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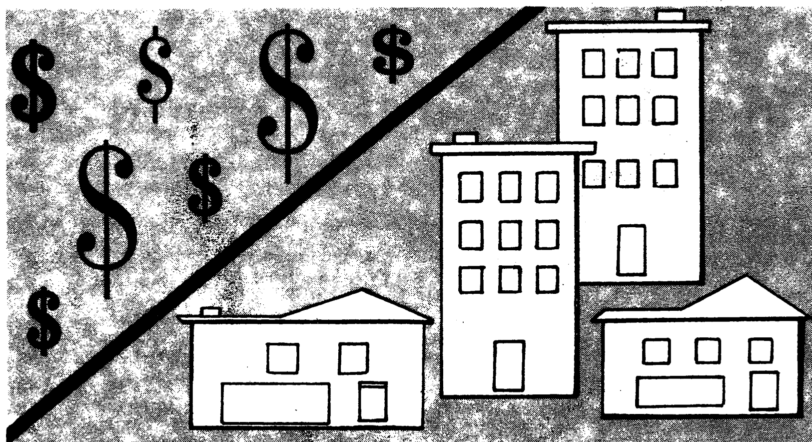

The Negotiation of Construction and Permanent Loan Commitments (Part 1)

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To understand a construction loan transaction, it is necessary to consider the identity and objectives of each of the parties to the transaction, the character of the particular project, the applicable law, and the documentation that will be needed.

This article will concern itself with loans to finance what might be referred to as development projects, in which a developer, as owner or long term lessee, seeks to develop a parcel of real estate either for resale or for investment. Many of the principles applicable to development projects are equally applicable to owner-user projects. The investment type development project usually involves an apartment house, hotel, shopping center, or office building that the developer intends to hold as an investment; the "for-sale" type project—houses or

condominiums that the developer intends to sell to ultimate users upon completion.

PROJECT STAGES • For ease of conceptualization, the history of a development project may be divided into stages. In the event the project is being constructed in sections, each section will itself generally pass through the same stages. Since these stages are not discrete events, work on one stage of a particular section may overlap that on another stage of the same section. In a phased project, various phases or development sections will generally at any point in time be at different stages of development, although often one section will not be commenced until the prior sections of the project have all reached the marketing and occupancy stage.

The stages through which a project or a section of a project generally proceed may be described as follows:

• *Market analysis, feasibility study, and acquisition negotiation:* the negotiation of terms for the purchase or long term lease of the land on which the project is to be constructed; an analysis of the feasibility of the proposed use of the land; estimates of the development and construction cost and the probable market for the proposed project; the effect of environmental, zoning, subdivision, and other land use control legislation and regulations; and the investigation of the availability of required interim and permanent financing.

• *Site acquisition documentation:* the drafting and execution of the acquisition documents, with the basic document usually being a long term lease, a purchase agreement subject to conditions, or an option agreement; and the tender of a deposit or an option fee.

• *Satisfaction of conditions precedent to site acquisition:* zoning, subdivision, and environmental approvals; the satisfaction of financing conditions, if any; the execution of leases with credit lessees; and the finalization of arrangements for utilities, storm drainage, and sewage disposal.

• *Land acquisition and construction loan closing:* often on the basis of an institutional land and improvement loan, but there may also be purchase money or "takeback" financing provided by the seller of the land.

• *Site development:* construction of on- and off-site improvements, such as access roads, drainage basins, trunk utility and sewage lines, and sewage disposal facilities.

• *Building:* construction of sample houses or apartments, buildings for lease, and support facilities such as

parking garages and recreational areas.

- *Preliminary marketing:* sales from samples or plans to test the demand for the project as a whole and for particular samples.

- *Program marketing:* sales of finished rentable space or speculatively built houses or condominium units.

- *Building finishing:* painting, decorating, and installing appliances, store fronts, office and store partitions, ceilings, lighting, and customizing space; move-ins.

- *Closing on permanent financing or sale of units:* assignment of construction financing to the permanent lender or paying the interim lender with the proceeds from sales or the permanent loan.

- *Operation of mature rental project:* maintenance and leasing.

- *Sale or refinancing of a rental project:* the eventual long term return for effort, risk, and investment.

OBJECTIVES OF THE PARTIES

- A construction lender, whether a bank, savings institution, or mortgage company, is interested in securing a high rate of return consistent with a reasonably assured repayment of principal within a relatively short period of time, usually one to 2 years. The net return on the loan to the construction lender is dependent not only upon the interest charged on the monthly outstanding principal balance, but also upon various fees payable to it, such as a service fee for the administration of the loan, a placement fee or other front end points, and possibly a standby fee based on the undisbursed portion of the loan.

These fees and interest on the outstanding balances are customarily paid from the construction loan itself to the extent that funds are available. Typically, upon the closing of the construction loan and as construction advances, the lender is credited with the fees and interest by way of disbursements of principal. Upon the completion of construction, the outstanding principal balance of the construction loan thus consists not only of the sums actually advanced by the construction lender but also of a sum equal to the fees and interest that the construction lender credited to itself during the term of the loan and charged against principal.

In the case of an investment type project, the construction loan balance is usually paid to the construction lender by the permanent lender when the latter acquires the loan upon the completion of construction and the satisfaction of other appropriate conditions. Under these circumstances, the permanent loan is the intended repayment source and may be viewed practically as the

primary security for the construction loan. Other security is intended to satisfy the permanent lender's requirements as they are set forth in the commitment for the permanent loan, thus constituting an integral part of the loan package to be acquired by the permanent lender. This security is, of course, also available for liquidation by the construction lender if the borrower defaults and the permanent loan does not close.

Although the construction lender views the permanent lender's commitment as the source for the repayment of the construction loan, the commitment itself would not qualify as the sole security. Good banking practice would generally condemn a loan on the basis of security that would be inadequate without the permanent lender's commitment. In other words, a banker should be satisfied that if, for any reason, the intended permanent lender fails to honor its commitment, the project to be constructed will, if liquidated, fetch proceeds sufficient to satisfy the entire anticipated advance.

A primary concern of the construction lender is that the project be completed; hence, with a reasonable margin for safety and contingencies, the cost of completion should at no time exceed the available undisbursed balance of the construction loan. In the language of the industry, the loan at all times must "remain in balance."

To this end, the construction lender will require at the construction loan settlement evidence of the anticipated cost of the completion of construction and proof that any amount—"gap"—by which the anticipated construction costs—including all professional fees, interest, taxes, and other builder's reserve items—exceed the construction loan will be available. It is not unusual for the construction lender to require that cash equal to the gap be deposited in escrow with it prior to commencement of construction, and that this gap money be disbursed prior to any loan proceeds. In a Federal Housing Administration, hereinafter "FHA," insured construction loan, the gap money must be "front ended," that is, deposited in escrow in cash and used to pay construction costs before any portion of the construction loan is disbursed.

The construction lender is also interested in insuring that any conditions precedent to the obligation of the permanent lender to pay off the construction loan be either reasonably within the construction lender's control or be satisfied prior to the disbursement of any construction loan funds. In the case of a for-sale type project, the construction lender seeks, prior to making its first advance, to assure itself that upon completion of the individual housing units, a market will exist for them.

The Permanent Lender

In the case of an investment type project, the long term or permanent lender—the so called "take-out lender"—seeks a completed facility capable of producing a long term income stream adequate to service the permanent loan, with a reasonable margin for safety. To this end, in its commitment, it will specify in detail the physical character of the improvements to be constructed. This is usually done either by a general description or, more often, by reference to an approved set of plans and specifications. The manner in which it seeks to insure that the project will yield the anticipated income stream needed to pay operating expenses and service the permanent indebtedness with a margin for safety will vary according to the character of the project.

Conditions precedent to the closing of the permanent loan on an investment type project often involve a specific number of executed leases in a form approved by the permanent lender. The tenant achievement requirements will, of course, vary with the nature of the project. A single purpose structure, like a motion picture theater or a restaurant, may call for an executed lease with an acceptable tenant on a lease form approved by the permanent lender. In the case of a shopping center, the permanent lender will usually require approved leases with the major tenants, and may also require that a certain percentage of the satellite space be leased at appropriate rentals with acceptable tenants. Other conditions precedent imposed by the permanent lender may relate to the availability of utilities and public services, approval by governmental units, and highway access.

