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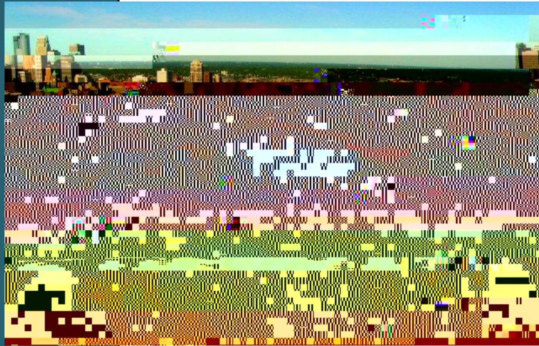
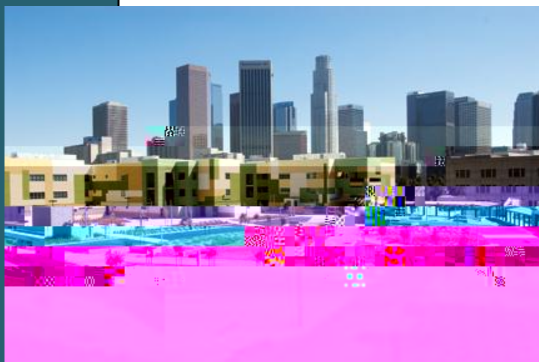
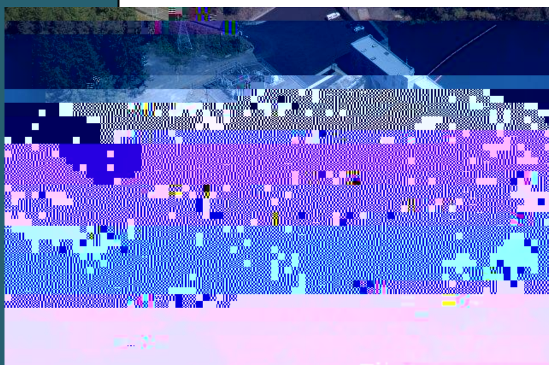
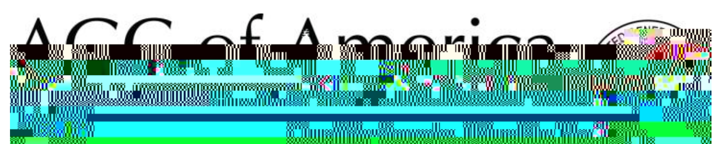
Guide to Construction Financing

Second Edition









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In 2009, AGC of America created a Construction Financing Guide Task Force in order to update the 1999 Guide. The following is a product of this Task Force.

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INTRODUCTION

Why should contractors care about construction project financing?

One of the major hurdles that almost any owner faces in a construction project is financing the construction and other development costs. More and more, contractors are finding themselves involved in the financing process. Indeed, complete lack of involvement is almost impossible to avoid on today's projects. The owner may look to the contractor for anything from "free" pre-construction services (a form of "soft money" financing) to direct equity investment in a project. Lenders, endeavoring to reduce financing risks, will look directly to the contractor for various assurances, certifications, and agreements regarding the construction of the project and its completion. Contractors, seeking new business opportunities or higher profits, will on occasion participate directly in the financing or development of a project.

A construction loan is simply a loan made on the security of a real estate mortgage (and perhaps other collateral), the proceeds of which are disbursed periodically (usually monthly) to pay the hard and soft costs of construction. They can be among the most complex real estate loans (compared to land acquisition loans or permanent loans, for example), and intimately

1. SOME MORAL TALES

The brief scenarios below illustrate some of the opportunities and pitfalls associated with the construction financing process. The scenarios are based on actual incidents, although they have been simplified and modified for our purposes.

A. The contractor as investor

A small contractor was looking for opportunities to expand its business. It was introduced to a developer with a few small projects under his belt, whose next project was to be in the downtown area of a nearby city. The project—a small mixed-use office and residential building on the edge of a growing office district—seemed to have great potential. The developer (whose day job was as a law professor at the local university) had already acquired the site and seemed to know the real estate business. A local bank was prepared to finance the project. Eager to land the job and seeing the possibility of greater

2. UNDERWRITING

other factors, and are one of the key benchmarks for underwriting the loan. Another underwriting benchmark is the *debt service coverage ratio,* or the ratio of projected cash flow (after expenses other than loan payments) to the amounts required to pay principal and interest on the loan on a periodic basis. Debt service coverage ratios always exceed a multiple of one, and a typical range might be from 1.2 to 1.6.

As part of its underwriting package, the lender will likely require *pro forma budgets* and *cash flows.* These *pro formas* will show the sources and uses of funds for the development of the project, as well as cash inflows and outflows on a monthly or other periodic basis.

