FUNDAMENTALS OF CONSTRUCTION LENDING

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I. INTRODUCTION AND SCOPE

A. Scope. This paper discusses the fundamentals of construction lending with emphasis on representing the lender. The focus is on the pragmatic aspects of documenting, closing, and administering a construction loan. While a variety of technical legal issues will arise in conjunction with any real estate loan, and especially in connection with construction lending, the focus here is mainly on the basic contractual considerations that lender and borrower need to address when undertaking the construction lending process.

B. Basic Overview of the Construction Loan Process. In the Construction Loan Process the lender advances funds incrementally, usually on a monthly basis, as construction of improvements is completed. At the initial closing of the loan the lender will typically advance funds for a variety of purposes, including, land acquisition costs, engineers and architects fees, survey costs, title insurance costs, legal fees and other similar matters. Thereafter, as materials are purchased and construction proceeds the contractor will on a monthly basis submit to the construction lender an application for progress payments delineating the work done to-date, the amount of construction funds previously received and the amount being requested in the particular application. These are typically signed by both the contractor and the contractor's architect and are reviewed and approved by the owner, lender, and perhaps an inspecting architect as described below. After review and approval the lender funds the amount requested subject to the retainage requirements and obtaining lien waivers and title assurance as described below. This progress continues then until work is satisfactorily completed at which point in time the construction loan would be fully funded. In order to monitor the progress, it is customary for the construction lender and borrower to agree ahead of time on a definitive budget for the Project and for the lender to carefully monitor the types of expenses incurred in construction to be sure that it is progressing in accordance with the agreed-upon budget. The budget will typically contain a line item for contingencies (i.e., unforeseen matters) as to which the lender may require prior approval before funding from this budget category.

II. FUNDAMENTALS OF CONSTRUCTION LENDING - WHY DOES CONSTRUCTION LENDING DIFFER FROM OTHER REAL ESTATE FINANCING?

A. Basic Comparison. The fundamental difference between construction lending and other types of real estate secured financing is that in construction lending the value of the collateral is being created from the loan funds as they are advanced. In financing completed property or unimproved property, the collateral value is fairly well fixed at closing, but in construction lending the value of the collateral, both the physical value of the improvements and the economic value from prospective tenants, is to be created in the future and there are, naturally, inherent risks as to whether that value will be realized.
B. Construction Risks.

1. One risk in construction lending is that the basic cost estimates for the project may be erroneous. Thus, it is incumbent upon the lender to be sure that the project can be built within the budget contemplated, keeping in mind that developers are generally optimistic sorts. To some extent, this risk can be minimized by using guaranteed maximum sum construction contracts and payment and performance bonds, depending on the economic viability of the contractor, but the construction lender must have the ability to effectively determine the anticipated cost of the project.

2. Even in the best planned projects the possibility of unforeseen circumstances or uncontrollable cost overruns exists. For example, since most, if not all, construction loans bear floating rates of interest, a sudden precipitous rise in interest rates can greatly increase construction costs. Similarly, subsurface soil conditions, inclement weather, unforeseen shortages of essential materials, labor disputes and other similar occurrences can add greatly to the cost of construction.

3. In addition to unforeseen circumstances, there also always exists the possibility of simple failure of performance by third parties, especially contractors and subcontractors performing construction work. Accordingly, it is important for a construction lender to know that its borrower is a solid, experienced developer well versed in managing construction of the type of project in question, and that the project will be constructed by a reputable contractor who will deal with reputable, well-capitalized subcontractors.

C. Leasing Risks. A completed commercial project is of little value unless it is occupied by rent-paying tenants. Accordingly, a construction lender must deal with the potential that the project may not lease as quickly as anticipated after construction, which will diminish its economic value. Further, if there is a commitment for long-term mortgage financing for a project, it will undoubtedly require that certain leasing levels be achieved before initial funding.

D. Lien Priority Issues. As discussed in Section III below, the law of mechanic's and materialmen's liens raises special concerns for the construction lender, as the preferential rights afforded to mechanic's and materialmen's lien claimants make it incumbent upon the construction lender to be sure the construction funds are properly applied to payment of construction costs to assure lien priority. The process of advancing loan funds incrementally can also raise lien priority issues.

