

What A Lender Needs To Know Before Making A Construction Loan: Part II

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Last month the authors discussed the various kinds of due diligence that a construction lender should perform before issuing a commitment for a project. This installment provides advice on administering a construction loan and discusses the utility of permanent loan takeouts. The construction lender can better ensure completion of the project and protection of its loan advances by incorporating any one or more of the following in connection with its construction loan:

- Never permitting the unadvanced portion of the loan to be less than the amount necessary to complete the project, including soft costs and the like. This amount should be verified to the construction lender prior to each draw of the construction loan, in the form of an affidavit of the construction lender's architect, the borrower's architect and of a principal of the borrower in order to create personal liability. This affidavit should affirmatively state, in essence, that the amount of the construction loan yet to be advanced will be sufficient to complete the project. If, at any time, this is not the case, and the borrower is not one whose financial ability is such as to render payment of the land and construction costs in excess of the amount committed under the construction loan, then the construction lender should discontinue making advances under the construction loan until the borrower has added additional financial resources into the project so that the balance of the monies to be advanced under the construction loan is sufficient to complete the project. A good way to avoid having shortfalls during construction is to require the borrower to fund all of its required contributions into the project prior to making any advances under the construction loan. It should be kept in mind that, if the borrower is also the contractor of the project, it is possible that its cost estimates may not include the usual profit that a contractor would require. Consideration should be given, therefore, to adding to the cost to complete the project, an estimated profit incentive for a new contractor in the event that the borrower defaults. This will not, however, be easy to obtain from a borrower.
- Obtaining a guarantee of completion by a principal of the borrower or other solvent party. This is a quite standard document in construction loans and should be coupled with a guarantee of payment since the construction lender wants payment of its loan not necessarily completion of the project.
- Obtaining a completion bond from a surety company. Since such a bond is conditioned upon completion of the project free and clear of liens, its cost may be prohibitive in the absence of a very responsible contractor.
- Obtaining a performance bond and a payment bond, each in favor of the construction lender, the borrower and, perhaps, the title insurer. Taken together, these bonds insure that the contractor will fulfill its contract and pay all amounts owing for labor and materials. Although these types of bonds are customarily obtained they require the contractor to receive the total amount due him under its construction contract in order to be operative regardless of whether there have been cost overruns which exceed the amount of the construction loan. Thus, if any cost overruns were not provided for in the construction loan, these bonds will not fully protect the repayment of the construction loan, unless the borrower has been required to add its own funds in an amount equal to the difference between the construction contract (including cost overruns) and the amount of the construction loan; and the construction lender requires that at all times the undisbursed portion of the construction loan is sufficient to complete the construction of the project. To the extent that this is not done and there are cost overruns and the construction lender

is not willing to fund the surety with the amount of the overruns, the surety will not be obligated to fully perform under the performance bond. Although the basic protection for the repayment of any construction loan is the borrower's investment in the project, these bonds should nonetheless be obtained.

- Do not make advances for materials stored on or off-site, unless the construction lender has a valid security interest in such materials under the Uniform Commercial Code or such materials are incorporated into the project. Also, all on-site material must be properly protected by the borrower and/or general contractor from theft or vandalism. In addition, there should be careful inventorying of such stored materials prior to each advance under the construction loan.
- Obtain lien waivers from the general contractor and all major contractors and subcontractors for all work performed at the project and fully paid for by the borrower prior to making any construction loan advances. The construction lender can best protect itself by either making the payment directly to the subcontractors and materialmen or through the title company or in such fashion as will satisfy the requirements of the bonding company, if any. Also, any amounts advanced by the construction lender in order to bond mechanics' liens should be done in such fashion as will avoid the possibility that the borrower defaults under the construction loan, settles with the mechanic for less than the amount of the lien and then obtains the difference from the bonding company. Possibly the simplest approach is for the construction lender to pay the amount of the lien directly to the bonding company under an agreement providing for repayment by the bonding company to the construction lender of any unexpended funds -- such repayment to be a payment of the loan.
- In those states which require that a construction loan agreement be filed or recorded or that the construction loan mortgage be recorded before any work is commenced in order to obtain absolute priority over mechanics' liens, such filing or recording should be done and photographs should be taken of the site on the date of filing or recording, as the case may be, and an appropriate affidavit of the photographer attached to the photographs. (The staging of advances, retainages, holdbacks and other provisions relating to construction draws are not covered by this article.)

Assurance of Payment

Payment of its loan, rather than completion of the project, is the ultimate concern of the construction lender. If the loan is made to a responsible, solvent entity for which repayment will be no issue, then the construction lender is quite fortunate. It is usual, however, for construction loans to be made to entities formed for the specific purpose of constructing the project without any additional assets and, therefore, satisfactory assurances of payment must be obtained elsewhere. Accordingly, it is not recommended that any construction loan be made without a firm source of repayment, because of prudent lending standards. The two most common assurances of payment a construction lender can obtain are a guarantee of payment and requiring a permanent loan commitment entered into prior to the funding of the construction loan.

