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CONSTRUCTION LENDING
If you build it, they will come.*

(*Subject to approved financing.)

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I. Introduction

Field of Dreams is the story of a man whose faith built the ballpark in his dreams. Yet how did he get the funding for the sod, fencing, bleachers, lights, etc.? Construction financing, of course, though strangely Hollywood left out this—likely mesmerizing—part of the story.

Without money, there would be no construction projects. And construction lending is the process by which money to fund projects is generated. Lending for a construction project is very different than other traditional loans. Unlike the financing of an existing home or car, for example, the value of the collateral at the origination of the loan usually does not support the loan, because the revenue generating aspect of the property has yet to be constructed. How, then, do Lenders protect themselves when their ultimate security—the completed construction project—does not exist at the time of loan documentation? How much control should a lender demand and how much control is reasonable to demand? How are participants in the project other than the Owner affected by the loan? Which type of construction loan is best?

This paper explores the challenges and unique aspects of construction lending. It begins by discussing the players involved, types of financing, due diligence, and underwriting. It then spends significant time exploring the anatomy of a construction loan, including key provisions and major negotiating points, with the goal of equipping readers to recognize and address key construction lending issues.

II. The Players

As in most negotiations, the construction loan looks very different depending on a party’s point of view. Each participant has different goals and different leverage.

A. Lenders

The Lender’s principal concern is ensuring the project is completed on time and within budget. In a construction loan, the expectation is that the value of the collateral value will increase
with the loan balance, because the construction project and its value advance as loan proceeds are drawn and invested in the project; however, when a project is delayed or goes over budget, the loan proceeds may be drawn faster than the value is added to the project, causing the “loan-to-value” ratio (“LTV”) to become out of balance and potentially jeopardizing the Borrower’s ability to reap the revenue needed to pay off the debt incurred. Of course, the Lender’s first line of defense is to do business with the right Borrowers. Lenders must work to ensure that a Borrower has the knowledge, expertise, and resources to complete the project successfully and on time. Lenders must also get comfortable that Borrowers and/or Guarantors can financially support a project if something goes wrong.

Lenders naturally have significant leverage in negotiating the construction loan: they control the funds. Lenders must use that leverage wisely, seeking the right amount of protection without stifling the success of the project. Lenders seek several provisions in the loan documents to secure such protection. First, Lenders usually insist on obtaining and maintaining lien priority over other secured creditors, such as sureties and other lenders, and potential lienors, such as contractors and design professionals. Second, Lenders often require provisions that allow them to step in and complete the project if necessary. Third, Lenders expect certain levels of reporting and control over the construction project to protect the monies they are putting at risk. Lenders must be careful, however, as construction projects are often fast paced and time sensitive. So if Lender’s control restricts the Borrower’s ability to react to issues as they arise or drains Borrower’s project resources, it could be problematic for everyone.

Notwithstanding the generic references to Lenders up to this point, there are actually many different types of Lenders with varied approaches to lending, funding capacities and risk appetites. National banks, for example, are able to fund larger projects than smaller or regional banks, but may be more risk averse than their smaller brethren due to increased regulatory scrutiny. Regional banks,
on the other hand, may be less conservative depending on the bank, but usually have fewer resources. Regional banks have the advantage, however, of having an appreciation of local markets that national banks may lack. As opposed to traditional banks, preferred equity investors, also called “hard-money lenders,” have significant flexibility to take on higher risk loans and to deliver funds quicker than traditional lenders; however, such lenders usually demand higher rates of return resulting in expensive costs of capital. Finally, real estate joint ventures are another alternative to traditional bank loans in project finance. Joint ventures provide a means for individuals or organizations with the expertise needed to develop a project, but not the capital, and individuals or organizations with the capital, but not the expertise, to pool their respective resources in order to acquire or complete a project otherwise out of reach of each, while also sharing in the profits and costs of doing so.

B. Borrower (or Sponsor)

Like Lenders, Borrowers have several concerns when considering a construction loan. First, Borrowers’ focus is on the amount of, and ease of access to, loan proceeds. When a Borrower is looking to use loan proceeds to pay their contractors on time so as to keep the Project on schedule and free and clear of liens, time is often of the essence. As such, the conditions of funding are a principal concern of Borrowers when seeking a loan.

Second, to keep a project on schedule and on budget, Borrowers need to retain sufficient control and flexibility to be able to unilaterally adapt to changing circumstances. Borrowers are therefore concerned with the level of decision making control Lenders will assume as a condition of the Loan. For example, if the nature of the project is expected to involve factors such as frequent change orders, multiple prime contracts, numerous agreements and permitting efforts involving local authorities, having to seek the Lender’s approval in each instance not only drains a Borrower’s
resources from the project but also risks delaying the project while Borrower attempts to comply with rigorous approval requirements and then waits for approval.

Third, in addition to project related concerns, Borrowers must also consider the costs and risks assumed under the loan compared to the benefits. For example, whether the loan is recourse or non-recourse, whether or not the repayment schedule is feasible and compatible with Borrower’s cash flow projections, whether or not the funding schedule, interest rate and origination fees negate the benefits Borrower is looking to achieve with the loan.

