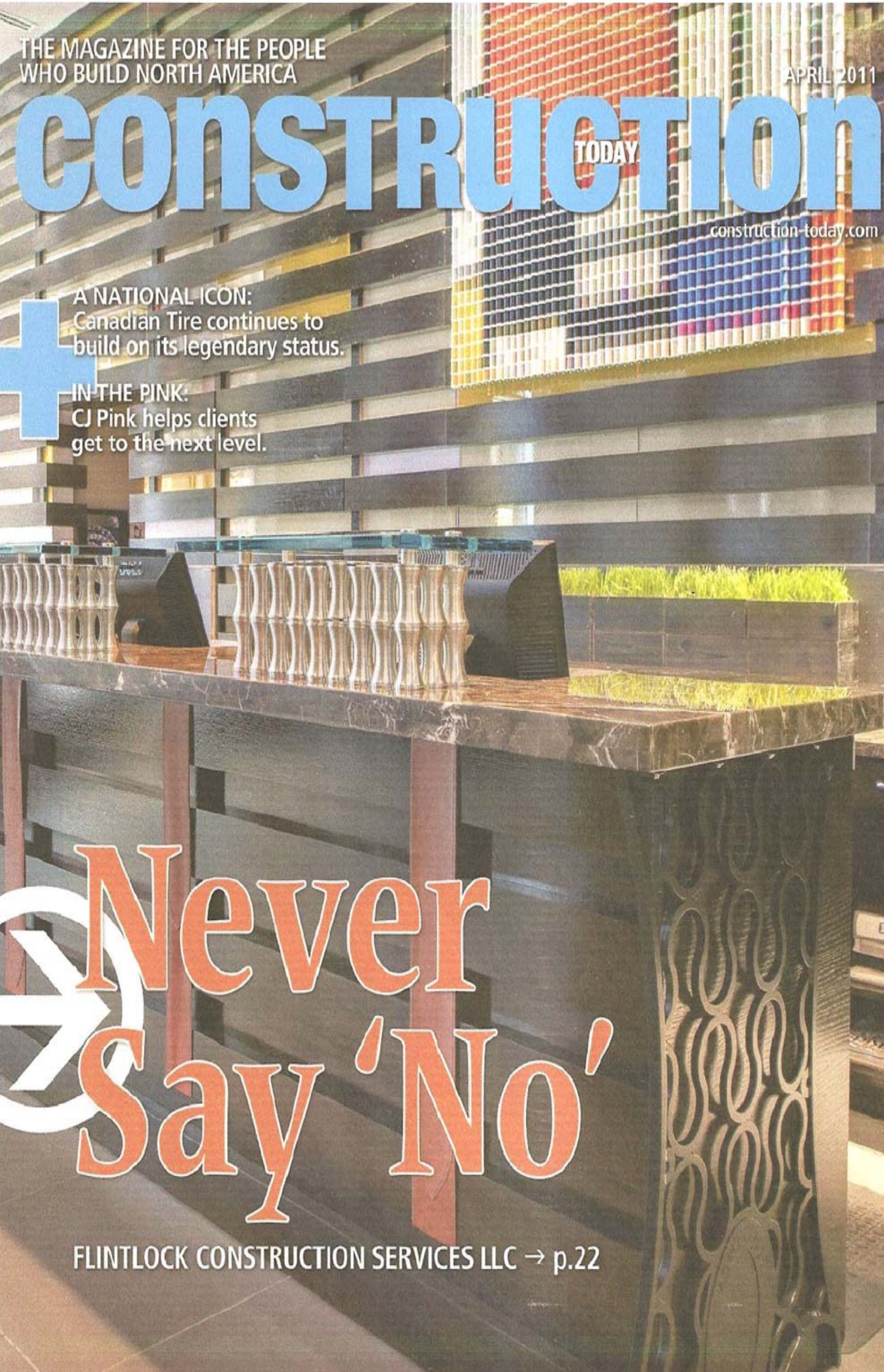

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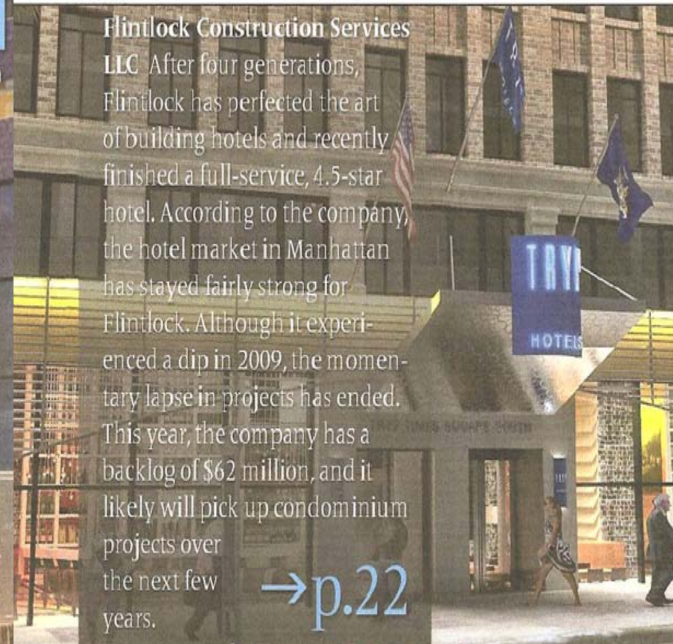

Flintlock Construction Services LLC After four generations, Flintlock has perfected the art of building hotels and recently finished a full-service, 4.5-star hotel. According to the company, the hotel market in Manhattan has stayed fairly strong for Flintlock. Although it experienced a dip in 2009, the momentary lapse in projects has ended. This year, the company has a backlog of $62 million, and it likely will pick up condominium projects over the next few years.

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Departments

Columns and Features

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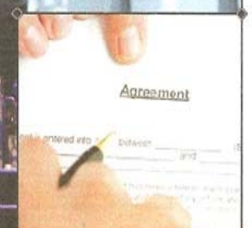

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KNOW YOUR LOANS

Protect your company's interests by getting familiar with loan disbursement. BY KENNETH FIELDS

Construction loans provide borrowers with a temporary source of funds to improve and sometimes acquire and improve real property. They come in all shapes and sizes, and can be used to fund virtually any type of construction project. The four players involved in every construction loan are a borrower, a lender, an architect and a contractor. In a design/build project, the architect and contractor may be the same person or entity. Sophisticated borrowers also involve their attorneys early in the process to help navigate through the many complex agreements involved in a construction project.

Borrowers properly focus on the design, function and cost of their project, as well as how they will pay for it. Unfortunately, they often overlook the process by which they will actually obtain loan proceeds from their lender to pay for project costs as incurred. Lenders have a justifiable interest in making sure loan proceeds are used to improve their loan collateral, and they have had decades to perfect the construction draw language in their loan documents. By comparison, most borrowers have managed very few or no major construction projects. As a result, borrowers are usually at a distinct disadvantage to their lender in the disbursement process.

A borrower should familiarize itself with the loan disbursement process before closing its construction loan. The borrower's architect and contractor can assist in this process, but they have their own interest in the process – to be paid in full as quickly as possible. Thus, a borrower should have its attorney review the loan disbursement provisions to insure that its own interests are adequately protected. Some of the principal issues that borrowers should consider in connection with the construction and disbursement process are discussed below.

Architect and Construction Contracts

When selecting an architect and contractor, a borrower should consider whether the proposed parties would be acceptable to a construction lender. The borrower should require its contractor to complete a qualification statement of some kind – such as an American Institute of Architects (AIA) Contractor's Qualification Statement – and should contact the bank, trade, surety and other references identified in that form. Simply put, the borrower should not just assume that its proposed architect or contractor would be acceptable to its construction lender.