III. MECHANIC'S AND MATERIALMEN'S LIENS AND LIEN PRIORITY ISSUES

A. General. Most states provide to parties constructing improvements, or providing materials for construction of improvements, special liens to secure payment of the obligations owing to them. For example, Chapter 53 of the Texas Property Code sets forth the requisites of Texas mechanic's and materialmen's liens claims. The applicable mechanical and materialmen’s lien statutes must be carefully considered in any construction lending context as there are typically basic preventative actions which the construction lender should take to protect its lien priority.
B. Basic Mechanic’s Lien Priority. First, it is important to note that an owner’s property is subject to being “liened” in the construction context by a party with whom the owner has no privity of contract. The basic premise of mechanic’s lien statutes is to protect subcontractors (of whatever tier) by insuring that the person in the best position to control the flow of funds (i.e. the owner) does so. The statutes are designed to be sure that the owner, when paying its general contractor, takes sufficient steps to be sure that the general contractor, in turn, pays its subcontractors and so on. Mechanic’s and materialmen’s lien statutes are state specific and thus it will be incumbent upon any practitioner to be familiar with the particular state in which a project is located to be sure that the loan is properly documented and administered. For example, under New York law there are specific statutory requirements for provisions to be included in the basic loan documents, without which a lender will lose a great deal of protection. See, N.Y. Lien Law §§1-39-c (McKinney 1999). Under applicable Texas law, if construction activity occurs prior to the recording of the construction loan deed of trust, the lender will lose all lien priority, and the Lender will not have priority as to certain types of fixtures no matter what preventive actions it takes. See generally Chapter 53, Texas Property Code (West 2004).

C. Lender Protective Actions.

1. Retainage. Under most state statutory schemes, an owner of property and, derivatively, the owner's lender can protect their position by complying with applicable retainage provisions. For example, under Section 53.101 of the Texas Property Code, if 10% of the contract price or the value of the work is retained until thirty (30) days after the work is completed, then all mechanic's lien claimants will have a ratable lien claim against the funds so withheld and will not be able to successfully maintain a mechanic's lien claim against the subject property. Thus, it is customary for construction lenders to withhold sufficient funds from the loan until the end of the requisite period. This can work a significant hardship on the general contractor for a very large project since the subcontractors performing the first part of the construction (as for example, foundation and concrete work) will have completed their work many months before final completion and will want to be paid in full, thus placing a burden on either the owner or the contractor to fund the final portion of that particular subcontract, unless the lender is willing to diminish the protection afforded to it by the retainage provisions.

2. Bonds. An additional method by which an owner and lender may typically protect their position vis-a-vis mechanic's liens is to either bond the job or, bond against specific liens. Bonding of the entire job is typically done at the outset of a project, and if properly done generally precludes a mechanic's lien claimant from filing a suit against the owner or the owner's property, and relieves the owner of its obligation to retain.

If a job is not bonded, but a lien claim is filed, then typically, the specific lien claims may be bonded against. After this type of bond is recorded, a person acquiring an interest in or lien on, or insuring title to, the property in question may usually rely upon it to the same extent as the lien claimant had filed a release of lien.

3. Subordination. An additional method by which the construction lender may protect itself in some jurisdictions is to require that the general contractor and major subcontractors subordinate their potential lien claims to the construction lender's deed of trust lien. While obtaining subordination agreements is good practice, keep in mind its practical
limitations - the lender generally will be able to obtain such agreements only from the general contractor and the most material subcontractors, and will not be able to effectively apply the procedure to relatively minor contractors who, in many cases, are the most likely lien claimants, although, of course, their claims are likely to be smaller. Further, in some jurisdictions such subordinations are ineffective.

4. **Loan Administration Techniques.** The prudent lender will also administer the loan so as to minimize the risk of mechanic’s lien claims. As described in Section V.A. below, the lender should require lien waivers from all parties receiving proceeds of a loan advance, and an affidavit of the general contractor that the loan proceeds have been and will be properly applied. Additionally, the lender may issue dual-payee checks, naming the general contract and appropriate subcontractor or materialman to further assure that loan proceeds are properly applied.

D. **Lien Priority & Future Advances.** Since construction lending inevitably involves the advancing of funds in periodic installments as construction progresses, there is the concern about the priority of funds advanced under the Construction Loan Agreement in relation to lien claims that are filed after recording the Construction Deed of Trust but prior to a particular advance, so-called "intervening" liens. In many jurisdictions it can be a difficult proposition to determine lien priority, requiring an investigation into whether the lender was "obligated" to make the particular advance in question. Generally, the range of possibilities under state law extend from each advance being protected by being related back to the initial advance date to situations where the lender must carefully search for filings of intervening claims as the same will prime interim advances.

IV. **LOAN CLOSING REQUIREMENTS**

A. **Title Requirements and Survey Requirements.** As is customary with all real estate transactions, verification of title begins with obtaining a commitment for title insurance and a current survey. The typical construction loan policy provides for increasing coverage as loan proceeds are disbursed by means of down data endorsements issued by the title company. These endorsements increase the coverage by the amount of the draw in questions and also based on the coverage current to the date of issuance.

B. **Compliance with Laws and Regulatory Matters.**

1. **Zoning.** Naturally, counsel will want to satisfy itself that the property and the proposed improvements comply with all applicable zoning ordinances. This will be accomplished by a combination of obtaining certificates from architects or other professionals, conversations with local zoning officials, and, perhaps, an opinion of borrower's counsel.

2. **Building Permit.** Nearly every city and most counties have requirements relating to the building of improvements and require a building permit as a precondition to commencement of construction of improvements. The lender will generally require the building permit as a prerequisite the first advance of funds under the construction loan.

3. **Certificate of Occupancy.** At the other end of the spectrum from the building permit is the certificate of occupancy to be issued upon completion of the