

# Construction Financing: An Additional Dimension

by Richard E. Strauss

A construction loan financing shares many of the ordinary banking and real estate features of both an acquisition loan and a future-advance loan. However, a construction loan has an additional dimension, which typically makes it riskier than both of these facilities, and which therefore requires special focus. The one obvious distinction is that, until construction is completed and the building may be legally occupied, the collateral value and liquidity of the property upon foreclosure is problematic. Thus, special due diligence and monitoring is required for the construction loan in order to minimize this risk. Secondly, unlike other loans, a construction loan by necessity impacts the rights of a protected class of creditors—contractors which may file a mechanics' lien in the event of non-payment. Therefore, to obtain maximum protection as to the special rights and priorities of this class, particular attention must be paid to the structure and form of the documentation for the construction loan.

The construction loan often is initiated with a detailed commitment letter, setting forth much of the structuring and documentation. Through the detailed commitment letter process, the parties can, hopefully, minimize the risk to lender and enable the borrower to plan ahead in order to facilitate the entire process. Another advantage of certainty to the lender involves lender liability claims should the loan not be funded; the commitment letter may avoid disputes as to whether either party is breaching its duties.

This article discusses some of the key elements of a construction loan through a review of a comprehensive commitment letter, and considers the impact on the lender, borrower and its contractor and how accommodations may be made in order to meet their needs.

## Budget

The borrower must create a construction loan budget, which is also a detailed road map for each separate sub-category of the project's cost, and what source of funds will pay for these costs, to assure that sufficient monies are available for completion of the project. "Hard costs" include site development, the actual construction of the base building and construction of tenant offices. "Soft costs" include the up-front costs of experts and consultants, such as surveyors, brokers, architects and lawyers, insurance premiums, interest on the construction loan and the cost of carrying the property (such as real estate taxes and ground rents, if any) until it becomes cash-flow positive. Normally, if construction plans and bidding are sufficiently completed, the construction budget can be approved and attached to the commitment letter.

## Lender's Construction Consultant

In order for the borrower's plans and budget to be understood and analyzed, a lender often retains the services of a construction consultant. The consultant will also review and analyze for the lender the due diligence matters referred to below and monitor the project for the lender during the course of construction until substantial completion, when it will certify whether or not the conditions to final disbursement of the loan have been satisfied. The borrower normally agrees in the commitment letter to pay the fees of the consultant whether or not the loan closes.

## Term of the Loan

The consultant will also help the lender determine when it may be expected that the project will be completed, and therefore when it will be required in the commitment letter that the loan be repaid. Some commitments contemplate that the original maturity date may be extended by the borrower for a discrete period upon payment of a fee, so long as there is no default, and all key documents, such as the permanent loan commitment and tenant leases, are in full force and effect.

## Exit Strategy

Although it may seem that a discussion of the lender's exit strategy at this stage is putting the cart before the horse, this is a first priority. Unlike most other collateral, the property is not readily refinancable or saleable until the construction process has been completed and an income stream has been generated. For example, in a

construction loan for an office building, when the base building has been completed so as to allow legal occupancy, there may nevertheless as yet be no rent generated to carry the costs of the building and pay interest and amortization on a loan. Therefore, some construction loan commitments also have a budget item to fund the up-front cost which the developer must incur to attract tenants during a marketing period. These costs typically include brokerage commissions, the cost of building or funding the tenant's initial space improvements and a free rent period during which the tenant may be in occupancy but enjoys a deferment of rents. If the budget for the construction loan includes funds to pay for these items, the maturity date may be deferred until some time after substantial completion of the base building, until rents are being generated by tenants, and when the owner may refinance the construction loan based on actual cash flow from the building. Therefore, the future risk of lease-up and refinance is an element of a construction financing which is additional to the construction risk itself. A construction lender will therefore often want to have in place, prior to funding the construction loan, a take-out commitment from a permanent lender upon which the construction lender may rely for refinancing.

### **Permanent Loan/Buy-Sell Agreement**

The construction lender will need to scrutinize carefully the permanent lender's commitment because, to the extent that the commitment depends upon satisfaction by the borrower of various conditions and lease-up requirements, the permanent loan commitment does not shift these risks away from the construction lender. For example, if modifications from the approved plans and specifications during construction would permit the permanent lender not to fund, the construction lender must assure that either no such modifications occur or that a mechanism be in place for the permanent lender to pre-approve minor modifications and promptly approve major ones.