The architect and construction contracts will be subject to the lender's approval, and the lender will require that those contracts, including all warranties thereunder, be assigned to the lender as additional collateral at loan closing. This assignment ensures that the architect and contractor will complete the project for the lender's benefit if the borrower defaults under the loan.

The architect and construction contract should include the architect and contractor's consent to this collateral assignment and performance obligation. The contracts should also include a "catch-all" provision that obligates the architect and contractor to modify their contracts to conform to a lender's demands, and the borrower should have the right to terminate without cause or penalty if the lender does not approve the architect, the contractor or project.

Plans, Specifications and Budgets

Construction lenders usually enter the scene after a borrower has completed its plans and specifications and obtained the necessary governmental entitlements and approvals. As a result, a borrower's plans and specifications should ordinarily be approved as of the loan closing.

Lenders will not thereafter allow a borrower to modify the approved plans and specifications without the lender's approval, although borrowers can sometimes negotiate dollar or scope thresholds below which the lender's approval will not be required. A borrower must work closely with its architect and contractor to ensure that they do not run afoul of this requirement during the construction process.

Lenders require line-item project budgets from their borrowers, and insist that the borrowers adhere to those budgets. Borrowers should work with their architect and contractor to establish the various line-item costs, including a contingency for unforeseen circumstances. Borrowers can often negotiate the right to shift cost savings in one-line item to cover shortfalls in others. Construction loans also require a borrower to deposit additional funds with the lender at any time the lender determines that the sum of the remaining loan proceeds and the borrower contributed equity will not be sufficient to complete either a particular line item or the project as a whole. Shifting cost savings among line items can keep a project from being derailed by a borrower's unexpected obligation to inject additional capital into a deal.

Construction draws are interim advances of loan proceeds, and are normally made based on the percentage of the construction completed to that date. Lenders disburse loan funds based on applications for payment prepared and submitted by the contractor. Some lenders require their own form of payment application, whereas others will accept those published by, among others, the AIA. The construction contract should therefore require the contractor to submit payment applications on an AIA form or any other form required by the lender, and the architect should be obligated to review and certify that application to both the borrower and lender.

The borrower should consider whether it has sufficient capital to advance funds to its contractor as billed or if it needs to pay the contractor with loan proceeds as and when received. Lenders expect to disburse loan proceeds to reimburse a borrower for invoices which the borrower has already paid, but a borrower can often negotiate for disbursements in advance if it obtains proper lien releases from its contractor.

Lenders will also fund only a portion (e.g., 90 percent) of costs until the project is completed, so a borrower should seek to impose a corresponding retainage on its contractor. Lenders may also insist on the right to pay the borrower's contractor directly, but a borrower should fight this because its lender may elect to pay a contractor invoice that the borrower wants to dispute.

Schedule and Completion Date

The lender and borrower both want to complete the project quickly, so one would expect them to be on the same page regarding the construction schedule. However, their interests are not completely aligned because a borrower's failure to adhere to the approved schedule will constitute a default under the loan.

A borrower should seek to negotiate cushions in the schedule to avoid such a default. The borrower should also consider including penalty and bonus provisions in its construction contract to create incentives for the contractor to deliver the project on time.

Lender's Cost

Borrowers will have to pay all of the lender's costs and expenses in connection with the loan including attorneys' and consultants' fees, title fees and possibly even the costs of an independent construction consultant hired by the lender. Borrowers should attempt to negotiate ceilings on as many of these costs as possible, because lender-engaged third parties might otherwise see themselves as holding the borrower's blank check.

Failure to consider the complexities raised in a construction loan can turn what should be an exciting process into a procedural and financial nightmare. Unsuspecting borrowers could find themselves at the mercy of unscrupulous architects or contractors who are not contractually obligated to cooperate with the borrower's lender. As with all transactions, knowledge, planning and engaging experienced advisors will help make a borrower's project run more smoothly. ◆

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