DEFENSIVE CONSTRUCTION LENDING: WHAT A LENDER NEEDS TO KNOW BEFORE MAKING A CONSTRUCTION LOAN

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The authors gratefully acknowledge the assistance of Ellen Kornfield Fogel, Esq., Elizabeth A. Gable, Esq., and the late Benet Polikoff, Jr., Esq. in the preparation of a previous version of this article.

Construction lending can be risky in the best of economic times and even more so against the backdrop of a sluggish or down-turning economy. Projects may struggle to become successful, potentially resulting in a failure to complete the project or retain its viability. Such failures can adversely impact the associated borrower's ability to repay its loan. It is important, therefore, that construction lenders identify the market and other risks associated with potential construction loans and adopt a course of conduct aimed at achieving timely payment thereof based on the particular project, the borrowing entities, and the economy. To offset potentially heightened market risks, a construction lender should make every effort to limit the non-market risks inherent in construction loans, setting up the borrower and the project for successful repayment of the loan, regardless of the state of the economy.

Few construction lenders have the opportunity to consistently make construction loans to high-credit entities or on commercial and industrial properties fully leased to lessees with high credit ratings. Construction lenders can, however, engage in a variety of strategies to ensure a project's attractiveness and success, such as: (i) intimately knowing their borrower and guarantor; (ii) pursuing cautious and diligent pre-commitment investigation; (iii) drafting and reviewing their term sheets with great care, including consideration of any potential requirements under the loan; (iv) attentive administration of the loan; and (v) being aware of any state-specific laws affecting the borrower or the project. This article discusses each strategy in turn.

THE BORROWER AND THE GUARANTOR

The construction lender must first be satisfied that the borrower, its sponsor, the guarantor, and their related parties have sufficient experience and knowledge to complete the contemplated project at its estimated cost and in accordance with the terms of the construction loan documents. Otherwise, the parties should not proceed, even to the term sheet stage. Conversely, a borrower's tremendously strong reputation and history may outweigh evidence of significant market risks. For example, the borrower or owner of a particular project may have such a substantial investment in the project that the construction lender could safely conclude that such personal investment sufficiently protects against possible losses due to poor market conditions, resulting in disappointing project performance. Further, a construction lender may decide to make a loan despite possible weaknesses of the project or in the economy because the borrower or owner has an excellent track record with prior projects or is so favorably known to the construction lender.

The Borrower and its Sponsor

Of primary importance to any construction loan is the identity of the borrower and its controlling entities (as borrowers are typically required to be special-purpose entities). The party's character, as well as its professional and financial capacity to accomplish the project and repay the construction loan, must completely satisfy the construction lender. In this regard, the construction lender should investigate the party's reputation, competence, and prior track record by obtaining references from lending institutions, contractors, architects, major tenants, and investors who have dealt with the applicable party in the past. Additionally, the construction lender should obtain from the borrower a list of all prior projects in which it has been involved, as well as disclosure of the results (e.g., whether any project was sold prior to completion, foreclosed upon, given to a lender in lieu of foreclosure, successfully completed, currently under construction), all of which the construction lender should independently verify. The construction lender should inspect these prior projects, including the success and current maintenance of these projects, particularly those projects similar in size or use to the one under consideration. During the investigation, the construction lender should keep in mind that most borrowers are a pleasure to do business with during the good times, but that good borrowers are those who live up to their obligations during the bad times as well. Therefore, the construction lender should always determine and consider the reliability of the borrower in bad times.

The construction lender should also review the annual and quarterly financial statements of the borrower and its controlling entities. These statements should be examined both from the viewpoint of real net worth and net income, which should include the income from the borrower's sponsor's other projects that could cause such sponsor to divert its resources and/or attention from the proposed project, particularly any commitment in which such sponsor has a minority interest. Minority interests may appear as minor investments in such sponsor's overall portfolio, but they may contain large potential liabilities and obligations of such sponsor.

Notably, the construction lender should have enough meetings with the principals of the borrower to determine their integrity and professional ethics. These intangible qualities may prove to be of paramount importance in the long-term relationship.

All of the information supplied by the borrower to the construction lender in connection with its review of the borrower should be deemed a part of the borrower's application for the construction loan. Additionally, the construction loan term sheet should recite that the construction lender issued the term sheet in reliance upon such representations.