Guaranty of Payment

A guarantee of payment from a principal of the borrower or another responsible party is one way a construction lender may be able to insure the payment of its loan. There are not many people associated with real estate development who have the financial wherewithal to respond to a guarantee of payment on a major construction loan. It is too often the case that the person or entity willing to guarantee payment of a construction loan has already given similar guarantees to one or more other lenders, many of which guarantees are existing concurrently. Calling upon the guarantor to respond to its obligations under a guarantee can have the effect of triggering a default under all of its other guarantees and the guarantor quickly becomes unable to respond to any of them. This does not mean that guarantees of payment should not be obtained. Even if they are not iron-clad,

they do create a psychological effect of obligation upon the guarantor enabling the construction lender to obtain and keep the attention of the guarantor and, at the very least, add an interested party or parties to any possible workout negotiation. A guarantee can, of course, be made stronger if it is backed by some form of collateral, such as a letter of credit, an escrow account, a lien on other property or a pledge of securities. A determination as to whether or not to request such collateral should be made prior to issuing the construction loan commitment. In all events the construction lender must be satisfied that the guarantor has the liquidity and substance to fund any obligations the guarantor is undertaking. The guarantor should be required regularly to submit balance sheets and income statements to the construction lender and there might well be financial covenants which if not realized by the guarantor would constitute a default under the construction loan, and if necessary enabling the construction lender to negotiate for additional collateral for its loan.

Permanent Loan Commitment

The more likely guarantee of payment is a permanent loan commitment from a reputable institutional lender in at least the amount of the construction loan. The construction lender is advised that most permanent commitments are never written on a completely unconditional basis and, therefore, they do not eliminate the construction lender's market risk. One way of avoiding this problem is for the construction lender to require that the parties enter into a tri-party agreement to limit the amount of subjectivity on which a permanent lender may condition the funding of its loan. Also, having a permanent loan commitment in place prior to the closing of the construction loan does not provide a substitute for proper loan analysis by the construction lender. If at the time of proposed funding of the permanent loan, the project is not truly viable, it is likely that the permanent lender will withhold funding its commitment. If, however, the permanent loan commitment is enforceable by the construction lender (either by virtue of an assignment or a buy-sell or tri-party agreement), the permanent lender may be required to fund or may reluctantly fund in order to avoid a lawsuit with the construction lender. A good permanent loan commitment, coupled with a buy-sell or tri-party agreement, is, in most cases, the basis for repayment of the construction loan and should be in place prior to the making of the construction loan commitment.

The following procedures are also advisable to avoid the possibility of a permanent lender not funding under its permanent loan:

- Prior to the making of the first advance under a construction loan, the construction lender should obtain proof that all of the conditions precedent to the permanent loan funding which can be satisfied as of that date have been satisfied. These would include acceptance of title exceptions, plans and specifications, soil tests and other environmental tests, lease forms, ground lease, non-disturbance agreement criteria, reciprocal easement agreements, major leases and the like.
- Nothing during the term of the construction loan should be approved by the construction lender or performed by the contractor, which may in any way relieve the permanent lender of its obligation. For example, no change orders should be consented to unless approved by the construction lender, the permanent lender and the supervising architects for both loans.
- The expiration date of the permanent loan commitment should be scheduled far enough into the future so that even with unavoidable delays in completion of the project, there will be no difficulty in meeting the permanent lender's closing date. Further, mutually understanding the term "completion" must be clearly defined to avoid later differing interpretations as to whether construction has been completed in the

manner required under the permanent loan commitment. It should be made clear, for example, that completion does not require that tenant work be done.

- There should be a prohibition on amending the permanent loan commitment without the construction lender's consent.
- The permanent loan commitment should be assigned to the construction lender and that assignment should be consented to by the permanent lender so that the construction lender could step into the shoes of the borrower in the event there is a default under the construction loan. The construction lender should also obtain an irrevocable power of attorney from the borrower authorizing the construction lender to make application for the permanent loan, to execute all papers incident thereto and to apply the proceeds to the payment of the construction loan. Quite frankly, if such an assignment is obtained and all of the other procedures and protections discussed in this section are followed, the addition of a buy-sell or tri-party agreement may be unnecessary.
- If the permanent lender has agreed to purchase the construction lender's note and mortgage, then the form and content of the construction loan documents should be approved by the permanent lender and, thereafter, there should be no modification of the construction loan documents without the consent of the permanent lender.
- The entire construction loan must be administered with a view to the fact that the ultimate source of repayment will be the permanent loan and that at no point should anything be permitted to occur which will result in a default under the permanent loan commitment.
- The permanent lender should not be permitted to terminate the permanent loan commitment by reason of any default occurring thereunder without giving the construction lender notice of such default and an opportunity to cure the same, if such default is curable by the construction lender.
- The construction lender should not make advances beyond the amount of the firm permanent loan commitment. For example, if there is a rental achievement over a base figure, the construction lender should only make advances to the base until such time as the permanent lender has confirmed that the rental achievement has been obtained. Under certain circumstances, the construction lender might be willing to make advances beyond the base, if it has a good guarantee of the entire loan or of the amount, which is in the achievement area.