The construction lender and permanent lender often have a mutual interest in entering into an agreement called a "buy-sell" agreement. This agreement requires the construction lender to sell the loan to the permanent lender and the permanent lender to purchase it from the construction lender upon completion and satisfaction of certain conditions. The permanent lender obtains assurance in the buy-sell agreement that the borrower cannot "shop" the permanent loan if interest rates have changed by the time of funding. The construction lender, through direct contractual arrangement, obtains a means to enforce the funding of the permanent loan against the permanent lender. In order to meet conditions to that funding, accommodation can often be made by the permanent lender to the construction lender in the buy-sell agreement to sign-off on, or waive or relax, certain conditions (such as title and construction requirements), which the permanent lender would not otherwise do for the borrower. To the extent that the buy-sell agreement contains these sign-offs, the construction lender receives additional assurance that its exit strategy will be successful. Other matters often required in the commitment letter to be covered in a buy-sell agreement are that the permanent lender will not exercise a right to terminate the permanent commitment until the construction lender has been given notice and an opportunity to cure, and that the expiration date of the commitment be deferred to give a reasonable opportunity for the construction lender to foreclose, take title and complete construction, and that the commitment may then be assigned to the construction lender or its designee.

Some permanent commitments require that before initial funding the property be leased up to a minimum level and that rentals meet a certain threshold, although in other cases the permanent lender will agree to buy the loan from the construction lender when the base building is complete. In the latter case, further financing will be required from some source in order for the owner to obtain the funds needed to put the tenants in place on a rent-paying basis, but the permanent lender may not be willing to make such loans. A construction lender which has obtained the benefit of a permanent commitment for the base building may agree that, after the funding of that commitment it will make "gap" mortgage loans for the costs of tenant brokerage, fit-out and free rent, with the mortgage securing these loans subordinate to the permanent lender's base building mortgage, but with the continuing take-out obligation from the permanent lender to refinance the gap mortgage once a certain cash flow has been achieved.

Once the key questions of the size, maturity and exit strategy have been addressed, the consultant and the construction lender must focus on the following:

### **Zoning and Permits**

Many projects are to be built on land which is already zoned for the type and size of the planned project. However, sometimes the use of the project or its size varies from that permitted by the zoning laws and either a variance or acquisition of additional development rights will be needed. In addition, construction cannot commence until a building permit and other similar permits are issued by the local building department. To assure

that no further variances or development rights are needed, and all required permits have been received, the lender will normally require in the commitment letter that the borrower's architect (or sometimes its zoning or construction counsel) certify that the proposed project may be lawfully constructed, used and occupied in accordance with the zoning laws and that if any building or special permits or variances were required, that they have already been obtained. Of course, to the extent some permits cannot be obtained until a later stage of construction, the commitment will condition advances for that stage upon receipt of the permit; but lender's consultant must be satisfied up front that the permit can later be obtained. Another essential issue which is addressed in the commitment letter is the requirement that all needed utility services are available at the site and in adequate supply for the use of the project. For example, sewer capacity is not always available for new or large projects. In some jurisdictions, impact fees are charged to developers in connection with extending water or sewer lines to the boundaries of the property, a cost which must therefore be included in the budget for the project. These issues can be addressed in a letter from the architect or another consultant of the borrower which is required to be obtained in the commitment letter. On the other hand, a newly constructed building is often eligible for real-estate tax abatement or other tax incentives, so that the commitment letter often requires that borrower satisfy lender of the project's eligibility.

### **Soil Study**

The prudent lender will require in the commitment letter that the borrower produce a soil report or engineering study for the project showing that the soil and/or existing foundation can support the project.

### **Construction Contracts**

Most commitments contain approval rights by the construction lender as the construction contractors and their contacts. If the borrower has a list of contractors from which it expects to receive bids, the lender can be asked to approve their names in advance, subject to review of their contracts. The lender may also pre-approve the standard trade construction contract which borrower will include in the bid package. Many projects are built by a general contractor which agrees to accept a guaranteed maximum price, meaning that so long as there are no changes in the approved plans and specifications, the owner and construction lender can look to the credit of the general contractor to pay for any cost overruns. The construction lender must review the terms and provisions of the construction contract to make sure that it is properly coordinated and consistent with the construction loan as to such issues as time for completion, payment terms and requisitions, limitations and procedures for changes in the plans and specifications and dispute resolution. In many projects there is no guaranteed maximum price contract but instead, the owner retains a construction manager for a fee to coordinate the process and arrange for separate construction contracts to be entered into by the major trade contractors directly with the owner. In such an event some or all of these trade contracts may themselves contain a guaranteed maximum price for the particular aspect of the work involved. In this structure, the construction lender and its consultant will also more carefully review the trade contracts for the same issues as mentioned above with respect to the general contract.