The permanent lender needs a degree of certainty that a loan conforming with its commitment standards will actually be delivered to it so that it may schedule its investment activity and minimize loan acquisition expenses. In making a commitment to acquire a loan several years in the future, the take-out lender is willing to risk the vicissitudes of a changing money market. On the other hand, in order to statistically offset the risk of periodic increases in interest rates, it seeks to reduce the possibility of delivery failures that might occur upon a drop in interest rates.

The function of the long term lender in the case of a for-sale residential development project is significantly different from its role in the investment type development project. This is especially true with the recent advent of various secondary markets that will commit themselves to acquire standardized residential mortgages in the future. The for-sale residential permanent mortgage commitment assures the construction lender only that if the dwelling unit is completed within a

specified period of time and if, within that time period, the unit is sold and delivered to a qualified purchaser, the permanent lender will finance the purchase of the unit on specified terms. These terms will include either a designated rate of interest or the market rate at the time of delivery.

The Borrower-Developer

The borrower-developer is seeking to construct one or more buildings or other real estate improvements with a minimum, if any, investment of its own capital. It is important to the developer that, as the project progresses, sufficient funds become available to finance construction and construction-related costs such as interest, overhead expenses, taxes, insurance premiums, professional fees, and marketing expenses. A developer may also try to limit its exposure in terms of liability in excess of its investment in the project.

The developer of a for-sale project such as a tract of single family houses markets its project to users who will themselves probably borrow from a permanent lender a significant portion, if not substantially all, of the funds to be paid to the developer. Upon completion of the construction and sale of a housing unit, the developer, in turn, uses a portion of the funds it receives from the purchaser of the unit to pay off the construction loan and pockets any balance to offset any funds it had previously invested in the project and, if the project is successful, as profit.

The investor-developer, on the other hand, is concerned that the project be completed on time in accordance with the approved plans and specifications, and that all the conditions precedent to the funding of the permanent loan are satisfied in time for the loan to be delivered to the permanent lender in accordance with the permanent loan commitment. To the developer, all of the conditions of the permanent and construction loans must be satisfied so that the permanent lender is not provided with a basis for refusing to acquire the loan.

The General Contractor

If a general contractor not related to the developer is employed to build the project, the general contractor will want, as a minimum, to be paid promptly for work in place as construction proceeds, and to be paid all retainage within a reasonable period after substantial completion of construction. Ideally, the general contractor would like to be certain that so long as it performs its obligations under the general contract, the owner-developer will likewise perform its obligations. This requires an owner who has substantial financial resources other than the construction loan and the project that is being developed—a

circumstance all too often unattainable.

The general contractor's investment in the project at any point in time prior to the disbursement of the full retainage is equal to the amount by which the sums it has expended or incurred for labor, material, and overhead and paid to subcontractors exceeds the sum drawn against the construction loan or otherwise paid by the owner to the general contractor. To these out-of-pocket and accrued expenses must be added the liability of the general contractor under equipment and material purchase orders and to subcontractors for work to be performed at later stages of construction.

To reduce its investment and perhaps even to anticipate profits, the general contractor, and, in turn, its various subcontractors, may seek to "front-end load" the job — that is, structure the payment schedule so that the amount paid during the early part of the job exceeds the actual value, less retainage, of the work done. This attempt tends to defeat the objective of the construction lender—and the developer, if other than the general contractor—that at all times the undisbursed balance of the construction loan must exceed the sum that would probably be required to complete the work. An alternative to front-end loading of the payment schedule is to overestimate the value of work already performed. The owner and construction lender will, however, seek to avoid this by diligent inspection and evaluation of the rate of progress of the job and by exercising corresponding control of the payment vouchers approved during the course of construction.

Risk Shifting

The construction lender, developer, general contractor, and permanent lender are all concerned with the completion of the project in conformity with the permanent commitment or marketing program, satisfaction of all conditions precedent to finalizing the permanent loan commitment or the sale of units, and the funding of the project as construction proceeds. Absent unforeseen circumstances or a miscalculation on the part of one or more of these parties, these objectives should all be realized and the expectations of each of the parties satisfied. Often, even in the best economic climate, this does not happen. Every several years, conditions appear that disrupt the building industry and cause even greater dislocation than is normally expected.

The attorney representing each of the parties to a construction loan transaction seeks to shift the risk of the unexpected from his client.

This article will deal with those aspects of negotiation and documentation that relate to the prob-

ability of a default and are intended to cushion the effect of the default upon one or another party to the transaction. It will not concern itself with the negotiation of the business terms of the construction loan arrangement, such as interest rates, front end fees (points), and other service charges.

THE CONSTRUCTION LOAN • A construction loan bank officer will normally base his risk-taking evaluations upon the quality of the project, market analysis, and past experience with, or the reputation of, the developer, the general contractor if other than the developer, and the permanent lender. Offers of personal guarantees and extraneous collateral rarely affect a lender's decision as to whether to make a loan, although collateral is often required by a lender as a condition to granting a construction loan.

A construction lender will often ask for items of security in excess of those demanded by the permanent lender in order to better protect itself during the high risk construction period. It will seek security that is ample to satisfy any loan balance which might remain if the permanent loan closes but fails to produce sufficient funds to repay the entire loan balance. This might occur, for instance, if, as a result of construction delays or a dramatic increase in interest rates, the interest reserve initially established fails to cover actual interest accruing prior to the closing of the permanent loan. Under those circumstances, if the borrower is unable to cover the gap from its own resources, the construction lender may be forced to increase the loan amount to prevent a default. The need to enlarge the loan amount may become particularly significant when a condition of funding the permanent loan is that the construction loan not be in default, not an unusual requirement when it is anticipated that the permanent loan will be closed by the assignment of the construction loan mortgage to the permanent lender.

A bank's internal procedures often require that its credit department approve all proposed real estate loans that have been structured by a real estate loan officer. Personal guarantees by the individual principals of the developer are usually required by the construction lender to provide a most significant inducement for them to complete the job and deliver the loan to the permanent lender. A personal guarantee is a useful device to prevent a developer from flying away from the aggravations of a project in trouble.

If a project is to be developed by a limited partnership, the general partner may, for tax reasons, resist becoming personally liable on the construction loan. Under sections 704 and 752 of the Internal Revenue

Code, a limited partner's deductions for partnership losses is generally limited to his contribution to the partnership plus his share of the partnership's non-recourse debt. Specifically, a partner's loss allocation for tax purposes is limited to the adjusted basis for federal income tax purposes of his partnership interest at the end of the partnership year in which the loss occurred. An increase in a partner's share of the liabilities of the partnership or any increase in a partner's individual liabilities by reason of his assumption of partnership liabilities is treated as a contribution by him of money to the partnership. Any debt for which the general partner alone is personally liable will generally not be allocated to any of the limited partners for purposes of determining the tax basis of the limited partners' interest in the partnership.

It thus often becomes important that the non-recourse nature of a construction loan be preserved. A properly drafted guarantee of completion by a general partner, or preferably by a general-contractor affiliate of the general partner, rather than by the general partner himself, may satisfy the construction lender that the developer will not lose interest in the project and, at the same time, satisfy the partnership's tax counsel that the loan amount will be allocated among all the partners for basis determination purposes under section 752.

It is unusual for a construction lender not to require some form of personal guarantee unless the actual construction is to be performed by a bonded general contractor. When that happens, the construction lender depends upon the obligation under the performance bond coupled with an adequate holdback as reasonable assurance of completion. Since a performance bond only guarantees performance of the general contractor's obligations under the construction contract, it is most important for a construction lender who is relying upon a performance bond to be sure that, to the greatest extent possible, the general contract actually requires the delivery of a completed building by the contractor for a specified maximum sum without any conditions that are not reasonably within the control of the construction lender.

Even at its best, a performance bond is not security in the true sense of the term. It is a safe document for a loan officer to require in order to complete his file and evidence his due diligence. As a practical matter, a lender seeking to collect under such a bond has a rough row to hoe.

