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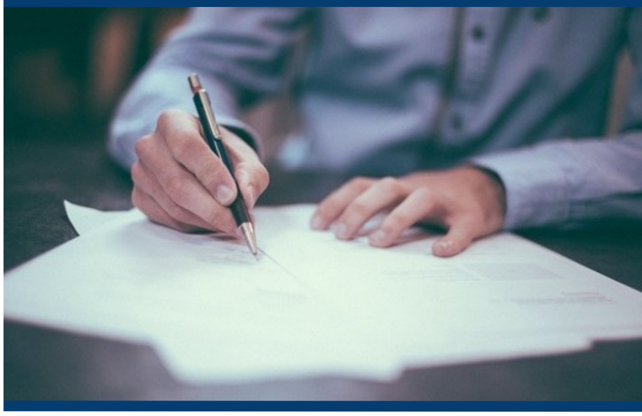

Construction Loans by Non-Traditional Construction Lenders: Due Diligence and Administration

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The international bank regulation rules called "Basel III", which took effect in 2014/15, restrict bank lending for "high volatility commercial real estate" (or "HVCRE"). Construction loans made by U.S. banks are generally HVCRE loans (unless exempted) and as such these banks are required to hold 50% more capital in reserve for such a loan. This makes construction loans more expensive and affects pricing and the willingness of such banks to have these loans on their books. The exemptions from the HVCRE rules could also make such construction loans less desirable from the borrowers' perspective, since borrowers must maintain capital contributions of 15% of the "as completed" value of the project and there must be no more than an 80% loan to value ratio.

As the effects of the HVCRE rules cause traditional U.S. bank lending to dry up for construction loans, other lenders have stepped in. These include foreign sources, U.S. private lending funds and even insurance companies.

Before committing to a construction loan, these non-traditional lenders should particularly focus on two special risks of such loans. First, there is the construction risk, as the property must first be completed for the projected collateral value and liquidity of the property to be achieved. Second, the financial risk, as construction might never be completed if the project costs more than budgeted. Therefore, special attention must be paid to due diligence prior to, and the administration of, a construction loan in order to address these unique risks.

Budget

The lender must get comfortable with borrower's construction loan budget, each separate sub-category of the project's cost, and what source of funds will pay for these costs, to ensure that sufficient monies are available for completion of the project. If construction plans and bidding are sufficiently completed, the construction budget can be fairly firm; otherwise, it will be a work in progress to be closely monitored.

Lender's Construction Consultant

In order for the borrower's plans and budget to be understood and analyzed, a lender which does not normally make construction loans, and which does not have a staff to administer such loans, should retain a construction consultant. The consultant will also review and analyze for the lender the due diligence matters referred to below and administer the project for the lender during the course of construction until completion.

Zoning and Permits

Most 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 ensure that no further variances or development rights are needed, and that all required permits have been received, the lender's construction consultant will require 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.

Soil Study

The prudent lender will require 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

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's consultant 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.

Performance Bonds or Guaranties

Quite often the construction lender does not solely 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, on which bond the lender should be named as co-obligee.

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.

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’s consultant must also have approved the budget costs and the construction schedule with a trade-by-trade breakdown of the estimated periods of commencement and completion of the work of each trade.

Construction loans are typically administered through periodic loan advances. Each subsequent advance should require documentation from the contractors which 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 contractors agree that they have received and shall not assert a lien for sums paid under the contract through the previous requisition. This mechanism helps prevent the borrower from diverting loan proceeds to another project and guards against the filing of a mechanics’ lien by an unpaid contractor. Nevertheless, the lender’s title policy should be updated on each advance to show no other liens or encumbrances.

The lender’s 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.

Balancing

If there have been changes in the plans, or cost overruns, the undisbursed loans should not exceed the cost to complete the project, funding interest on the loan, and other soft costs through completion. If the balancing formula is exceeded, prior to making an 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 to fund the shortfall.

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. It is necessary that the lender’s construction consultant monitor the retainage.

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 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 subcontractors 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.

Conclusion

Therefore, a non-traditional lender will need to perform due diligence and administration for the special risks of a construction loan. Rather than staffing up to address these needs, the lender could retain a construction consultant before the commitment letter is signed, and to support the lender during the term of the loan.