The Guarantor

Repayment of its loans, rather than completion of the underlying projects, is the ultimate concern of the construction lender. If the construction lender makes the loan to a responsible, solvent entity who has no issue repaying the loan, then the construction lender is quite fortunate (and unique). More typically, however, as mentioned above, the borrower's sponsor forms entities for the specific purpose of constructing the project without any additional assets. Therefore, the construction lender must obtain satisfactory assurances of payment elsewhere. Accordingly, the construction lender should make every construction loan with a firm source of repayment: a guaranty.

Most guarantors with the financial wherewithal to respond to a guaranty of payment on a major construction loan have already given similar guaranties to one or more other lenders. Many of these guaranties exist concurrently. Calling upon the guarantor to respond to its obligations under a guaranty can have the effect of triggering a default under all of its other guaranties and the guarantor quickly becomes unable to respond to any of them. Therefore, prudence mandates a financial study of each guarantor and its other obligations.

To the extent that someone other than the borrower or a principal of the borrower guaranties payment of the construction loan or completion of the project, the construction lender should also conduct the borrower review described above with respect to each proposed guarantor. The construction lender must keep in mind that any guaranty is only worth the value of the guarantor giving it. Regardless, the construction lender should still obtain a guaranty of payment. Even if such guaranties are not ironclad, at a minimum they create a psychological effect of obligation upon the guarantor, enabling the construction lender to obtain and keep the guarantor's attention and, add an interested party or parties to any possible workout negotiation. A guaranty is, of course, stronger when backed by some form of collateral, such as a letter of credit, an escrow account, a lien on other property, or a pledge of securities. A construction lender should determine whether to request such collateral prior to issuing the construction loan term sheet. In all cases, the construction lender's financial review of the guarantor's financial condition must conclude that the guarantor has the liquidity and overall net worth to fund any obligations the guarantor undertakes.

Additionally, keep in mind that guaranties by subsidiaries or affiliates of the borrower could be subject to attack in a bankruptcy proceeding as being an "upstream" or "sister company" guaranty and, therefore, may not be enforceable in bankruptcy.

PRE-TERM SHEET INVESTIGATION

In order to minimize the risks generally inherent in construction loans, a construction lender should pursue cautious and diligent pre-term sheet investigation by adhering to certain practices, procedures, and principles during its underwriting and due diligence process. Although this article cannot discuss every conceivable problem or legal or business consideration that the construction lender should address before making a construction loan (e.g., methods of credit investigation, peculiarities of local lien law, requirements that a lender qualify to do business, matters of local taxation, the details of construction loan documents, and title insurance), this article will, however, attempt to set forth the most basic considerations, all of which apply whether the lender directly makes the construction loan or the lender acts as a co-lender or participant in a construction loan made by another lender.

The construction lender should not hesitate to engage its own independent experts, such as an appraiser, inspecting architect or engineer, insurance consultant, and environmental consultant, to review the proposed project at the earliest possible date. Other consulting personnel, such as a marketing and planning consultant, may assist in certain types of projects where the market for such projects has not yet been fully determined or tested.

Before the construction lender expends any money on experts, it should enter into a term sheet with the borrower. The term sheet will account for the costs of the construction lender's due diligence, together with the requirement that the borrower deliver a good faith deposit. The construction lender could return any balance of the deposit to the borrower in the event the parties do not ultimately enter into the construction loan documents.

The Project

The construction lender should also review the viability of the contemplated project itself. During this review, the construction lender should ask whether: (i) the project is well-conceived and likely to be successful; (ii) the project makes economic sense; and (iii) the economy will support this particular type of project at the time of completion. In this regard, the construction lender ought to obtain an independent feasibility study and a cash-flow projection in order to determine the economic viability and the total possible cost of the project. Additionally, the construction lender's loan personnel and inspecting architect or engineer should visit the site with a local appraiser selected by the construction lender in order to fully understand the project.

The construction lender should carefully and critically analyze the project's budget, including all construction costs (soft and hard), potential operating deficits, and amounts set aside for tenant improvements. If there is the slightest chance that final costs will exceed the proposed construction budget, including contingencies, the borrower must identify and provide a source for those funds. Otherwise, the risk exists that in order to complete the project, the construction lender will need to fund the excess to obtain the full realization of its collateral.

Generally, the construction lender should avoid making loans on specialty projects not readily adaptable to an alternate use in the event that the intended purpose of the specialty project is not economically viable by the time of the maturity of the construction loan.