The ability of a contractor to deliver a bond does, at least, qualify him as being considered an appropriate bonding risk by a bonding company. Since a contractor's ability to secure bonds may be his life blood, there is some possibility that he will protect his bonding line of

credit by fully performing his contractual obligations under bonded contracts. A corporate contractor's individual principals will often provide security in the form of personal guarantees to their bonding company that go far beyond what an owner would require of a general contractor.

The Construction Loan Commitment

The construction lender will obviously concern itself most deeply with the financial responsibility of the developer. A paramount concern is whether the developer will, if required, be capable of advancing additional funds to protect the project.

Although useful to establish the basis of the loan arrangement, a formal construction loan commitment is not essential and is oftentimes either completely ignored or so abbreviated as to consist only of a brief memorandum of the salient provisions of the proposed loan. A construction lender with extensive experience and an ongoing relationship with a particular developer will thus often rely upon a relatively informal construction loan commitment. On the other hand, many lenders will use multipaged detailed commitments.

A developer of an investment type project will primarily concern itself with satisfying the permanent lender's prerequisites once it has received a construction lender's agreement in principal to advance funds for a particular project. A final construction loan commitment can generally be fashioned only after the details of the permanent loan and an arrangement with the general contractor, if other than the developer, have been established. Before the construction loan can be concluded, the commitment for permanent financing must be acceptable to the construction lender, the general contract arrangement basically completed, and the costs of construction through subcontracts must be settled. Specified lease achievement is often a precondition to funding by the permanent lender of projects such as hotels, shopping centers, warehouses, industrial parks, and office buildings; in that case, the necessary leases must be secured.

Barring prior experience with the same construction lender on the basis of which the developer is willing to take a risk that the prospective construction lender will not renege or change terms when the time comes to close the construction loan, the construction and permanent loan commitments on an investment type project should be secured simultaneously.

A form of permanent commitment acceptable to one construction lender may not be acceptable to another. The developer may find itself in a most difficult position if, after paying the commitment fee for

a permanent loan commitment that he thinks will be acceptable to a particular prospective construction lender, the construction lender does not provide the construction funds and the frustrated developer has to search for another construction lender. The negotiating stance of a permanent lender often changes dramatically once the commitment fee has been paid and the commitment letter accepted.

As previously noted, in the case of an income-producing investment type project, the construction lender is depending primarily on the permanent loan commitment as its source of repayment; while with a townhouse, single family residence, condominiums, and other for-sale type projects, the loan, including interest and fees, is intended to be repaid out of sales proceeds. Thus, in a for-sale project, the construction lender is depending upon the ability of the developer to sell the housing units being constructed, rather than upon the satisfaction of the conditions of a specific permanent loan commitment. The ability to sell housing units is dependent upon the completion of the unit, including all offsite improvements, in a proper manner, the ability of the developer to transfer good title to a purchaser, the existence of a market for the product being built, and adequate financing for the ultimate purchaser.

As a result, in the case of the income-producing investment type property, the market analysis is performed basically by the permanent lender and is not a major concern of the construction lender so long as it has a secure permanent commitment for the repayment of the construction loan. On the other hand, in the case of for-sale housing, a market analysis is all important to the construction lender.

The Terms

The actual construction loan commitment, if one is used, will concern itself in more or less detail with such matters as the loan amount, interest rate, service charges and loan fees, term, and security. It will also establish various conditions precedent to closing on the construction loan, including an acceptable permanent loan commitment, the quality of the title to be provided, a specification of fire, liability, rent loss, and workmen's compensation insurance requirements, and possibly a personal guaranty requirement. The commitment should specify generally the provisions to be contained in the construction loan agreement itself, including a requirement that construction be completed in accordance with certain plans and specifications for a maximum specified sum. If the interest rate is based on a prime rate, the method of determining the applicable prime rate should be stated. The construction loan

commitment should also describe the manner in which the difference between the loan amount and the total project cost will be provided by the developer.

Commercial banks and mortgage brokers and other mortgage intermediaries that customarily borrow funds from commercial banks will often relate the interest rate to a prime rate. Although the practice varies throughout the country, the interest rate on loans by insurance companies, savings banks, and savings and loan associations will often be based on the market rates in effect at the time the commitment is issued. The rate on an FHA insured construction advance loan is specified in the FHA commitment.

An FHA commitment issued in conjunction with any of the various GNMA (Government National Mortgage Association) tandem purchase plans will specify a construction loan interest rate that will be effective until the date of "final endorsement" and a rate to be applicable thereafter. In FHA parlance, the term "final endorsement" refers to the closing that takes place after the completion of construction and the FHA cost certification procedures. At final endorsement, the FHA "endorses" its insurance of the permanent mortgage. In a GNMA tandem plan transaction, provision will often be made by the construction lender to collect a service fee which is intended to cover the amount by which the rate of return required by the construction lender exceeds the GNMA interest rate—7½ per cent under a typical current program—during the period following the final endorsement and prior to the assignment of the permanent mortgage to the GNMA.

The dangers inherent in a variable interest loan pegged to a prime rate are obvious. Predictability of total project cost is, from the point of view of both the construction lender and the developer, the keynote of a successful project. A variable rate without a limit injects an unknown factor of possible catastrophic magnitude. The interest is typically paid from the construction loan advances. It is doubtful whether a construction lender would ever proceed with a project if any other cost item were so uncertain. As a rule of thumb, approximately half of the full loan amount will be outstanding for the full term of actual construction. On this basis, if the cost of construction is to be $5 million and construction is to take 18 months, the interest cost at an 8 per cent rate will be approximately $300,000 [$5,000,000 x 1.5 x .08 x .5]. Obviously, a delay in construction time or an increase in interest rates may have a significant effect on the total fund requirements. For instance, an increase of 4 percentage points over the life of the loan will add approximately $150,000 to the total project

costs. If we assume a 10 per cent developer's equity—$500,000, this $150,000 amounts to a 30 per cent increase in equity requirements.

Often, construction lenders will issue letters of intent, rather than loan commitments, because of the number of variables involved and the difficulties of adequately documenting a construction loan commitment. The conditions precedent to settlement on the construction loan that are found in a construction loan agreement provide a good summary of the various items that must be handled by the developer's counsel in preparation for the construction loan settlement.

Construction Related Conditions

The paramount concern of the construction lender is the completion of the facility upon which the loan is predicated. To the construction lender, the facility consists not only of a building such as a single family house, a phase of a condominium project, an apartment house, or a warehouse, but it also includes all onsite and offsite improvements required before the building can be sold or produce its full projected income. The construction lender will seek to assure that the completed for-sale facilities conform with the descriptions of the market survey and the appraisals. Conformity is particularly important to a regulated lender, like a bank, saving and loan association, or insurance company, as the appraisal constitutes the basis on which to establish the required loan to value ratio upon which the loan was based. There is a significant possibility that the loan may experience serious problems if the physical improvements constructed differ significantly from those contemplated by the loan commitment.

Drawings and Specifications

Since the construction lender is looking to a take-out permanent lender to acquire the loan upon the completion of construction, it is essential to the construction lender that the facility be constructed strictly in conformity with the requirements of the permanent loan commitment. The optimum approach is for the construction and permanent loan commitments to describe the improvements to be constructed by reference to the same set of working drawings and specifications approved by all interested parties. As a practical matter, this is often not feasible due to the unavailability at this stage of a full set of working drawings and specifications.

If a complete set of working drawings and specifications is available, the physical description of the project will be given in the loan commitments by reference to these plans and specifications. Otherwise the project will be described in a less detailed manner, usually by refer-

ence to the then available preliminary plans, with the proviso that the final plans and specifications must be approved by the permanent lender. In accepting such a commitment by the permanent lender and substantially changing position in reliance upon it, a developer is ever sensitive to the possibility that should the permanent lender become less enthusiastic about the loan, the conditions for approval of final construction documents may become significantly more stringent than anticipated. It is imperative to be ever conscious of a basic fact of life—the developer's bargaining position significantly changes once a permanent commitment has been accepted and a fee paid. It is always best to leave as few items as possible open and subject to later approval.

