the life of the construction loan.

In order to minimize the risks inherent in construction loans, the construction lender should adhere to certain practices, procedures and principles during its underwriting and due diligence process. Although it is not possible to discuss every conceivable problem or legal or business consideration which should be addressed by the construction lender before making a construction loan (*i.e.*, methods of credit investigation, peculiarities of local lien law, requirements that a lender qualify to do business, matters of local taxation, the details of construction loan

documents and title insurance), this series of three articles will, however, attempt to set forth the most basic considerations, all of which apply whether the construction loan is being made directly by the construction lender or the lender is acting as a participant in a construction loan made by another lender. This month's discussion will focus on the parties and the project itself and the pre-commitment investigation. Next month, assurances of completion of the project and protection of the construction loan advances as well as assurance of payment and the commitment letter will be considered. The last article will cover loans in other states, lien priority problems and participations and will conclude with cardinal rules of construction lending.

### **The Borrower, the Guarantor and the Project**

If the construction lender is not satisfied that the borrower, the general contractor, the subcontractors and the related parties are sufficiently experienced and knowledgeable to complete the contemplated project at its estimated cost and in accordance with the terms of the construction loan documents, there is no point in proceeding even to a loan application.

#### **The Borrower**

Of primary importance to any construction loan is identity of the borrower. The construction lender must be completely satisfied with the character of its borrower as well as its professional and financial capacity to accomplish the project and the repayment of the construction loan. In this regard, the construction lender should investigate the borrower's reputation, competence and prior track record. The construction lender should obtain references from lending institutions, contractors, architects, major tenants and investors who have dealt with the borrower in the past to determine the borrower's reputation, competence and prior track record. It is also helpful to obtain from the borrower a list of all prior projects in which it has been involved and disclosure of their results, all of which should be independently verified ( *i.e.*, whether or not the project was sold prior to completion, foreclosed upon, given to a lender in lieu of foreclosure, successfully completed, currently under construction, etc.). The borrower's prior projects, including the success and current maintenance of these projects should be inspected, especially those projects similar in size or use to the one under consideration. Construction lenders should be cautioned that most borrowers are a pleasure to do business with during the "good times", but "good borrowers" are those who live up to their obligations during the bad times as well. Therefore, the reliability of the borrower in bad times should also be determined.

In furtherance of the construction lender's analysis of the borrower, the construction lender should review the borrower's financial condition by examining its financial statements, both from the viewpoint of real net worth and from the viewpoint of net income from the borrower's other projects which may be contributed to the contemplated project. Of central importance are other commitments the borrower may have with respect to other projects then in progress, which may result in the borrower diverting its resources and/or attention from the proposed project. In reviewing the borrower's financial condition, it is essential that the construction lender analyze the realizable value of the borrower's total real estate interests, especially when they are represented as minority partnership interests in other projects. Also, of most recent importance is the requirement that the borrower and its operations are "Y2K" compliant. The construction lender's experts and auditors should confirm

this during their audit and examination of the borrower, as well as, add this as a representation and covenant from the borrower in the construction loan documents.

Moreover, the construction lender should have a sufficient number of meetings with the principals of the borrower to determine their integrity and professional ethics, as these may prove to be of the essence in the long-term relationship.

All of the information supplied by the borrower to the construction lender in connection with its review of the borrower should be deemed to be part of the borrower's application for the construction loan and the construction loan commitment should recite that it is issued in reliance upon such representations.

#### The Guarantor

To the extent that payment of the construction loan or completion of the project is to be guaranteed by someone other than the borrower or a principal of the borrower, then the review set forth above with respect to the borrower should also be conducted with respect to each proposed guarantor. The construction lender must keep in mind that any guarantee is only worth the value of the guarantor giving it. Also, guarantees by subsidiaries or affiliates of the borrower could be subject to attack in a bankruptcy proceeding as being an "upstream" or "sister company" guaranty and, therefore, may not be enforceable in bankruptcy.

#### The Project

The next consideration for the construction lender is to review the viability of the contemplated project itself. During this review, the construction lender should ask the following two questions: "Is the project well conceived and likely to be successful?" and "Does the project make economic sense?" In this regard, it is advisable for the construction lender to obtain an independent feasibility study and a cash flow projection in order to determine the economic viability and the total possible cost of the project. In addition, the construction lender's loan personnel and supervising architect or engineer should visit the site preferably with a local appraiser selected by the construction lender in order to fully understand the project.

The project's budget, including all construction costs (soft and hard), potential operating deficits and amounts set aside for tenant improvements, should be carefully and critically analyzed by the construction lender. As discussed later in this article, if there is the slightest chance that final costs will exceed the proposed construction budget, including contingencies, a source for those funds must be identified and provided for from the outset. Otherwise, there is the risk that in order to complete the project so that it can obtain permanent financing, the construction lender will need to fund the excess in order to obtain the full realization of its loan. This could result in the construction loan being greater than the amount of the permanent take-out loan, which may result in the construction lender needing to take a permanent second mortgage of some duration at the closing of the permanent loan.

Of most importance, the construction lender should avoid making loans on specialty projects not readily adaptable to an alternate use in the event the intended purpose of the specialty project is not economically viable by the time of the maturity of the construction loan.

### **Experts and Pre-Commitment Investigation**

The construction lender should not hesitate to engage its own independent experts, such as an appraiser, supervising architect and supervising engineer to review the proposed project at the earliest possible date. Other consulting personnel, such as a marketing and planning consultant, may also be of assistance in certain types of projects where the market for such project has not yet been fully determined or tested.