The Appraisal

The appraisal is not just something for the construction lender's file pursuant to bank examiner requirements. Instead, if done correctly, it greatly facilitates the decision as to whether or not the contemplated project has economic viability and assists the construction lender in determining specific loan terms. Although the appraisal contains important information for the construction lender, also keep in mind that, at this stage of the project, the appraiser generates the appraisal somewhat in a vacuum, since work on the project has not even commenced. Notwithstanding this fact, the construction lender (not the borrower) should commission an appraisal done by a member of the American Institute of Real Estate Appraisers (MAI) to ensure the appraiser is accountable only to the construction lender. Additionally, the appraisal will assist the construction lender in determining the necessary loan-to-value ratio. Standards may vary from state to state, but many states require, and prudent practice generally dictates, a loan-to-value ratio of no more than 65 percent to 75 percent for loans secured by improved real estate and of no more than 60 percent to 65 percent for loans secured by vacant land.

Appraisers utilize various appraisal methods: replacement value, market value, income, etc. Construction loans most commonly use the "as-is" value of the land together with a capitalization of the projected stabilized net income. In no event should the appraiser use the residual method for unimproved land valuation because the residual method is based upon a valuation of the land as improved by its highest and best use. A method considering the highest and best use can only be justified with a completely constructed successful project.

General Contractor and Construction Contract

Before entering into a formal commitment, the construction lender's inspecting architect or engineer should review many elements of the transaction. They should begin with the plans and specifications of the project to determine their completeness and the soundness, engineering, and feasibility of the design. Additionally, they should conduct an independent cost analysis of the proposed site work and construction, especially if the construction contract does not set forth a guaranteed price by the general contractor. Finally, they should independently review the construction schedule and the draw schedule. Borrowers often attempt to front-load the draw schedule and reduce the estimate of the amount of funds needed for finish work, landscaping, and the like. Additionally, if the general contractor grossly underestimates the timeframe of construction, the project will likely exceed budget. Both situations can result in the borrower requesting increases in the construction loan as the loan approaches the maturity date. An independent review of both the construction schedule and the draw schedule can decrease the likelihood of these eleventh-hour loan increase requests.

Unless the borrower's or a guarantor's net worth alone assures the repayment of the construction loan, the construction lender should insist upon the construction contact containing a guaranteed maximum price from a financially responsible general contractor, notwithstanding the extra cost involved in obtaining such a guaranteed maximum price. Even if the construction contract does reflect a guaranteed maximum price, the construction lender's inspecting architect or engineer should perform an independent cost-out of the construction of the project and an in-depth investigation of the general contractor's financial ability to complete construction to determine the accuracy of the proposed construction budget. The inspecting architect or engineer should also review the completeness of the construction contract as well as the track record and bondability of the general contractor. This review should include a determination of whether the general contractor has built any comparable projects, how such projects fared over time, and whether the contractor completed the projects within the cost of the proposed budget.

If the general contractor does not have firm contracts for all of its costs or final plans and specifications prior to the loan commitment or closing, the general contractor often operates under a fast-track method (i.e., construction begins without complete final plans and specifications). The construction lender should always avoid fast-tracking, particularly in a slow economy, because it forces the borrower to enter into the unknown and, thus, creates an additional risk to the construction lender. However, if the construction lender is determined to proceed with the project, and the general contractor is unable to secure contracts or final plans and specifications, the parties have another option. The construction lender and the borrower can enter into a preliminary acquisition, demolition, and/or foundation loan pursuant to the construction loan documents, with the intent that the preliminary loans will be rolled into a construction loan. The construction lender should only advance under the preliminary loans, and not the full construction loan, while the general contractor obtains the remaining contracts and plans and specifications, which also must be acceptable to the construction lender. Obtaining these contracts and plans and specifications must be a condition prior to any advance under the construction loan. Using this strategy, the preliminary work on the project can commence after the initial loan closing and by the time the borrower is ready to draw on the construction loan, the general contractor should have had sufficient time to obtain contracts and create final plans and specifications. Otherwise, the borrower is in default under the construction loan documents and the construction lender has the ability to withhold funding under the construction loan. What has been set forth above with respect to general contractors and construction contracts applies equally to construction managers and construction management agreements.