In contract negotiations, an often used escape for parties that do not wish to face directly the problem of establishing objective standards for later approvals is to provide that the approvals shall "not be unreasonably withheld." Most lenders will strenuously resist any attempt to condition approval in this manner. Lenders seek to make loans on terms as favorable to them as possible, and, above all, they do not want to expose themselves to law suits.

Developers will generally seek to postpone incurring the substantial cost of working drawings and complete specifications until they are reasonably certain they have a project—until after a permanent loan commitment has been secured on the basis of site plans, schematic drawings, outline specifications, and perhaps a market survey. Such a commitment naturally will be conditional upon the permanent lender's approval of final working construction documents. The final set of working drawings for a high rise structure may not be completed until after construction has actually commenced. Time pressures arising from such ever present factors as escalating costs and the need of the developer to complete the improvements prior to the lapse of the permanent loan commitment often lead to an early start of construction before all the variables have been finalized—an approach that greatly increases the risk inherent in what is, at best, a very risky business.

Premature commencement of construction might also be induced by extraneous circumstances, like the imposition of new zoning or environmental regulations in the locality, the possibility of sewer or other utility moratoriums, changes in building codes, the timing of trade union contract terminations, climatic conditions, and backlogs in agency approvals. In certain localities, construction will often proceed on major projects on the basis of foundation building permits only. "Foundation only" permits, if available, will usually be issued subject to the right of the permitting agency to

approve or disapprove the final working drawings and specifications. In addition, the permit-issuing agency will reserve the right to require modifications to the previously approved foundation plans in the event that, upon receipt of the final plans for the entire building, it determines that the previously developed foundations are not appropriate to support the structure as finally engineered. Needless to say, the necessity of any modification may have a catastrophic effect on the project. It might, for instance, require a significant design change to accommodate additional footings or perhaps a major redesign of a structural system.

Mechanics' Liens

The commencement of construction prior to the execution of all construction documents presents major problems in those states in which the priority of the lien of the construction mortgage is based upon the "obligatory advance doctrine." Under this doctrine, the lien of a mortgage is established upon each advance of funds as to such advance, not upon the recording of the mortgage, unless the mortgagee is obligated to advance the funds on the basis of the occurrence of circumstances over which it has no independent control. Most obligatory advance states also generally adhere to the "relation back doctrine," pursuant to which a mechanic's lien dates from the commencement of construction on the project even by a contractor or subcontractor other than the one claiming the lien. In those states that apply both doctrines, the lien of the construction mortgagee as to funds advanced after the commencement of construction will have priority over a mechanic's lien only if the construction loan mortgage is recorded prior to the commencement of construction *and* the construction lender is obligated at that time to advance the loan proceeds on the basis of objective criteria that are not subject to his control.

If a construction lender or developer is contemplating activity in a state other than its own, it must, at least prior to the issuance or acceptance of any loan commitment, familiarize itself with the local mechanics' lien laws. Many a developer has seriously jeopardized a project by prematurely commencing construction in a "relation back-obligatory advance" state before an obligatory advance construction loan agreement was executed and the construction loan mortgage recorded.

Progress Payments

The schedule of progress payments may be based upon either designated stages of construction or the percentage of completion by the various construction trades. Under the stages of completion approach,

which is the simplest to arrange and is common for smaller or for single family house projects, a specified number of dollars are disbursed at each visible stage of construction.

For a two story single family house, for instance, 10 per cent of the loan amount might be disbursed upon completion of excavation, rough grading, footings, and foundations; an additional 20 per cent upon the completion of the framing; and an additional 20 per cent when roof, drywall, electric wiring, and masonry are finished. The final half of the construction loan would be disbursed in the same way, based on final construction phases, including the installation of electrical and plumbing fixtures and heating and air conditioning systems, floor finishing, painting, and the installation of kitchen cabinets and appliances.

Under the percentage completion by trades approach, the general contractor or developer submits a schedule to the construction lender that allocates the entire contemplated hard construction cost—the so-called "brick and mortar costs"—among the various construction trades, such as carpenters, masons, excavators, electricians, plumbers, plasterers, and painters. As construction proceeds, progress payments are disbursed on the basis of the estimated percentage completion of each trade. This approach is customarily employed on larger projects, and its use raises the front-end load problem.

It is vital to the construction lender and, if an unrelated general contractor is used, also to the owner, that the progress payments as construction proceeds do not exceed a predetermined percentage—usually 90 per cent—of the actual cost of construction to that point in time. Although now construction contracts and loan agreements sometimes provide for half of the accumulated retainage to be distributed at some point prior to the substantial completion of construction—perhaps, halfway through the job—the undisbursed balance of the retainage, less any "punch-list" reserve, is generally distributed only upon substantial completion.

The construction documents generally provide that a project is substantially complete when the owner can "occupy or utilize the project" or a designated portion thereof "for the use for which it is intended." A variation of this definition which perhaps better protects the owner requires that to be classified as being "substantially completed," a phase of construction or the entire project must be capable of being occupied or utilized for its intended use without substantial diminution in its utility to the occupant. Warranty and guarantee periods generally commence to run from substantial completion.

A building is typically considered to be substantially complete although there are a number of punch-list items to be completed by the contractor. The punch-list consists of items to be completed or corrected after substantial completion. This list is usually prepared by the general contractor and submitted to the architect for approval. Typical punch-list items might include touch-up painting, the installation of some missing door hardware, and the balancing of mechanical systems.

An owner or contractor will often seek to front-end load the trade payment breakdown by allocating a disproportionate part of the cost of completion of the project to the trades that are on construction phases which are completed earlier in the project. The front-end trades include excavators, rough graders, and framers of structures, whether this be rough carpentry in the case of a wood-framed structure, or concrete, structural steel, and, perhaps, masonry, in the case of the multistory high or midrise building. A front-end loaded trade payment breakdown will favor these start-up trades at the expense of the finishing trades, such as painters, plasterers, and installers of hardware, fixtures, and appliances.

One method that construction lenders use against front-end loading is to review the subcontracts covering the major trades and compare the contract price for each subcontract with the trade payment breakdown. Adjustments are often necessary, since a particular construction lender's trade payment schedule will often not parallel the work allocation among the subcontractors on the basis of the subcontracts that were actually written. It is rare, for instance, for a developer to allocate the work among subcontractors in the same manner as provided by the FHA trade payment cost breakdown in Form No. 2328.

The provisions of the construction loan commitment relating to the physical process of construction will vary according to whether the developer will also function as its own general contractor or whether there will be a financially responsible and possibly bonded general contractor who will build the project under a legally binding contract with the developer. If an unrelated general contractor is involved, the construction lender will often require that the general contract itself be assigned to the construction lender, and if a performance bond is required, that the construction lender be made a joint obligee under the bond. The construction loan commitment will provide for the approval by the construction lender of the general contract and, possibly, also of the prime subcontracts, as well as his acceptance of the performance and payment bonds issued thereunder.

Assignment of Interests

The construction lender will seek to assure that, in the event of a default, either it or, more practically, its nominee will be in a position to step into the shoes of the borrower-developer in order to complete the construction of the work. The construction lender will secure a contractual right in the event of default to succeed to the developer's various project-related rights and assets—including the architectural contract, purchase orders, subcontracts, the building permit, sewer and utility connection authorizations, and leases. In the case of a project such as a hotel, the construction lender may seek to secure from the hotel franchiser the privilege of designating a qualified nominee to operate the project under the franchise in lieu of the developer or its lessee in the event of a default. Nevertheless, the experience of most construction lenders has been that it is far better under default circumstances to work with the defaulting developer in attempting to complete the project rather than for the lender to take over the physical construction.

A construction lender providing funds for an investment-type project will invariably require that the permanent loan commitment be assignable to it and actually be so assigned. Many lenders will seek to buttress the assignment with undertakings by the permanent lender running directly to the construction lender. At a minimum, the direct undertakings will acknowledge the validity of the assignment, obligate the permanent lender to provide the construction lender with copies of all notices sent by the permanent lender to the developer, and afford the construction lender an opportunity to cure specified defaults by the developer that might impair the ability of the construction lender to enforce the permanent commitment.