If and when it is determined that it is prepared in principal to make the loan, the lender and the borrower will enter into a *loan commitment.* The commitment letter will set forth the basic terms of the loan, such as the amount, the interest rate, the repayment schedule, the collateral, and the like. It will also set forth some of the key terms of the loan documents and conditions to funding of construction draws, such as receipt of satisfactory appraisal, environmental reports, title insurance policies, land surveys, and the like. These conditions will also typically include review and approval of the construction contract.

It is important to keep in mind that:

- the construction company needs to act as an underwriter for the loan in order to assess the risk of the owners' financial health as well as the financial health of the lending facility.
- you may request copies of:
    - personal financials
    - credit reports
    - bank strength ratings (www.bankrate.com)
- you should:
    - pay close attention to underlying contractual terms.
    - understand the underlying strategy of the construction loan and how it is being financed and the game plan for repayment of the loan.
    - get your surety involved early and use them as the hammer for transparency of the loan information – it is not uncommon for the surety to request this type of information and typically it will remove the contractor from the line of fire if the surety is making it a requirement for bonding support.
- the construction company should use the same diligence and underwriting as a bank would use at the beginning—the construction company is lending money to the client in the form of work completed without payment.
- the contractor should make certain that the owner or someone on his or her team has sufficient experience in the project being considered. If not, it might be prudent to explore hiring an outside resource.

Red Flags

- Incomplete plans and specs
- Owner caused delays
- Payment slow-down or default
- Heavily layered financing with no strong lead
- Inexperienced owner
- Deferred development fees

- Change in lender involvement
- Changes in communication (owner becoming more distant)
- Adversarial posturing by the owner
- Reluctance towards transparency of financing
- Abnormal invoicing requests
- Cash infusion requests of the

As projects under construction typically do not generate income (an exception would be the construction

the contractor may be too far down in the hierarchy to be effective in getting paid if there is simply not enough money to satisfy all debtors.

Therefore, try to get a 2nd mortgage position on the project. While it may not help if the project is underwater you will at least be ahead of general lien claimants if there is any money. Even a 3rd mortgage position might help. (This could possibly create unexpected liability however).

C. Single-purpose entities and guarantees

The owners of many real estate projects are *special-purpose* or *single-asset* entities established exclusively for the project at hand. These entities, as their names suggest, have no significant assets other than the project. These entities are established most frequently to insulate their owners from liability. They also protect the current project from being jeopardized should a common owner run into financial difficulties on unrelated activities

- Get the social security number and names of all members of the LLC/partner/guarantors (this is important, but very difficult to get once challenges arise)

- Ask for personal financial statements from the principal members, etc. if an LLC

- Do credit reports, court record searches, and Universal Commercial Code

There are several web sites which provide resources to assist contractors who want to learn more about PPPs.

- Continually monitor and verify funding availability as compared to the cost to complete (or budget) for the job.

- Maintain a feel for the industry health for the type of construction you are performing—both economically and geographically.

- Need to open and maintain a clear line of communication between the contractor, owner, and lender.

- Watch for unusual financing requirements or owners asking the contractor to participate up front to help finance – it could be Ponzi scheme or a similar fraud.

D. Other types of debt financing

The myriad of requirements of borrowers and projects have lead to many other types of lending structures beyond the traditional construction loans described above. However, many, if not all, of the elements of the traditional construction loan described above will be incorporated into these more complicated structures. Some of the more typical structures are described below.

Tax exempt bonds are a mechanism by which state and local authorities can issue bonds and make the sales proceeds available to certain types of real estate development projects at a lower financing rate than would otherwise be available for that project. The bonds are sold in a *public offering* arranged by an *underwriter,* or are issued in a *private placement* to a small number of investors, usually institutions or other sophisticated investors. The bonds are simply a promise to repay the money loaned by the bond purchasers (or investors) on specified terms and conditions, as with any other loan.

Tax exempt bond financing is available only to certain types of projects and borrowers, such as certain manufacturers, private businesses located in federally-designated enterprise communities, health care providers, utilities, colleges and universities, and other non-profit cultural, civic, professional, educational, and other organizations qualifying under Section 501 (c)(3) of the Internal Revenue Code. For these types of projects, interest payments on the bonds are not subject to federal income tax in the hands of the bond purchaser (it may also be exempt from state income taxes, depending on the circumstances). Because the interest on the bonds is free of federal income taxes, the bond purchasers are willing to accept a lower rate of interest than they would if they had to pay taxes on the interest income (as would typically be the case), and hence, tax exempt bonds provide a relatively low cost source of financing. Typically, they can reduce a project's interest costs by 2% or more per year. Thus, a project that might otherwise be financed at 7% per year can be financed at 4%-5% per year. As interest costs are a very significant component of a project's overall costs, the result in savings can be significant.