In addition, the construction lender may require in the commitment letter that the general contractor and/or the trade contractors enter into a "recognition" agreement with the construction lender. This agreement addresses the problem of a default by the borrower in the middle of construction and the possibility that the construction lender may choose to take over construction on obtaining title to the property. Should this occur, the construction lender may wish to require that the contractors continue performance of their contracts for the benefit of the construction lender on the same basis as had been originally agreed to, if the construction lender will pay the requisitions. A similar recognition agreement may be required by the construction lender from the architect, which additionally provides that the construction lender will have the right to utilize the plans and specifications prepared by the architect for the project.

### **Performance Bonds or Guaranties**

Quite often the construction lender does not rely only on the credit of the borrower and/or the contractors to protect against cost overruns. In that event, the lender may require that the contractor obtain a performance bond from a rated surety company, which is an obligation of the surety, up to the amount of the bond, that a construction contract will be performed (i.e., the general contract will be completed) for the guaranteed maximum contract price. But first, the developer (or the lender in its place) must make available to the surety the unpaid contract sum. A lender which wishes to enforce the bond could be met with defenses, such that extensions of time or changes in the plans released the surety; the lender should therefore be originally named on the bond as co-obligee, so that many of these potential defenses can be waived and the lender can enforce the bond directly

in its own behalf. The commitment letter would then require that the borrower produce the required surety bond prior to the first advance.

An additional resource on which the construction lender may rely is a completion guaranty made by a credit-worthy principal of the borrower. The principal guarantees timely completion of the project on a lien free basis, and performance by borrower of its obligations under the construction loan agreement.

### **Lien Law**

In New York, only a "statutory" construction loan mortgage has statutory priorities regarding mechanics' liens. Thus, a properly drafted construction loan mortgage must be limited so as to secure advances made only for specifically identified statutory hard and soft "lienable" costs or, as defined in the statute, "costs of the improvement". Other "nonlienable" costs must be secured by a separate subordinate mortgage. Examples of nonlienable costs include marketing costs, certain brokerage commissions, reimbursement of certain out-of-pocket expenses prior to loan closing, tenant work fees and certain professional fees. This is done because it is felt that there is no statutory priority rule for the "nonlienable" costs, so that separating these advances into a subordinate loan, note and mortgage minimizes the risk that the entire construction loan could be attacked by mechanics' lienors as not being a "building loan mortgage" entitled to the benefits of the statute. So long as no mechanics' lien has been filed, all construction loan mortgage advances have a higher priority than mechanics' liens. Aside from properly separating the lienable and nonlienable costs, in order to attain priority over mechanics' liens, it is necessary that a "Section 22 Affidavit" be properly completed and filed in the county clerk's office along with the building loan agreement; this affidavit identifies the funds available from the loan to pay hard and soft "lienable" costs. If the building loan agreement and the Section 22 affidavit are not properly filed, then all mechanics' liens may achieve priority over the construction loan mortgage. Similar loss of priority is possible if the Section 22 affidavit is not properly completed. A Section 22 affidavit is a complicated and difficult instrument to complete, but the key to this process is found in initially structuring the costs of the construction loan and the other loans to differentiate the lienable costs.

Sometimes the lender or the borrower requires that the general contractor obtain a payment bond from a surety company. The purpose of the bond is to assure the borrower that if it pays the general contractor, the general contractor shall pay all amounts that it owes to contractors and material suppliers, and thereby indemnify against the filing of such a mechanics' lien. If the construction lender is named co-obligee on this bond, it will also obtain this protection.