The Buy-Sell Agreement

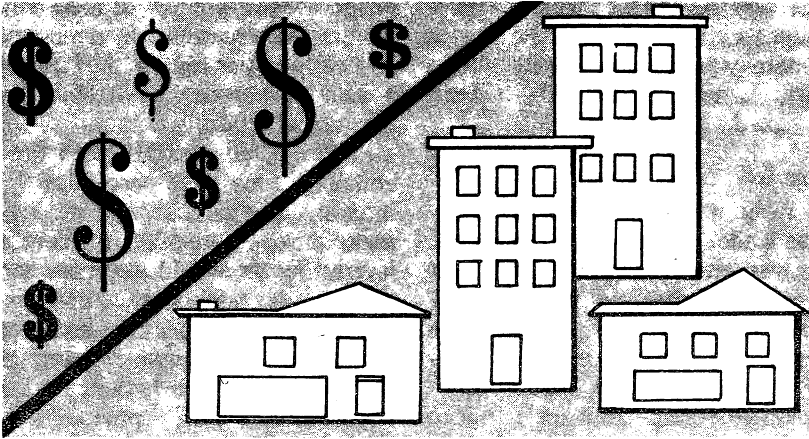
Under a buy-sell agreement—on occasion referred to as a "tripartite agreement"—the permanent lender agrees that if all conditions precedent to acquisition of the loan are satisfied by a specified date, it will buy the loan from the construction lender at par or at a specified discount. In turn, the construction lender generally agrees that it will not accept prepayment of the loan obligation nor sell the loan to any other permanent lender, and that it will deliver the loan to the permanent lender if all conditions precedent not waived by the permanent lender are satisfied.

Unless otherwise provided by the terms of the tripartite agreement, that agreement, in effect, probably will constitute an amendment to the permanent commitment to the extent that it is inconsistent with the commitment. A bilateral amend-

ment of the commitment might be adverse to the interest of the developer. For instance, a common form of tripartite agreement requires that the construction loan be made in conformity with the construction loan agreement. A breach of that provision might constitute a ground for the permanent lender to refuse to honor its permanent commitment, to the detriment of both the construction lender and the developer. Nevertheless, that provision, in modified form, might perhaps be appropriate in a relation back-obligatory advance mechanics' lien state. In such a jurisdiction, the provision would be intended to protect the permanent lender from the possibility of a mechanics' lien acquiring priority over the mortgage on the basis that the construction lender's advances have been voluntary.

Typically, tripartite agreements will prohibit construction lenders from releasing any part of the security for the loan, accepting prepayment, accelerating maturity, or otherwise assigning or transferring the loan other than to the permanent lender, unless the developer should be in default. An obvious way for the construction lender and developer to avoid the sale obligation of the tripartite agreement would be for the developer to default on the loan from a friendly construction lender. In order to safeguard the permanent lender, the tripartite agreement will usually provide that in the event of a developer's breach, a default may be declared only with the consent of the permanent lender, unless the permanent lender fails to agree in writing that the specified borrower's default shall not affect the permanent lender's agreement to purchase the loan pursuant to the permanent commitment and the tripartite agreement. This clause precludes a cooperative default from enabling the construction lender to avoid its obligation to deliver the loan to the permanent lender.

The developer, being the third party to the arrangement, agrees on its part that it will not prepay the obligation, that it will seek to satisfy all the conditions precedent to the sale of the loan by the construction lender to the permanent lender, and that it will execute those documents—in particular, the affidavit of no set-off—which are critical to the assignment of the loan. The tripartite buy-sell agreement is a document of particular concern to the construction and permanent lenders. It is additional assurance to the permanent lender that the acquisition of the permanent loan will not be frustrated, even if, due to market conditions at the time the permanent loan is to close, it would be more advantageous to the developer or the construction lender to deliver the loan to some one else.



The Negotiation of Construction and Permanent Loan Commitments (Part 2)

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THE PERMANENT LOAN COMMITMENT • Permanent loan commitments for new construction are issued anywhere from one to 3 years prior to the anticipated delivery date of the loan. In issuing the commitment, the permanent lender is assuring itself continuity of loan placement at prenegotiated interest rates. In effect, a permanent loan commitment is a financial future akin to a commodity future. On the other hand, the developer can rest assured that, regardless of changes in the money markets, it will be able to borrow in the future the required funds at a specified interest rate so long as it satisfies appropriate conditions. Advance permanent loan commit-

ments are valuable money management tools to life insurance companies and savings banks that have a generally predictable supply of long term monies they need to keep invested at optimum yields.

The Impact of Interest Rates

When it is time for the construction lender to deliver the loan to the permanent lender, the then rate for long-term loans may be greater or less than the rate specified by a permanent loan commitment. Loss of the one or two point nonrefundable commitment fee is not in itself a sufficient sanction to induce a developer to deliver a loan to the issuer of a permanent loan commitment if the current rate of interest is significantly lower than the rate in the permanent loan commitment. The monthly payment on a $1 million 30-year constant monthly-payment amortizing loan at 9 per cent interest is approximately $8,000—a 9.6 per cent annual constant. If, during the construction period, the interest rate for the same 30-year loan should drop from 9 to 8 per cent, the monthly payment on the $1 million loan will drop from approximately $8,000 to approximately $7,300—a difference of nearly $8,000 a year. If the developer were free to secure a new permanent loan, the loss of a 2 per cent deposit would be recovered by the developer in less than 3 years at the more favorable interest rate.

Even more significant to the average developer would be the chance to increase the loan amount by nearly 10 per cent on the basis of a monthly payment of $8,000. If a permanent lender will make a loan on a projected monthly cash flow equaling at least 125 percent of the monthly mortgage service requirement, the decrease of one per cent in interest costs would decrease the monthly mortgage service costs by approximately 10 per cent and thus increase the permissible mortgage amount by the same 10 per cent. At 8 per cent, monthly payments of $8,000 will support a loan of $1,100,000, as against $1,000,000 at 9 per cent. Were the developer able at delivery time to drop a disadvantageous commitment issued several years previously under different money market conditions, it might not even be required by the *new* permanent lender to pay an additional 2 per cent placement fee for the loan, since placement fees are often reduced for spot real estate loans, especially in a market in which interest rates are receding. Indeed, because of the certainty of delivery and a lender's need for immediate investments, spot loans are often available on more advantageous terms than commitments for future delivery.

An institutional permanent lender would be exposed to a significant adverse statistical selection were the retention of a one or 2 per cent

deposit its sole remedy when the developer willfully refuses to deliver a loan to the permanent lender. When interest rates receded significantly, loans would not be delivered on the basis of prior commitments; when interest rates rose, the lender would be compelled to accept assignments of construction loans. The permanent lender would, as a practical matter, be issuing option commitments, which, in time, would have a significant adverse effect upon the total yield of a long-term mortgage portfolio. A permanent lender wants all qualifying loans for which it issues advance commitments to be delivered to it even when a more favorable rate is available to the developer. The buy-sell agreement described in Part 1 is significantly better suited to effectuate this objective than the somewhat technical right to specifically enforce the agreement to deliver the loan upon completion of construction.

The Significance of Postsettlement Terms

Although the construction lender is most concerned with the terms of the permanent commitment, once it delivers the loan to the permanent lender, the permanent commitment has served its function. On first impression, therefore, the construction lender should not be concerned with the postsettlement terms of a permanent loan commitment—whether, for instance, the rate of interest the developer will pay the permanent lender is substantially in excess of the market rate, or whether the permanent loan becomes due and payable on demand or within a relatively short time thereafter.

Such matters might, of course, be relevant to a construction lender with an ongoing relationship with the developer, since the calling of a permanent loan would obviously have a significant adverse effect upon the credit worthiness of the developer. Nevertheless, any knowledgeable construction lender has reason to be concerned with postsettlement terms, for, if the terms of a permanent commitment are too onerous, the developer may, if pushed to the wall, prefer to prevent the assignment of the construction loan to the permanent lender, who would immediately assert its default remedies. A developer will often have reason to believe that it is preferable to be in default to a local bank than to an institution located possibly halfway across the continent.