Other Due Diligence Investigations

The borrower and the construction lender often procrastinate assessing the characteristics of the land upon which the project will be built until the very end of the transaction. However, these characteristics embody a critical aspect of the project, and any problems which result can create a huge risk for the construction lender. The review must analyze compliance with laws (e.g., the local zoning and building codes, the plans' compliance with the Americans With Disabilities Act, and whether architectural review board permits are required), any environmental issues (e.g., subsoil conditions, whether boring tests and percolation tests should be conducted, the presence of rock or marsh or water which could cause construction problems), water matters (e.g., water resources, sewer allocation, storm water runoff, any nearby wetlands), potential traffic restrictions (e.g., a general traffic study, particularly for shopping center properties, access to the property, availability of curb cuts, deceleration lanes and the like), adequacy of utilities (e.g., police and fire protection), use restrictions, deed restrictions, and the grade of the property vis-à-vis the street and the abutting land. Analysis of these items will uncover most hidden construction problems which could result in increased construction costs.

As part of its due diligence, the construction lender must also require preparation of a Phase I Environmental Report of the proposed project, which in some instances may point to the need for a Phase II Environmental Review. The borrower may try to downplay this important investigation, especially when utilizing vacant land. However, the construction lender must keep in mind that sites can become contaminated from a polluted site several miles away. The presence of an environmental problem on the project can act to cut off a lender's remedies under any type of loan, because the local law may dictate that foreclosure on a contaminated site exposes the lender to environmental liability. Therefore, the construction lender must never waive this important due diligence investigation.

TERM SHEETS

Regardless of the construction lender's relationship with the borrower and the assurance the construction lender feels based on the oral understanding they have reached, the construction lender should ensure the term sheet is drafted with great care and includes any potential future requirements under the loan. Ideally, the construction lender grants to an attorney, who fully understands the terms of the transaction and of any special conditions, the task of preparing the letter. The construction lender must use such extreme caution with the preparation of the term sheet because it can create a binding obligation on the construction lender, either because the text of the term sheet itself creates the obligation or because the construction lender wants to maintain its reputation with potential borrowers and is reluctant to dishonor the term sheet. The term sheet must explicitly contain the specific business terms of the transaction (e.g., the loan-to-value ratio, the loan-to-cost ratio, equity requirements, and the specific terms of any permitted subordinate financing), including any terms both the construction lender and the borrower consider oral understandings. Otherwise, the construction lender will have difficulty incorporating such terms in the ultimate loan documents.

A term sheet should also set forth the following additional items, each of them subject to the construction lender's approval, as requirements before any funding of the construction loan:

The Parties

- As many specific parties as possible (e.g., the borrower, the borrower's controlling entity, the guarantor, the general contractor, etc.);

- The financial statements described above for the borrower, its controlling entities, each guarantor, and any major tenants; and
- Current financial statements for the general contractor or, if the owner will act as the builder, financial statements of major contractors and subcontractors.

General Terms

- The project and general proposed improvements;
- Maximum loan amounts, the loan term and any extension options, and the applicable interest rate;
- An outline of the cash management structure and required reserves; and
- Clarification of any equity requirement.

Fees

- Requirement of a good faith deposit and any other fees the construction lender may feel appropriate; and
- Provisions for the payment of the construction lender's expenses, including the fees of the construction lender's counsel, appraiser, inspecting architect or engineer, environmental engineer, and insurance consultant, among others, and closing costs by the borrower.

Loan Documents

- The general documents essential to the transaction (e.g., loan agreement, promissory note, first priority mortgage, first lien security interest on personal property, first assignment of agreements, contracts and permits, a guaranty of payment, a completion guaranty, environmental indemnity, and the like); and
- Opinions of counsel that address enforceability of loan documents; due organization, power and authority, due authorization, and due execution of entities; usury; security interest; and choice of law. Often, the transaction will require multiple opinions. For example, opinions should be provided in the state of the property location, the state of formation of the borrower, and the state of the governing law of the loan documents. Additional opinions may be required based on the borrower's structure as a special purpose entity or as tenants-in-common.

Covenants

- The maximum loan-to-value ratio and minimum debt service coverage ratio;
- The borrower's and guarantor's specific financial covenants (e.g., minimum liquidity, minimum net worth, and contingent liabilities), as well as an obligation for the borrower and guarantor to maintain these requirements throughout the term of the loan; and
- A specific time period for completion of both the loan transaction itself and the project.