Nevertheless, if a mechanics' lien is filed, it may have certain priorities as to the construction lender under applicable state laws. In New York, the lien law provides that mechanics' liens will have priority over advances upon a construction loan mortgage made after the notice of mechanics' lien is filed. In addition, with respect to advances made prior to the filing of a notice of a mechanics' lien, a construction loan mortgage only has priority if the construction loan agreement and the Section 22 Affidavit were properly filed and the agreement contains certain trust fund covenants required by the lien law (whereby the borrower agrees to hold the loan proceeds to pay the cost of the improvements). If a construction lender's title company makes a continuation search for a loan advance which shows that a mechanics' lien has been filed, and if the lender chooses to advance through the lien, there is a risk that the lender's advance will be subordinate not only to that lien but to subsequently filed mechanics' liens. This is because a section of the lien law provides that all mechanics' liens have equal priority whenever filed, suggesting that subsequently filed mechanics' liens relate back to the first to file. However, there is some authority to the contrary which gives priority among mechanics' lienors only as to those who filed in the interim between each advance. In order to continue the loan advances, the borrower may obtain a surety bond and a court order discharging the lien from the real property.

### **Loan Advances**

The documentation customarily required for a construction loan advance is more complicated than for other loans. In addition to the usual conditions to the first advance of any real-estate loan, at the first advance of a construction loan the lender must also have approved the budget for the lienable costs and the separate budget for the non-lienable costs, the construction schedule with a trade-by-trade breakdown of the estimated periods of commencement and completion of the work of each trade, the architect's contract, detailed plans and specifications, the agreements of the general contractor and/or major subcontractors, and have received a report from the lender's consultant as to the consultant's review of the plans, the budget, the permits and other construction matters.

Each subsequent advance should require documentation from the contractors. This certifies on a trade-by-trade basis the requested contract amount for the month in question and in the aggregate and the percentage of work completed, with a partial lien waiver whereby the contractor agrees not to assert a lien for all sums paid under the contract through the previous requisition. In the event that the contractor does not submit the partial lien waiver, the construction-loan documents should allow the lender to deduct from the loan amount requested for that month a sum equal to that of the contractor's previous requisition or, to refuse to disburse any amount for that month. The loan documents should require the borrower to provide proof of payment of all sums covered by the previous loan advance. Should loan proceeds have been paid to the borrower or general contractor which were required by the construction documents to have been disbursed to the contractors, but which have not been received by them, there is potential created for the filing of a mechanics' lien by the unpaid contractor. However, the construction advances still maintain priority until a mechanics' lien is actually filed.

The construction consultant should also determine and certify that (1) the loans for hard costs do not exceed the construction costs incurred or the costs of construction in place, less retainage, as of the date of the loan request and (2) the loans for soft costs do not exceed the soft costs then due and payable, and (3) that the contractor, supplier or vendor is entitled to payment in the amount requested. The consultant should determine the total costs of the project which have been incurred, the total estimated cost to complete the project, whether or not the loan and each budget line item is "in balance" and that construction of the project has been performed substantially in accordance with the plans reviewed by the consultant.

The borrower should obtain the agreement of the lender that within a specific period from receipt of an advance requisition package, the lender will either fund the advance or advise the borrower of whether there are any specific deficiencies or unfulfilled conditions. The borrower must have allowed sufficient time in the construction contracts for the loan requisition to be processed and the lender to fund the advance.

### **Balancing**

If there have been changes in the plans, or cost overruns, after giving effect to the loan advance for that period, the loans should not exceed the lender's "balancing formula", which is intended to assure that there is sufficient undisbursed loan proceeds to complete construction. An example of such formula is that the loans for any line item in the budget and in the aggregate not yet disbursed are sufficient to cover substantial completion of the project, funding interest on the loan and other soft costs through substantial completion. If the lender holds or has a perfected lien on other funds provided by the borrower, or revenue from the project, these can be credited to the borrower in the formula. If the balancing formula is exceeded, prior to making the advance, the lender may require the borrower to furnish a completion deposit in the amount of the insufficiency, to be held as additional cash collateral and to be disbursed prior to the disbursement of any of the additional loan proceeds. Alternatively, the borrower might provide a letter of credit in the amount of the deficiency, which may be drawn upon once the loans for any line item are completely funded. If there is a completion guaranty, it also guaranties the obligations of one borrower to keep the loan in balance.

### **Title Insurance**

As the construction loan is one for future advances, the commitment letter requires that satisfactory title insurance be obtained for the mortgage at the initial loan closing. The policy will also contain a "pending disbursements" clause committing the company to provide "down-date endorsements" for each advance and increasing the amount of the policy by that advance. Thus, each loan disbursement is made subject to a satisfactory down dating by the title insurance company and receipt by the lender of a certificate from the company increasing the insurance.