On the other hand, if there is some form of personal guarantee of the construction loan and no personal liability on the permanent mortgage, the motivation for the developer to complete the assignment of the construction loan and thus be relieved of any personal obligation is obvious. The problem then is that the onerous terms of the permanent

loan commitment are symptomatic of the lack of any desire by the permanent lender to acquire the loan. It may seek to avoid honoring the permanent loan commitment on some basis or other. Hence, another reason a construction lender will seek personal guarantees from a developer is to encourage the developer to satisfy the permanent lender's delivery conditions, however harsh they may be.

THE STANDBY COMMITMENT • Permanent loan commitments might be roughly classified as "standby commitments" or "funding commitments." Funding commitments are issued by insurance companies and other institutional lenders that desire to acquire the loan upon the completion of construction. Standby commitments are more traditionally issued by mortgage brokers and, heretofore, by Real Estate Investment Trusts ("REITs") that do not really want the loan. For a fee, a standby lender provides the construction lender with a commitment that if alternative permanent funding is not secured by a specified date, the standby lender will acquire the loan upon the satisfaction of specific conditions precedent. The experiences of the last several years have highlighted the somewhat illusory nature of many standby commitments. As a result, at the present time many construction lenders will not advance construction funds on the basis of standby commitments.

A typical standby permanent commitment issued by a REIT in the early 1970's might have either been due on demand immediately after the assignment of the construction loan to the standby lender or might have provided for an interest rate of perhaps five to ten points in excess of a variable prime rate of interest and be due in 3 to 5 years. It was not unusual for the REIT to charge for issuing the commitment anything from three to five points—that is, from 3 to 5 per cent of the total loan amount. Many a REIT looked upon the standby commitments that it believed it would not be called upon to fund as a good source of immediately reportable income, income that would cause its securities to be traded at high multiples and permit it to issue additional securities and thus expand its equity base. In issuing a standby commitment, it was really insuring against the unavailability of a spot commitment upon completion of construction. In light of the boom conditions existing then, those responsible for managing REITs felt that they would never be called upon to fund the commitments.

Many REITs had arranged for lines of credits with major banks, both to fund standby commitments and, if required, to refinance commercial paper. When the commer-

cial paper no longer proved marketable and, at the same time, construction lenders sought to enforce standby commitments, the REITs exercised their rights under the standby lines of credit to borrow needed funds from the banks. In many cases, the banks had also provided credit for a fee with no expectations of actually funding the loans. In a number of instances, the REIT, mortgage company, pension trust fund, or other standby lender sought to avoid funding its standby loan commitment by raising technical defenses and, in some instances, reneging on the commitment when the project for which the standby commitment had been issued proved not be as viable as the standby lender had originally projected.

Gap Standby Commitments

Standby commitments might be characterized either as gap standby commitments or full-value standby commitments. A gap standby commitment is often intended to cover the contingent portion of the permanent commitment—that amount by which the maximum sum to be advanced by the permanent lender in the event of maximum rental achievement exceeds the sum to be advanced without regard to rental achievement. The minimum sum to be paid under the most disadvantageous rental experience is referred to as "the floor" of a permanent commitment, while the spread between the minimum and maximum amount of the commitment is referred to as the "gap."

The conventional practice is for the gap to be covered by the developer's cash deposit with the construction lender. An exceptionally credit-worthy developer might be permitted to cover the gap with a personal guarantee. Other developers may supply a letter of credit from a bank or deposit securities or other collateral with the construction lender. A marginal developer with neither cash, credit, or securities to cover the gap may resort to a commitment from a standby lender to provide a second mortgage for the amount of the differential.

Dependence upon a gap standby commitment is, at best, a dangerous approach for the developer, for it may face a catastrophic exposure in the event projected rental or sales are not achieved. A knowledgeable construction lender will be leery of any standby commitment so onerous as to indicate that the standby lender does not contemplate funding the commitment or that the developer will seek to prevent the construction lender from assigning the loan to a standby lender who may immediately call the loan.

HOLDBACKS • Commitments for investment type projects often involve holdbacks of all or a portion

of the loan proceeds pending satisfaction of completion, occupancy, or rental achievement requirements. On occasion, holdback requirements are absolute in nature, as when the full funding of the permanent commitment is conditioned upon meeting specific conditions. More often, a period of time after the delivery of the loan will be allowed for the satisfaction of the holdback requirements. For instance, a $5 million permanent commitment for an apartment house may call for delivery of the loan within 2 years, with the full $5 million being paid by the permanent lender only if a rent roll of $960,000 is achieved. The same commitment may provide that if at closing the rent roll is less than $960,000, only four and a half million dollars is to be disbursed, with the remaining $500,000 to be paid only if the $960,000 rent roll is achieved within one year thereafter.

Typically, a rent achievement clause is not based only upon gross rentals. The lender has to protect itself against a reduction in scheduled unit rents by a developer pressed to meet a rent achievement clause. The usual requirement, therefore, interrelates the gross rent to a specified level of rent. Often a rental achievement clause is articulated in terms both of a minimum occupancy and a minimum rent roll for actual occupancy. Permanent lenders are leery of the possibility of a rental achievement condition being satisfied with a limited number of high rent leases that provide for rents in excess of those anticipated at the time the permanent commitment was issued, since those leases may not reflect the long-term rental potential of the project.

In the case of a shopping center or a special-purpose building such as a movie theater or hotel, the disbursement by the permanent lender of the entire amount of the loan will usually depend upon the existence at settlement of fully executed leases, in form and substance acceptable to the permanent lender, with major tenants either specified by name or who satisfy specified conditions. Since the construction lender is looking to the permanent commitment as its principal payment source, it will generally not disburse funds equal in amount to the contingent portion of the permanent commitment until it is satisfied that all "accomplished rental" provisions have been met.

As with all commitment conditions, a construction lender feels most secure when the permanent lender acknowledges prior to the commencement of construction that a commitment condition has either been satisfied or waived. Thus, a construction lender will seek at the time of the construction loan closing to have the permanent lender waive a condition based on a lease that is already in existence. There is,

of course, the possibility that circumstances occurring after the construction loan settlement and prior to permanent loan closing may invalidate or terminate the lease. At issue is whether the construction lender or the permanent lender should bear the risk of changed circumstances, such as the bankruptcy of a major tenant prior to the permanent loan closing or the failure of the developer to satisfy all of the conditions of a major lease. Usually it is the construction lender who assumes substantially all the risks of events prior to the permanent loan closing.

Thus, the manner in which the permanent lender acknowledges the satisfaction of conditions precedent can be quite vital to the construction lender in the event of unanticipated problems arising after the construction loan settlement and before settlement on the permanent loan. The construction lender would prefer that the permanent lender waive conditions rather than acknowledge that certain circumstances constitute a satisfaction of the conditions. The permanent lender, on the other hand, normally feels that the risk of intervening adverse events should be the construction lender's.

CREDIT LEASE REQUIREMENTS • So-called "credit leases" with highly rated tenants generally form the foundation of the economic viability of commercial rental projects, such as shopping centers, warehouses, factories, industrial park type buildings, motion picture theaters, freestanding stores, bank buildings, service stations, tire stores, and restaurants. Permanent commitments involving these structures inevitably require that at permanent loan settlement a lease in specified form be in effect with a specified lessee. The form and the terms of the lease are either specified in some detail in the firm permanent commitment or made subject to the approval of the permanent lender.

TRANSFER OF PERMANENT COMMITMENT • A permanent commitment normally will be issued on the basis not only of the facility being built but also the developer who is responsible. On occasion, a permanent commitment will even stipulate that the developer must manage the project for a specified period of time, often for 5 years after the permanent loan closing. Thus, the assignment of the permanent commitment is usually prohibited and often a specified entity is required to own the project at the time of settlement on the permanent commitment.

A construction lender will be extremely circumspect as to any limitations in the permanent commitment upon the transferability of the commitment, the underlying real

estate, or the owning entities, since it seeks to fund the commitment with the permanent loan even if it or its nominee takes over the project following a default by the developer. The construction lender will therefore require that the commitment be assignable to it. It will also generally require that in the event of a default, it be permitted to reassign the commitment to any party to whom the real estate is transferable. The permanent lender will generally resist any such right and, in fact, will seek to include "no adverse change" clauses and condition its obligation to close on the permanent loan upon the absence of default on the construction loan.