Although a state or local public entity is the issuer of the bonds in order to afford them with tax exempt status, the authority is typically not responsible for the repayment of the bonds. Rather, the bondholders look only to project revenues, the owner of the project, and/or other collateral or security (frequently a letter of credit posted by a bank associated with the owner) for repayment of the bonds. Tax exempt bond financings are significantly more complex than traditional construction loans, involve many more players, and must comply with a series of complicated federal income tax requirements, as well as state and local requirements.

project costs, including interest, are greater than the loan limit.

- Get an authorization letter at beginning of project to be able to

assigning the construction contract to a lender (or others) without the contractor's consent.

There are similar or identical provisions in other standard contracts, such as Section 14.1 of the ConsensusDOCS 500, Standard Agreement Between Owner and Construction Manager, (See also AIA A121/Cmc 2003 and AIA A133-2009. Note that the AIA A121 will no longer be available as of May 31, 2010.).

The ConsensusDOCS 200 permits an owner to assign the construction contract without contractor consent "to a wholly owned subsidiary of Owner when Owner has fully indemnified Contractor or to an institutional lender providing construction financing for the Project as long as the assignment is no less favorable to the Contractor than this Agreement." Section 13.2 of the 2007 edition of A201 permits the owner to assign the construction contract to a "lender providing construction financing" without the contractor's consent, and requires the contractor to "execute all consents reasonably required to facilitate such assignment." The lender must assume all of the owner's "rights and obligations under the Contract Documents."

The contractor should be aware of two key points in connection with assignment provisions. *First,* it is highly unlikely that a prudent lender would make a construction loan without a provision authorizing assignment of the construction contract to the lender, as completing the project as originally contemplated may well be the best approach to maximizing the value of its collateral. Thus, even if the construction contract is written on older or non-standard forms that prohibit assignment to a lender without the contractor's consent, that provision is likely to have been modified, or the lender will insist that it be modified as a condition to making the loan. Second, the provision is not completely clear as to the lender's responsibility for payments to the contractor that were due, or are for work performed, prior to the date that the lender takes over the construction contract.

From the contractor's perspective, it would be wise to clarify this point. The contractor should also be concerned if the bank/lender is not experience/sophisticated in construction lending.

B. Agreement to complete

Matters such as the lender's right to take over the construction contract in the event of an owner's default (discussed in the previous section) are frequently addressed in an "Agreement to Complete and Assignment of Construction Contract," or similar agreement directly between the lender and contractor. The provisions that a lender may seek in such an agreement include:

- The contractor's agreement to complete the project in accordance with the terms of the construction contract, upon receipt of a notice from the lender that the owner has defaulted under the construction loan. Such a provision may expressly state that the contractor must continue to perform under the contract notwithstanding that the lender will not be responsible for paying for work performed prior to the date that the lender takes over the project. (The owner is still responsible for these payments, but as the owner is in default at this point, that is likely small consolation to the contractor.)

- An assignment to the lender by the contractor (to be exercised by the lender only upon the owner's default under the construction loan) of the contractor's rights in permits, shop drawings, and the like.

- An agreement by the contractor that it will not exercise any of its remedies under the construction contract upon the owner's default, until it has given the lender notice and 30 days to cure the default.

- An agreement that no change order is effective without the bank's consent.

- A confirmation of the guaranteed maximum price (if any).

- An agreement that any loan proceeds disbursed directly to the contractor will be held by the contractor in trust and will be used first to pay project costs and the contractor's fee.
-

properly within the purview of the architect, not the contractor. As before, the contractor does itself and its client a service if it anticipates these issues and discusses them in advance with the client. A simple and effective approach is periodically to remind the client that the contractor should be given an early opportunity to review proposed construction draw and provisions in the construction loan agreement before it is finalized, to the extent that they relate to the contractor prudent its work7 The are approach is r

Some lenders will request that the contractor sign a Subordination Agreement. It would be prudent to have your attorney review this as to the impact it could have on your place in the hierarchy of payment which can hinge on several factors including state laws. At a minimum the contractor should demand notice of any default on the loan and of any problems with the financing.

Request a copy of the Owner's Builder's Risk policy and review it with your insurance broker. This is a critical piece to help you get paid in the event there is an insured loss during construction.