Project Requirements

- An appraisal, environmental report, soils report, structural engineer's report, and the like;
- Mutually agreed-upon budget, unit release price (if a condominium), and contingency percentage of hard and soft costs to remain throughout the term of the loan;
- Plans and specifications for improvements and evidence that they comply with all applicable laws and ordinances, including zoning and regulations applicable to building codes and licensing authorities;
- Evidence of satisfactory zoning, issuance of all building permits and licenses, and availability of utility and municipal services, including sewer and water; and
- Preliminary, progress, and final "as-built" surveys that match the property description provided in the title report; and
- Evidence that the property is free of any and all environmental problems and that it is not located in an area that has been identified by any state or federal authority as wetlands or by

the Secretary of Housing and Urban Development as an area having special flood hazards.

Insurance

- Evidence of builders' risk insurance, boiler and machinery insurance, liability insurance (e.g., public liability, automobile liability, and umbrella liability), casualty insurance, terrorism insurance, contractor's liability, and workers' compensation insurance. The construction lender's insurance consultant should review all such evidence and a mortgagee endorsement should specifically name the construction lender as a loss payee;
- Mortgagee title insurance from a title company which has sufficient assets to justify writing the policy. To the extent such is not the case, the construction lender should require coinsurance or reinsurance with direct access. Additionally, if the company is an agent for a title insurer instead of a title insurance company, the construction lender should obtain a closing protection letter; and
- Errors and omissions insurance, in amount, form, and substance satisfactory to the construction lender, covering the borrower's architect and engineers.

Contractors

- Architects', contractors', engineers', materialmen's and sub-contractors' contracts relating to design and construction of improvements, and assignment of such contracts to the construction lender;
- Undertakings of the architect and the general contractor or, if the owner will act as the builder, major contractors, subcontractors, and the architect should agree to continue performance in event of the owner's default; and
- Faithful performance and statutory labor and material payment bonds.

Miscellaneous

- Whether or not the construction lender will allow subordinate financing and, if permitted, the terms of such subordinate financing and whether the construction lender will require an intercreditor agreement;
- Whether or not the construction lender maintains the right to syndicate the loan, and if the construction lender so chooses, require the borrower to reasonably assist with the syndication process;
- A warranty that all the borrower's representations to the construction lender made to obtain the loan continue to be accurate and that lender is relying on such representations to make the loan;
- Time periods specifying when the construction loan terms must be accepted by the borrower and the construction loan closed;
- The right for the construction lender to require additional information or vary the loan terms as the transaction progresses; and
- The borrower's signature to the term sheet.

As stated previously, each transaction will have its own special conditions, but the foregoing provides the basic provisions that the construction loan term sheet should address.

ATTENTIVELY ADMINISTER THE LOAN

Throughout the loan term, the construction lender can best protect its investment by diligently keeping informed of the project and reviewing ongoing materials provided to it. The following processes are recommended in order for the construction lender to ensure completion of the project and protection of its collateral.

Ensure receipt of mandatory quarterly and annual financial statements and review such statements for compliance with the required minimum liquidity, minimum net worth, and contingent liabilities.

Actively monitor the borrower's budget and contingency level and ensure conformity with the required figures prior to any advances.

Obtain and review any contracts the borrower promises to acquire post-closing and obtain assignments running to the construction lender of such contracts.

Ensure that the estimated amount necessary to complete the project, including soft costs and the like, never dips below the unadvanced portion of the loan. The construction lender should verify this amount prior to each draw of the construction loan, in the form of an affidavit of the construction lender's inspecting architect or engineer, the borrower's architect and a principal of the borrower, in order to, among other things, create personal liability on the part of such affiliates to the construction lender. This affidavit should affirmatively state, in essence, that the unadvanced portion of the construction loan will be sufficient to complete the project. If, at any time the unadvanced portion is insufficient, and the borrower or the guarantor cannot render payment to satisfy the deficiency, then the construction lender should discontinue making advances under the construction loan until the borrower has invested additional financial resources into the project to bring the budget back in balance. If the budget imbalance causes concern to the construction lender from the outset, the construction lender should require the borrower to fund all of its required contributions into the project prior to making any advances under the construction loan. Keep in mind that, if the borrower also acts as the contractor for the project, cost estimates may not include the usual profit that a contractor would require. Therefore, consider adding an estimated profit incentive for a new contractor, in the event that the borrower defaults, to the cost to complete the project. This will not, however, be easy to obtain from the borrower.