### **Changes in the Project**

The construction loan commitment usually precludes any changes in the plans and specifications without the lender's consent and may require as a condition to making an advance that the permanent lender approve any changes to the extent required under the permanent commitment or buy-sell agreement. However, some construction loan agreements will allow certain change orders within certain preapproved parameters, including a limitation on the amount which may be applied from contingency towards the additional costs or on the aggregate amount of change orders outstanding at any one time, but that there be no material effect on the "scope of the work," that the loan remain "in balance" and that the change not affect any building permits. When lender's consent is required, the borrower should insist on a response within a specific short period, in order that the

construction process not be delayed, and also require that the lender not unreasonably withhold consent. In this regard, the construction loan documents normally will not allow the borrower to reallocate any line item on the budget to another item without the construction lender's prior approval, although the parties may agree to allow borrower to reallocate certain of the contingency without lender's consent. In addition, if a modification to the construction budget would have the effect of changing the amount available to the contractors, lien law issues are created which may require additional filings with the county clerk's office reflecting the changed budget and approval by the construction lender's title insurance company which is insuring the mortgage.

### **Survey**

In addition to the usual survey requirements, a condition to certain advances of the construction loan is that the lender receive an updated survey showing the current stage of completion of the project and that the construction has not encroached over the boundary lines or other set back requirements or violated any easements.

### **Retainage**

Loan advances for construction costs are usually subject to retainage of up to ten percent, which is only disbursed upon substantial completion, either of the entire project or sometimes prior thereto for contractors which have completed their work at an early stage of the project. In any event, retainage is not paid to the contractor until a final waiver of lien and release certificate satisfactory to the construction lender is received. In order for the requirements of the construction lender to mesh with the disbursement provisions of the construction documents, it is necessary that the retainage formula under all such documents be consistent.

### **Stored Materials**

The term "stored materials" means materials that have been purchased by the borrower for use in the project but are either stored on site and not yet incorporated into the building or not yet delivered to the site. Disbursing a loan for these materials is riskier than for construction in place because of the possibility that the materials may not ultimately be delivered to the site or may be lost or stolen while on site. Accordingly, in the commitment letter disbursements for stored materials are often not permitted or limited to an aggregate amount at any one time and when so limited, they are further conditioned on evidence of the borrower's ownership of the stored materials, the perfection of the lender's security thereon and insurance coverage against casualty and loss.

### **Leasing**

Typically, the commitment letter provides that the borrower may not enter into leases of commercial space unless the construction lender has consented thereto. However, sometimes there is worked out advance preapproved leasing parameters for such basic terms as the minimum rent, expiration date, escalation provisions, free rent and maximum cost of tenant fit-out, and a standard lease form is approved by the construction lender, with provision made for the approval of variations to the basic lease form. Of course the identity of the tenant must be approved by the construction lender and by the permanent lender if required by the permanent commitment and buy-sell agreement. Additionally, it may be made a condition in the commitment letter to the first advance of the construction loan that such eligible leases be entered into for a minimum portion of the project and that these leases be in full force and effect. Thereafter, if the construction loan provides for disbursements for tenant fit-out, the construction lender may also need to review these plans and specifications, obtain the permanent lender's approval thereto and separately provide for loan balancing with respect to the particular budget for that tenant's work. As part of the loan balancing, the borrower may be allowed to reallocate unused cost of tenant improvement towards the other leases.

### **Construction Loan Defaults**

The commitment letter will require that there be default provisions should the borrower fail to commence and complete construction by certain dates, or to continuously conduct construction, although certain allowance may be made for force majeure. Other defaults are that the permanent commitment, the general contract or a major lease ceases to be in full force and effect, a building permit is revoked or otherwise ceases to be effective, or the borrower is unable to satisfy the conditions to any advance (subject to borrower's rights to notice and time to cure).

## **Final Advance**

The final advance of the construction loan, which includes the release of retainage to the extent not previously advanced, requires that the lender be satisfied that the project has been substantially completed and a certificate of occupancy and other necessary permits have been issued, and that all necessary utilities, streets and roads have been finished and made available for use of the project, that the lender has received final lien waivers from the general contractor and the contractors and suppliers, that the construction lender's consultant has certified to the foregoing effect and that the lender has received the final and comprehensive endorsement to its title insurance policy.

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