If the assignment clause permits an assignment to the construction lender but not a reassignment by the construction lender, then in the event the developer fails to complete construction, the construction lender will be forced to complete the project itself so as to be able to transfer its loan to the permanent lender. Its decision may be academic since, in the event of a developer default, the time required for the construction lender to exercise its remedies and complete the project will usually exceed the period within which the permanent commitment must be delivered. In most construction-phase project workouts, the developer remains involved in some manner, while the construction lender controls all expenditures and advances the funds to complete the project. As a practical matter, in default situations the construction lender often has to renegotiate the permanent commitment—if it is fortunate enough to have a prospective permanent lender who continues to be interested in the project.

INTERRELATED COMMITMENTS • Prior to 1971, institutional lenders often funded the entire cost of a project by a series of loans and equity participations. There is every reason to believe that this practice will eventually return, since real estate financing practices tend to be cyclical, with each new generation of real estate loan officers believing that they know how to make creative high-yield loans better than their predecessors. In a typical transaction of this type, a developer might assign an agreement to purchase a parcel of land to an insurance company, which would lease the land back to the developer, who would then mortgage the leasehold with the same insurance company to finance the construction of the improvements. The insurance company might also arrange for an equity participation with the developer in a so-called joint venture. These arrangements inevitably involved some sort of "kicker."

The term "kicker" originally was intended to refer to a supplemental

source of income over and above the fixed interest payable to the institutional investor. The amount of the kicker was based on the economic value of the project in excess of a specified base point. Kickers would often involve annual payments to the lender of sums over and above the stipulated fixed interest on the basis of gross rental or net income of the project or some other criteria that were intended to reasonably relate to the economic success of the project. The kicker might be provided in either the lease or the leasehold mortgage or through the joint venture that gave the institutional lender an equity interest.

THE PHASED PROJECT • For-sale and large rental residential projects are often constructed on a section by section basis, with each section financed by a separate construction loan. Phasing significantly reduces the exposures of the construction lender, the permanent lender, and the developer.

The construction lender will normally prefer a phased project because it reduces exposure in the event of marketing difficulties. A for-sale single-family house project construction lender will generally limit the number of speculative units—units for which the developer does not have a purchaser at the time construction commences. In most parts of the country, a developer must build speculative houses to achieve an acceptable volume. Prospective purchasers generally will not wait more than 2 to 3 months for the delivery of a new moderate-priced house. This is especially true in those areas in which there are established resale markets for houses or in which sales to newcomers into the area, who need a home immediately, is a significant share of the new home market.

By phasing a project, the developer avoids building too many units in advance of demand. Perfect timing would reduce to the barest minimum the cost of carrying unsold or unleased units. A lender seeks to hold the number of speculative units to a minimum until a market absorption rate has been established.

In addition, phasing a residential project permits the developer to modify his models on the basis of "test marketing." A builder will try to avoid too many four-bedroom units if the market turns out to favor three-bedroom units.

The Federal Home Loan Mortgage Corporation ("FHLMC"), known also as "Freddie Mac" or "the Mortgage Corporation," requires as a condition of acceptance of a mortgage in a Planned Unit Development ("PUD") that 70 per cent of the units in the PUD be sold to bona fide purchasers. In section 3.208 of its Seller's Guide, FHLMC reserves the right

to reduce the 70 per cent presale requirement to 51 per cent. The Federal National Mortgage Association ("FNMA"), also known as "Fanny May," has similar presale standards. It indicates in section 503.03(c) of its Seller's Guide that in analyzing its requirements for a mortgage on a phased project, it will consider the requirements of other lenders in the area and such factors as whether:

- Strong initial sales demonstrate a ready market;
- The developer will provide cash assets or acceptable bonds for payment of full common-area assessments to the Owners' Association until these assessments are assumed by the unit purchasers;
- Later phases of an overall development are being undertaken in a proven market area;
- The developer's experience in similar projects in the same market area indicates strong market acceptance; and
- The project is in an area that has repeatedly indicated acceptance of similar projects.

Similar standards may well be applied by construction lenders in establishing limits on the construction of speculative residential units.

Front-End Costs

Phased projects generally present the problems of high front-end costs and coordination of phase inter-relationships. High front-end cost is best exemplified by the typical single-family house development in which, prior to the issuance of occupancy certificates for any of the homes, the developer may be required to provide access roads, sanitary and storm sewer systems, trunk lines for water and other utilities, and perhaps even a drainage basin or other extensive storm drainage facility. These fixed front-end development costs are to be distinguished from the variable phase-development costs, such as individual streets, sidewalks, local sewer lines, and water distribution mains. The fixed front-end costs must be spread over all of the homes to be built in the project, rather than merely the group of homes constituting the first phase.

It is not unusual for a developer to commence the construction of a 500 or 1,000 house project on the basis of a construction loan authorizing three or four samples and perhaps as few as ten speculative houses. The so-called offsite facilities necessary to provide services to the entire project may cost $3,000 to $5,000 per lot if the costs are distributed over all the lots in the project. Obviously, if only 3 per cent of the projected lots are initially used, the construction lender will not advance the total offsite improvement costs on the security of only the first

group of houses to be built. It will, instead, generally divide its loans into a development loan and a construction loan. The development loan will be secured by a lien on the entire land and will provide the funds for the required offsite facilities and major trunk lines for utilities. These improvements will increase the value of all the lots in the project, and each lot will have a significantly greater value as security for a loan after the offsite improvements have been completed.

The increase in the value of a lot due to the construction of offsite improvements will generally support a loan of between 50 and 80 per cent of the cost of the offsite facilities. The land loan and the development loan will often be combined upon the commencement of the development process. All prior liens on the entire site will either be cleared or subordinated to permit a first lien to be given for the development loan. Under any circumstances, there are significant market exposures for all parties where there are heavy front-end expenditures for offsite improvements, utilities, and similar facilities.

Rental residential projects will usually be phased in larger individual sections than for-sale residential projects, since a minimum number of units are required for economical management—usually in the range of 100 units. In a rental project, the front-end expenditures may involve not only the usual offsite improvements, utilities, and other facilities, but also recreational facilities, such as swimming pools, tennis courts, and a community building, that involve a significant expenditure on a per unit basis. For instance, for a rental project the appropriate size of a swimming pool that serves 100 units should be in the range of 1,000 square feet. A pool for 200 units should be only 50 to 60 per cent larger. The per square foot cost of the pool and the pool related amenities decreases significantly as the size of the pool increases. Thus, there is a significant cost efficiency in a single pool for 200 residential units than two pools for 100 units each. If the construction lender finances the construction of a 1,600 square foot size pool for a project to consist of two phases of 100 apartment units each and, because of adverse marketing conditions, the second phase of the project is not built, the larger pool would prove not only more expensive to build than a pool that would have been adequate for the 100 units but would also be more costly to operate and maintain. Even then, the construction lender is still ahead because of the phasing of the housing units, even though amenities were intially constructed for 200 units. Were all 200 housing units built initially, a significant number might have remained vacant for a long time.

In an inflationary period, reasonable planning dictates consideration of the inflation factors. The inflation rate of the last decade, however, has been somewhat lower than the interest rates. As a result, it pays to phase the construction of a rental project, even though availability of new rental units over a long period may hinder somewhat the rental of the existing units. Construction lenders, however, will normally not loan funds on the basis of a commitment that conditions the obligation of the permanent lender to acquire the loan on one phase upon another phase not being in default at the time of the permanent loan settlement.

Liens

In most cases, the construction lender is also the land and development lender, although there may also be some takeback type financing by the seller of the ground to the developer. In a typical phased rental project, the construction lender will place two or more mortgages on the site. One mortgage will cover the amount of the land and improvement loan and will apply to the entire site, while the other mortgage, for the amount of the construction loan, will usually be a first lien on the portion of the site on which the construction is proceeding. Oftentimes, the construction lender will also require an additional lien in the amount of the construction loan on the unimproved portions of the land as collateral for the construction loan. Any such collateral lien is usually subordinate to the lien of the land and improvement loan on the undeveloped ground.