Obtain a completion bond from a surety company acceptable to the construction lender. Since such a bond is conditioned upon completion of the project free and clear of liens, its cost may be prohibitive in the absence of a very responsible (financial and otherwise) contractor.

Obtain payment and performance bonds from surety companies acceptable to the construction lender, each in favor of the construction lender and the borrower. Taken together, these bonds ensure that the contractor will fulfill its contract and pay all amounts owing for labor and materials. Although contractors customarily obtain these types of bonds, they require the contractor to receive the total amount due it under its construction contract in order to be operative, regardless of whether the project contained cost overruns which exceed the amount of the construction loan. Thus, if the construction loan did not provide for any cost overruns, these bonds will not fully protect the repayment of the construction loan, unless the borrower has been required to add its own funds in an amount equal to the difference between the construction contract (including cost overruns) and the amount of the construction loan. To fully protect payment, the construction lender must require that at all times the undisbursed portion of the construction loan be sufficient to complete the construction of the project. Otherwise, the surety will not be obligated to fully perform under the performance bond. The borrower's investment in the project should always act as the basic protection for the repayment of any construction loan. Nonetheless, these bonds should be obtained.

Prior to advancing under the construction loan, conduct a careful inventory of stored materials. The construction lender should not make advances for materials stored on- or off-site unless the construction lender has a valid security interest in such materials under the Uniform Commercial Code or the project incorporates such materials. Also, the borrower and/or the general contractor must always properly protect all on-site material from theft or vandalism.

Before making any construction loan advances, to the extent permitted by applicable law, obtain lien waivers from the general contractor and all major contractors and subcontractors for all work performed and fully paid for at the project. The construction lender can best protect itself by making the payment: (i) directly to the subcontractors and materialmen; (ii) through the title company; or (iii) in such fashion as will satisfy the requirements of the bonding company, if any. Also, any amounts advanced by the construction lender in order to bond mechanics' liens should be advanced in such fashion to avoid the possibility that could allow the borrower to default under the construction loan, settle with the mechanic for less than the amount of the lien, and then obtain the difference from the bonding company. The construction lender should simply pay the amount of the lien directly to the bonding company under an agreement providing for repayment by the bonding company to the construction lender of any unexpended funds.

If state law requires filing or recordation of a construction loan agreement or mortgage before any work commences in order to obtain absolute priority over mechanics' liens, simultaneously conduct such filing or recording and take photographs of the site which include an affidavit of the photographer attached to the photographs.

LOANS IN OTHER STATES

Loaning monies for construction conducted in another state requires knowledge of that state's lien laws, recording statutes, and qualification-to-do-business laws, all of which greatly affect the loan complication and documentation.

Lien Laws

The necessary steps to protect a mortgage against mechanics' liens vary from state to state because no uniform federal lien law exists. The construction lender and its counsel should have intimate knowledge of the state-specific lien law, and should hire local counsel, if necessary. The ultimate protection against mechanics' lienors is a title insurance policy issued by a reputable title insurance company insuring against mechanics liens. The title company can provide the policy either at the time of the first advance and for all time or at the time of each advance, as is customary in New York.

Although a title policy protects the construction lender, knowledge of the lien law is also critical to ensure protection of the construction lender's collateral and to maintain a first priority lien throughout the loan. Despite the absolute priority set forth in some lien law statutes, courts tend to erode the protections given to construction lenders, especially in those instances involving a foreign bank as the construction lender and a local tradesman as the mechanic. The construction lender should consult local counsel at the earliest possible date with respect to applicable lien laws to take whatever steps possible to protect and preserve the priority of the construction loan mortgage lien. To demonstrate the importance of knowing the specific jurisdictional lien law, the following identify the essence of common state-specific lien laws:

- In some states, mechanics' liens have priority regardless of when the work commenced relative to recordation of the mortgage;
- In some states, the construction lender has absolute priority (according to the text of the statute, but a court may hold otherwise);
- In some states, a construction loan mortgage recorded prior to the commencement of any visible construction activity has priority over all liens recorded after mortgage recordation (according to the text of the statute, but a court may hold otherwise);
- In New York, the lien law protects a prior advance under a construction loan against a later recorded mechanic's lien, provided the mortgage contains a clause authorized in Section 13 of the New York Lien Law, and the construction loan agreement *is* filed pursuant to Section 22 of that law. This establishes a trust fund in the mortgagor for payment of cost of improvement. However, a lien filed prior to the later advance has priority over all advances made after the filing.