6. DOES THE OWNER HAVE THE FINANCIAL CAPABILITY TO COMPLETE THE PROJECT?

Both the ConsensusDOCS and AIA standard contract documents contain owner financial information provisions; however, the ConsensusDOCS 200 contains provisions that many contractors view as more advantageous to contractors and subcontractors than the 2007 A201. Specifically, ConsensusDOCS allows contractors to request necessary project financing information from the owner not only prior to construction, but also during the construction phase. AIA has a provision similar to ConsensusDOCS for obtaining project financing information prior to the start of work, but places potentially onerous restrictions on access to such information once construction has begun.
Section 2.2.1 of the 2007 edition of A201 entitled the contractor to request and receive "reasonable evidence" that the owner has sufficient financial arrangements in place to fulfill its obligations to the contractor, and suggested that absent such assurances, the contractor would not be required to start work. The document provides that if such assurances are requested and not given, the contractor is not required to commence or continue the work. In addition, the owner cannot "materially vary" its financing arrangements for the project without prior notice to the he r3n407

original financing arrangements may remain in effect, the project costs may have increased in the interim beyond the funds committed, or the requirements for the continuing disbursement of those funds may not have been met.

- Consider requesting project financing information by referring to the ConsensusDOCS 290 Guidelines for Obtaining Owner Financial Information and the related 290.1 Owner Financial

contractor may be required to pay all of its subcontractors for work completed, even if the contractor has not been paid. A proactive approach to knowing your client, understanding the financing and the associated risks, and monitoring the financial aspects as diligently as the physical construction of the project will go a long way toward preventing financial hardship for the contractor and its business partners.

This document is intended to be a reference
to get† to get

GLOSSARY

Accrued Interest—Interest that is earned on a loan, but is added to the principal balance instead of being paid as earned.

Amortization—The payment of principal (as opposed to interest) on a loan. Amortization reduces the outstanding principal balance.

Appraisal—A formal evaluation, often by a Member of the Appraisal Institute (MAI),

Joint and Several Liability—A liability is 'Joint and several" when the lender or other creditor may sue all of the liable parties separately or together, each for the full amount of the debt, regardless of their responsibility or level of participation in the venture.

Joint Venture—A commercial undertaking-such as a real estate development project-undertaken for profit by several individuals and/or entities that is limited in scope and duration, but not necessarily in liability of the participants. General and limited partnerships and limited liability companies are specific examples of joint ventures.

Letter of Credit—A formal written

mortgagee can foreclose on the property, auction it off to the highest bidder, and retain the proceeds to the extent that they do not exceed the amount of the obligation plus costs of collection.

Mortgage Broker— An intermediary that arranges mortgage loans for a commission.

Non-recourse Loan—A loan for which the borrower and/or its owners or principals that would otherwise be liable for repayment are not liable by reason of an agreement to that effect with the lender. The lender's recourse is limited to the collateral and any parties to which it has retained recourse.

Owner Financial Questionnaire—A questionnaire used by Contractors that is designed to obtain the project financing information necessary to help ensure a successful project for all parties. The ConsensusDOCS 290.1 provides a good example of a straightforward form.

Permanent Lender (see also "Takeout Lender")—The lender under a permanent loan.

Permanent Loan—A loan following the development and construction period.

Prime Rate—The published rate that a bank offers to its more creditworthy customers. Most banks set their own prime rate and adjust it periodically. Despite its name, the prime rate is not necessarily the lowest rate that a bank offers; so most banks prefer the term 'base rate" instead.

Principal Amount—The total amount borrowed under a loan.

Recourse Loan—A loan that if in default, permits the lender to sue the borrower (and perhaps its principals or owners), rather than merely foreclose on the collateral.

Security—Property, such as real estate or tangible or intangible personal property, pledged to secure the repayment of a loan if the borrower does not pay as scheduled.

Single-Asset Entity—An entity established to pursue the development of a single project. The entity has no assets that are not project-related.

Soft Costs—Costs other than the actual "hard" costs of acquisition and construction (including the contractor's fees), such as design and financing costs, and other fees.

Special-Purpose Entity—An entity that is organized to own, develop, and operate a single project.

Syndication—The offering of loans or equity investments for participation by others as investors.

Synthetic Lease—A synthetic lease is a complicated lending transaction that is an operating lease for financial accounting purposes, but a mortgage loan for federal and state income tax, bankruptcy, and other purposes. It is also referred to by a myriad of other names, including "tax retention operating lease," or "TROL".

Swap—A transaction in which (in its most common form) two borrowers exchange the floating rate interest obligations of one borrower for the fixed rate interest obligations of the other.

Takeout Loan—The loan that replaces - or "takes out - a construction loan, on pre-specified conditions.

Takeout Lender—The lender under a takeout loan.

Tax-Exempt Bonds—Bonds, the interest on which is exempt from federal and/or state income taxation in the hands of the holders, thus lowering the interest rate that they will demand.

Taxable Bonds—Bonds, the interest on which is taxable.

Title Insurance—Insurance against specified preexisting defects in title to real property.