Subordinate Financing

In the event that the borrower needs to infuse additional funds during the term of the construction loan, it is most sensible for the construction lender to prohibit any type of subordinate financing, sale-leasebacks or subordinate pledges. A purchase money mortgage may not relate to value and may lead to foreclosure and the introduction of a new developer. Further, even if a second mortgage loan is arm's length, cash will probably be drained from the project in order to make the required debt service payments under the subordinate financing. Also, another lender or a holder of a subordinate interest will become an additional party with whom to negotiate in workouts and they will probably have different interests from the construction lender. The construction lender may note, however, that if the subordinate lender is not successful in its negotiations with the construction lender, its subordinate position can be cut off on foreclosure of the construction lender's mortgage. Last, if there is a need to increase the amount of the construction loan and, therefore, to amend the operative documents, the second position may become first as to any new money being advanced under the construction loan or, at an extreme, as to the entire amount. A subordinate sale-leaseback creates other problems, as well. There is a new fee owner as

well as a new long-term lease, which must be examined. The fee owner would have to be a party to future takedowns. Again, it is an additional party with whom the construction lender must deal, which is not necessarily in its best interest.

Commitment Letter

It is recommended that at such time as the construction lender determines it is prepared to issue a commitment letter for the construction loan, the task of preparing the letter be given to its attorney who should be advised of the terms of the commitment and of any special conditions. A commitment letter can well be a binding obligation of the construction lender (either because it is written as such or because the construction lender will be reluctant not to honor the commitment even though not legally binding) and it should, therefore, be carefully prepared. The specific business terms of the transaction must be in the commitment letter (for example, a prohibition on sale or on subordinate liens) or it may not be possible to incorporate such terms in the ultimate documentation (construction loan agreement, note, mortgage, etc.).

Next month's concluding article will include Appendix A, an outline of basic considerations from the borrower's viewpoint in connection with financing commitments. While no two transactions are identical, the matters set forth in Appendix A are crucial and will in all likelihood have to be reviewed at the time of each commitment. A commitment letter should also include that the following additional matters be subject to the construction lender's receipt and/or approval prior to the funding of the construction loan:

- Current financial statements for the borrower and each guarantor and any major tenants.
- Evidence of builders' risk insurance, liability insurance, contractors' liability and workers' compensation insurance. The construction lender's insurance department or risk manager should review all such evidence.
- Opinions of Counsel.
- Mortgagee title insurance from a title company whose assets are sufficient to justify writing the policy. To the extent such is not the case, coinsurance or reinsurance (with a direct access) should be required.
- Preliminary, progress and final "as-built" surveys.
- Evidence that the property is free of any and all environmental problems and that it is not located in an area that has been identified by any state or federal authority as wetlands or by the Secretary of Housing and Urban Development as an area having special flood hazards.
- Plans and specifications for improvements and evidence that they comply with all applicable laws and ordinances including zoning and regulations applicable to building codes and licensing authorities.
- Architects', contractors', engineers' and sub-contractors' contracts relating to design and construction of improvements.
- Current financial statements for the general contractor or, if the owner will be the builder, financial statements of major contractors and subcontractors, including evidence of Y2K compliance.
- Evidence of satisfactory zoning, issuance of all building permits and licenses and availability of utility and municipal services, including sewer and water.

- Undertakings of the architect and the general contractor or, if the owner will be the builder, major contractors, subcontractors and the architect should agree to continue performance in event of the owner's default.
- Faithful performance and statutory labor and material payment bonds.
- Errors and omissions insurance, in amount, form and substance satisfactory to the construction lender, covering borrower's architect.
- Soils report.
- Structural engineer's report.
- Appraisal.
- Assignment of the permanent loan commitment, consent to assignment by the permanent lender and evidence that the permanent lender has approved state of title, plans, survey and such other documents required by the permanent loan commitment to be approved by the permanent lender.
- The permanent lender should agree to accept the certificate of the construction lender's inspecting architect in satisfaction of any conditions of the permanent loan commitment requiring certification as to performance of construction and completion of improvements in accordance with plans.
- Satisfaction of any special conditions to the permanent loan commitment, which can be, satisfied prior to the closing of the construction loan.
- Provisions for the payment of the construction lender's expenses and closing costs by the borrower, especially legal fees.
- A warranty that the borrower's representations to the construction lender that were made to obtain the loan continue to be accurate.
- A period of time in which the construction loan commitment must be accepted by the borrower and the construction loan closed.

As stated previously, each transaction will have its own special conditions, but Appendix A and the foregoing give the basic provisions which should be addressed in a construction loan commitment.

Conclusion

Now that due diligence and loan administration have been considered, the last article in this series will discuss loans in other states, lien priority problems and participations and will conclude with the rules of construction lending (cardinal and otherwise).

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