Recording Statutes

Knowledge of the recording statutes in a particular jurisdiction avoids any issues with the execution and filing of loan documents. The title company and local counsel can act as an invaluable resource to the construction lender by ensuring the mortgage is in proper form and alerting the parties to any jurisdiction-specific documents or requirements.

Qualification to do Business

If a state deems that the construction lender has conducted business without properly qualifying, it may tax the construction lender, fine the construction lender, or declare the construction loan documents invalid. Therefore, if a bank makes construction loans for property located in states in which it is not qualified to do business, it must determine what activities it can conduct without requiring it to qualify to do business in that state or subjecting it to local franchise or income taxes on the income received from the construction loan. The mere making or holding of a loan on foreign real estate may subject a bank to franchise or income taxes. Unfortunately, the laws of the 50 states differ and failure to qualify prior to doing business in a state could subject the lender to penalties which may include payment of all overdue fees and taxes, with interest, fines on officers, and, worst of all, the unenforceability of the construction loan documents. Luckily, not all states have the same penalties and only a few make contracts entered into prior to qualification void and unenforceable. In some states, regardless of whether the construction lender conducts business, the income from its loan is taxable. For all the foregoing reasons, it is absolutely imperative that counsel, either individually or through local counsel, intimately knows the laws of the state in which the real estate security is situated.

To avoid the detailed requirements of a state's qualification-to-do-business statute, construction lenders often seek other options. The construction lender may purchase a loan made by a local bank, it may participate in a larger construction loan, or it can obtain a local servicer. These options may allow the construction lender to engage in the loan without qualifying, depending on the state and level of activity of the construction lender.

Instead of a direct loan, the construction lender may purchase a loan originated by a local bank. The construction lender should exercise caution with this option because making advances and/or servicing the loan during the construction period may constitute doing business in a particular state. If the construction lender considers this option, its counsel must review the state-specific continuing activity aspects of construction lending.

Additionally, the construction lender may participate in a loan originated by a local bank. If the construction lender considers this option, it should ensure that the lead bank has sufficient financial interest in the loan to make certain that it treats the loan with the care the construction lender would as the lead lender. When exercising this option, the construction lender must always obtain a doing-business opinion and enter into a participation agreement. The doing-business option must state that the participation will not subject the construction lender to qualification or to tax or prevent or interfere with the use of the courts of the state in enforcement proceedings. At the time of each advance, each participating bank should receive a certificate evidencing the then-amount of its participation. Unless the participating bank is satisfied through an opinion of counsel that the participation will not constitute doing business in the state where the real estate is located, the bank should not participate. The participation agreement should restrict the actions the lead bank may take without the consent of the participating bank. It should also contain as many protections as possible in order to place the participating bank as closely as possible to the same position had it made the loan in its own name. Most participation agreements expressly state that the participant cannot rely on the due diligence of the lead bank. Therefore, any participant in a construction loan should be prepared to perform its own due diligence, or at least review as much of the materials comprising the lead lender's due diligence prior to participating in the construction loan. During this review, focus on the financial strength of the lead lender and on protections (to the extent possible) incorporated into the participation agreement or the loan documents.

When a construction lender originates the construction loan, it almost always should retain a local bank to service the loan. A servicing agreement should clearly establish that the local bank acts as an independent contractor, and not an agent, of the construction lender. Otherwise, the state could deem that the construction lender has done business in the foreign state through its agent, the servicer. Generally, the less contact with a foreign state, the less likely the necessity exists to qualify to do business. As stated before, the mere making or holding of a loan on foreign real estate, however, may subject a bank to franchise or income taxes.

Often national banks (e.g., Bank of America, JPMorgan Chase, Citibank, and Wells Fargo) do not have to qualify to do business in a state in order to make a real estate loan. In transactions involving a construction lender and one or more national banks, each bank must individually investigate the requirements for qualifying to do business, even if the participating national bank has determined that it does not have to qualify to do business.

CONCLUSION

In sum, a construction lender which conducts business only with the borrowers and guarantors in whom it has the utmost confidence, undertakes cautious and thorough pre-term sheet investigation, considers term sheets as very serious and binding documents, actively administers the loan, and knows and follows local laws will be more likely to have a successful and fully repaid construction loan, regardless of the economy.