Upon completion of a section, the construction lender will assign the first lien construction loan on the developed section to the permanent lender. If it is not customary in the locality to settle on the permanent loan by assigning the construction loan, the lien of the construction loan will be released upon the receipt of the permanent loan proceeds. If the permanent loan permits a subordinated lien, the construction lender may retain a subordinate lien on the built sections for the amount of the development and land loan still due in respect of the unbuilt section.

Cross-Easements

When different permanent lenders are advancing funds for different sections of a phased rental project, there will be a need for cross-easements, so that, upon foreclosure of one section, a purchaser will have a right to use the common facilities not located in the section purchased. These cross-easements can either be included in the mortgage documents or, preferably, be established by cross-easement agreements placed on record prior to the mortgage.

A cross-easement declaration will

generally state that in the event all the sections of the project are not under common ownership, the owner of each of the sections will have a right to permit its tenants to use specified facilities located on the other sections upon the payment of a pro rata portion of the expense of operating those facilities. The declaration may also provide for necessary access for sewers, water lines, and other utilities over the unimproved portions of the project to service the improved portions of the project.

In creating the cross-easements, a construction lender must consider various sequences of defaults that might occur during the course of the sectional development of the project. After the assignment of the construction loan on a prior section, a default may occur during the construction of a later section, or there may be default on the remaining balance due on the improvement and land loan. In the latter case, as the developer is probably personally liable on the improvement and land loan, it is quite possible that a default will also occur on the permanent loan on the previously completed sections. Since the previously completed sections will be owned after the foreclosure by the permanent lender or its transferee, the construction lender must have all requisite easements over the previously constructed sections and the right to use recreational areas and other facilities that would be valuable to later sections. As the owner of the undeveloped lands, the construction lender must be in a position to sell that land with a right to the easements. The permanent lender will also insist on similar easements over the unimproved land to the extent that its lands require access over the undeveloped ground or a utility service constructed on the other sections. The drafting of these cross-easements requires consideration of many possibilities, as illustrated by a typical set of cross-easement agreements in the Appendix to this article.

DEFAULT PROBLEMS • Construction lenders are becoming increasingly sensitive to the possible use by developers and others with a conflicting interest of the debtor rehabilitation provisions of the Federal Bankruptcy Act. So-called "chapter proceedings" are often initiated to prevent a construction lender seeking to limit its losses from taking control of a defaulting project. The developer will often threaten to utilize these procedures in order to extract from the construction lender concessions in the form of releases from personal liability, cash payments for equity positions of little value, or agreements not to proceed against posted collateral security or under or against performance bonds or third party guarantees. To reduce

their exposure to demands in the event of trouble, construction lenders will often require assignments absolute on their face of all the various rights held by the developer.

A developer is much more likely to subject a corporation he controls to a debtor rehabilitation proceeding than to subject himself. If the lender can foreclose against the stock of the corporation, the developer has little motivation to seek relief on behalf of the corporation. The only relief that would be of value would be a stay of execution against the assets of the developer—i.e., the stock of the corporation—and such a stay would generally be available in the context of a chapter proceeding only if the holder of the stock, and not the corporation itself, were subject to the protection of the bankruptcy court.

Lenders will on occasion require hypothecation of the stock or other evidence of ownership of the entity owning the real estate so as to avoid the necessity of real estate foreclosure proceedings. It is usually more expeditious to proceed under the Uniform Commercial Code against personalty such as stock than to foreclose against real estate. In subjecting the stock to a lien in its favor, the construction lender should be sure that the corporation is more than a mere nominee titleholder, with the real ownership in the developer or some other entity such as a limited partnership. The construction lender will also secure an assignment of all development rights, like building permits and authorizations by governmental authorities, franchises, in the case of hotels and restaurants, leases, and all construction related documents, such as architectural and engineering agreements, the general contract purchase orders, and subcontracts.

Furthermore, many construction lenders require that all subcontractors agree that in the event of a default by the developer under the construction loan, they will complete the work for the unpaid balance due in the subcontracts if requested by the construction lender, and that these undertakings be assignable, subject only to the obligation of the construction lender to pay for work done and materials supplied *after* it takes over the project.

This provision that third parties acknowledge rights in the construction lender may lead to negotiations between the construction lender and the third parties. The general contractor, for instance, often has no choice but to look to the construction loan as its sole source of payment. Hence, it may seek some assurances from the construction lender that in the event the construction lender should take over the job in a default situation, the construction lender will make all payments to which the general contractor is entitled. Most construction lenders will

resist such an obligation. A possible alternative for the construction lender is to agree that if it avails itself of the general contractor after taking over the project, it will pay both for work prior to, as well as following, its assumption of the project. Often the commitment will extend to the amount due for work for which construction funds have not been disbursed yet—work not included in vouchers against which advances have actually been made.

When the general contractor understands that the owner has no significant resources other than the funds from the construction loan, the general contractor often will enter into a contract only if the construction lender agrees that in the event the lender takes over the project and proceeds to complete construction, the general contractor will be employed by the construction lender to finish the work. Provisions, however, should be made for renegotiation or escalation of prices in the event of a significant time delay or other major change of circumstances.

APPENDIX

Declaration of Cross-Easements

The undersigned, being the owner of certain premises in ______________ Township, ______________ County, State of ______________, described as parcels no. 1, 2, 3, 4, and 5 on Exhibit "A" attached hereto and made a part hereof, having acquired said premises from ______________ on the _____ day of ______________, 19_____, by deed filed with the Recorder of Deeds of ______________ County, in Deed Book _______ at page _____ on the _____ day of ______________, 19_____, does hereby declare in respect to such premises as follows:

1. The term "Premises" as used in this declaration shall mean the entire lot or piece of ground, or lots or pieces of ground as the case may be, consisting of Parcels 1, 2, 3, 4, and 5, as described on Exhibit "A" attached hereto.

2. If at any time in the future any one or more of the separate parcels constituting the Premises shall be severed from the other parcels, then in such case the owner from time to time hereafter of each and every one of the parcels—and, to the extent so authorized by such owner, the occupants of any dwellings constructed at any time on any such parcel or parcels—shall have access to, and the right to use in common with the owners and occupants of each of the other parcels, any swimming pool and associated

(Continued on page 54)

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facilities that may at any time hereafter be constructed on Parcel No. 4. This right is conditioned upon the owner of the parcel or parcels claiming such right paying that proportionate part of the cost of maintenance, use, and operation of any such swimming pool and associated facilities as the total number of dwelling units erected on the parcel whose owner claims a right under this easement bears to the total number of dwelling units constructed on all parcels whose owners claim a right to use, or otherwise use, such swimming pool or associated facilities.

3. The owners of each of the parcels described as Parcels 1, 2, 3, 4, and 5 on Exhibit "A" attached hereto shall have the right for all time hereafter to connect to and use any and all storm sewers or sanitary sewers that may at any time be constructed on any one or more of such parcels, to the extent that any such sewer to which such owner seeks to connect is designed for and intended to serve a building or the portion of premises sought to be connected to such sewers. Each owner who shall connect to any such sewer shall be responsible for a reasonable proportion of any costs of maintenance or upkeep, to the extent the same is not the responsibility of the Township or other public authority.

4. This Declaration shall be binding upon and shall accrue to the benefit of the undersigned, its successors and assigns, and any person or other entity which at any time hereafter shall become the owner of any one or more of the parcels or any portion thereof described in Exhibit "A."

WHEREFORE, this Declaration of Easement has been executed on this _____ day of ______________, 19____, with the intent that the same shall be recorded with the Recorder of Deeds of ____________ County.

ALI/ABA BOOKS DEALING WITH REAL ESTATE

Anderson, Paul E.
TAX PLANNING OF REAL ESTATE (7th ed. 1977). 242 pp., $12.48

RESOURCE MATERIALS: MODERN REAL ESTATE TRANSACTIONS (2 vols., 2d. ed. 1976). 1236 pp., $51.75

THE PRACTICAL LAWYER'S REAL PROPERTY LAW MANUAL NO. 1 (1974). 189 pp., $5.48

THE PRACTICAL LAWYER'S MANUAL OF MODERN REAL ESTATE PRACTICES (1969). 140 pp., $4.48