It is advisable that before the construction lender expends any money on experts, it should enter into some type of "proposal" letter agreement with the borrower covering the costs of the lender's due diligence, together with the requirement that the borrower deliver a good faith deposit, the balance of which could be returned to the borrower in the event the parties do not ultimately enter into a formal loan commitment or enter directly into the construction loan documents. The commitment letter will, no doubt, pass these costs onto the borrower (and, hopefully, any guarantors) and may provide for an additional deposit for such costs incurred by the lender from and after the time of the loan commitment.

### **The Appraisal**

The appraisal is not just something for a construction lender to have in the file for bank examiner requirements; it is a document which, if done correctly, greatly facilitates the decision as to whether or not the contemplated project has economic viability. It should, however, be realized that an appraisal of the proposed project at this stage of the review process is somewhat in a vacuum, since the project has not even been commenced. Notwithstanding this fact, it is essential to have some sort of appraisal done by an appraiser who is a member of the American Institute of Real Estate Appraisers (MAI) and who is selected by the construction lender and not by the borrower so that the appraiser is accountable only to the construction lender.

Although the standards may vary from state to state, many states require, and prudent practice generally dictates, a loan-to-value ratio of no more than 80% for loans secured by improved real estate and of more than 66-<sup>2</sup>/<sub>3</sub> % for loans secured by vacant land. It is the appraisal which will assist the construction lender in determining this loan-to value ratio. There are various possible appraisal methods: replacement value, market value, income, etc. The standardized market value is the most common method of appraisal used for construction loans. The construction lender is cautioned that in no event should the residual method be used for unimproved land valuation since the residual method is based upon a valuation of the land as improved by its highest and best use and such a valuation method can only be justified where a successful improvement has been completely constructed.

## **General Contractor and The Construction Contract**

At this same, pre-commitment stage, the construction lender's architect and/or engineer should review the plans and specifications of the project to determine their completeness and the soundness, engineering and feasibility of the design. As briefly mentioned in this article, the construction lender's architect or engineer or other experts should also perform an independent cost analysis of the proposed site work and construction, especially if the construction contract does not set forth a guaranteed price by the general contractor. The architect and engineer should verify the cost-flow chart as it is customary for the borrower to heavy-load the front end of the construction loan advance schedule and to reduce the estimate of the amount of funds needed for finishing work, landscaping and the like. This can result in the borrower requesting increases in the construction loan as the loan approaches the maturity date.

Unless the construction lender is satisfied that the borrower's net worth is sufficient to assure the repayment of the construction loan, the construction lender should insist upon the construction contract containing a guaranteed construction price from a financially responsible general contractor notwithstanding the extra cost involved in obtaining such a guaranteed construction price. Even if the construction contract does reflect a guaranteed construction price, the construction lender's architect or engineer should perform an independent cost-out of the construction of the project as well as an in-depth investigation of the general contractor's financial ability to complete construction to determine whether the proposed construction budget is too low. There must also be a review of the completeness of the construction contract and the track record and bondability of the general contractor. This should include a determination of whether the general contractor has built any comparable projects, how the projects fared over time and whether the project was completed within the costs of the proposed budget. As stated earlier, the general contractor, as well as all of its subcontractors, architects and engineers must be able to demonstrate that its operations are Y2K compliant.

A very difficult situation occurs if the general contractor is using the fast-track method under which it does not have firm contracts for all of its costs prior to the commencement of construction (*i.e.*, construction is begun before final plans and specifications are completed). Fast tracking should generally be avoided as the borrower may be entering into the unknown. However, if the borrower cannot avoid a fast-track construction contract, an in-depth review of the project is essential not only to determine whether the project can be brought in on budget, but, in addition, to determine whether the borrower or the general contractor will be able to meet financially cost overruns. In the event the general contractor is using the fast-track method and will not provide a guaranteed maximum construction price, then an alternative position may be to have the construction contract provide that any cost overruns would be payable by the borrower only after the construction loan has been paid in full (*i.e.*, paid from the permanent financing).

The feasibility of the time frame of the construction of the project should be analyzed. There must be sufficient leeway to be certain that the outside date of completion of construction will not extend beyond the permanent loan takeout. Such outside date should not be more than thirty months after the date of the permanent loan commitment or buy-sell agreement.

## **Other Due Diligence Investigations**

Characteristics of the land upon which the project will be built should be analyzed for compliance with the local zoning and building codes, environmental issues, water resources, sewer allocation, storm water runoff, wetlands and whether architectural review board type permits are required, availability of curb cuts, deceleration lanes and the like, use restrictions, deed restrictions, subsoil conditions, whether boring tests and percolation tests should be conducted, the presence of rock or marsh or water which could cause construction problems, and the grade of the property vis-a-vis the street and the abutting land. Essentially any or all of these items need to be analyzed in order to determine whether there will be any hidden construction problems which could result in increased construction costs.

Current prudent lending practices generally require a Phase I Environmental Report of the proposed project site be prepared as part of the construction lender's due diligence, which in some instances may point to the need for a Phase II Environmental Review. Borrowers may try to downplay this important investigation, especially when the proposed project is planned to be constructed on vacant land. However, the construction lender must keep in mind that sites can even become contaminated from pollution caused on a site several miles away. The presence of an environmental condition on the project can act to cut off a lender's remedies under any type of loan, as the lender may find that under local law if it forecloses on a contaminated site, then it can expose itself to environmental liability. Therefore, this important due diligence investigation should never be waived by the construction lender.

For all projects the construction lender should also determine the adequacy of available utilities, fire and police protection, access to the property, and, particularly with shopping center properties, there should be a traffic study. Also, the construction lender should make certain that its engineers and architects have confirmed that the plans and specifications are compliant with the Americans With Disabilities Act and any other law or regulation effecting construction of the project. In most cases there should be a market study of the project, addressing the population growth, age, median income, market area and the like.

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