Finally, separate from the project related concerns, Borrowers are often concerned with the contribution of equity they are required to make in a Project. The less equity Borrowers have to provide, the less cash Borrowers may have to take from and put at risk from its own pockets and those of its investors. In many cases, loans from a lender may be less costly than Borrowers equity due to the rate of return owed on capital contributions. Further, the less cash invested in the project, the more cash they may have available for unfunded aspects of the project, to address unforeseen issues and overhead and general operational expenses.

Unfortunately for Borrowers, due to the unavoidable need for cash to fund construction, Borrowers’ leverage in negotiations is typically limited. Borrower can gain some leverage, however, through soliciting financing options from competing lenders wherever possible. Borrowers may also gain leverage from the ongoing relationship Borrower can offer to a Lender. If a Borrower or its project manager has more than one project or multiple phases that might need financing, one loan may lead to future business for a Lender. Borrowers can also improve their position by alleviating Lenders’ concerns and risk profile. As noted above, Lenders should look to do business with the right Borrowers. Borrowers can therefore attempt to negotiate certain matters by highlighting past successes of both Borrower and its project team, whether on the project in question or on others, so that Lenders further view the specific loan in front of them as part of a larger fruitful business
relationship and not a one-off transaction. Finally, Borrowers can increase negotiating leverage by reducing the risk a Lender will assume in the transaction. For example, Borrower can decrease the LTV by offering more collateral so that the Lender knows that if it had to foreclose, Lender would be able to recover its costs in a sale of the property. Alternatively, Borrower can offer the Lender a portion of project proceeds, such as sales proceeds if available, to apply to the outstanding loan balance in advance of and as a supplement to mandatory prepayments or agree to escrow the total anticipated interest on the loan to give Lender additional security that the debt and interest will be repaid.

In sum, Borrowers seek to obtain money they need at the lowest cost while maintaining sufficient control to keep their operations and construction on time and on budget.

C. Equity Funders

Equity Funders want to protect their investment. Thus like Lenders, Equity Funders are also concerned with ensuring the project stays on time and within budget. However, in addition, Equity Funders also want the ability to take over management or ownership of the Borrower/Sponsor in the event the Project or operator is not meeting expectations or in the event of a potential default under a loan and to step into the Borrower’s relationship with the Lender without disruption of the Project. They will also be concerned with receiving their returns timely and without disruption. As such, Equity Funders will pay particular attention to terms in the Loan Documents, limiting or allowing Lender to control or prevent transfers of Borrower/Sponsor assets, Change of Control, distributions, replacement of guarantors and the like. Equity Funders, depending on the mechanism for or terms of their funding obligations, may also pay attention to the cost of the debt under the loan compared to the cost of equity contributions. Similarly, they may be concerned with terms of a loan that require equity advances as a condition of funding, the timing of loan funding, where the
intent of the loan is to avoid additional input or spend of additional equity, or the escrow of costs to complete during the term of the loan that would require input of additional equity.

D. General Contractors, Subcontractors, and Design Professionals

Unsurprisingly, General Contractors, Subcontractors, and Design Professionals want to be paid. And paid promptly. To ensure payment, they will be concerned with the terms of any subordination of lien rights required of them by their client’s Lenders. In addition, they will want to limit any liability they may have to assume as a result of a project financing, including liability to Lenders. Further, these parties will also want to preserve offsets and defenses vis-à-vis the Borrower/Owner against the Lender. In other words, when facing claims brought by the Lender, contractors and design professionals want to be able to offset those claims with costs incurred by the contractors and design professionals caused by the Borrower/Owner. Finally, these parties will want to limit any other obligations to the Lender. For example, they will want to understand the approval process for change orders and modifications to plans and specifications as well as avoid direct obligations to Lender with respect to the same, for they feel that it is the Borrower who has the relationship with the Lender and therefore, it is the Borrower’s responsibility to comply with the requirements of the Lender, not theirs.

E. Counsel

Given the importance of project financing terms to the success of the project and operations of all the players involved, Borrower’s internal counsel will often engage outside counsel specializing in project financing transactions, to tap into their subject matter expertise and additional resources. In such cases, internal counsel will usually focus (but not limit) their efforts on business terms, project specific information, representations and warranties, and implications on corporate governance and project administration, to limit the burdens and conflicts project financing may generate for the Borrower/Sponsor, the project as a whole, and other pertinent players such as joint
venture members, contracts and design professionals, and pre-existing providers of capital. In addition, internal counsel will concentrate efforts on due diligence and compliance with certain corporate governance requirements, such as obtaining written consents of joint venturers, ensuring proper authorizations are granted to signatories, and involving investors and seeking their approvals as may be required pursuant to the relationships therewith and as otherwise required under operating agreements and other governing documents.

Meanwhile, internal counsel will often rely on the outside counsel to focus on the more general and overarching terms of the loan document and the transaction. For example, where Borrowers have little leverage, loan negotiations often require Borrowers to pick and choose their battles carefully. To do so, internal counsel may look to outside counsel to advise as to where to fight and where to concede based on what they have seen in the market and locality given their more concentrated experience in the field. In addition, where internal legal departments may often be smaller, with resources stretched thin across multiple projects and in-house functions, internal counsel may rely on outside counsel to collect general concerns and themes voiced with respect to the transaction and to incorporate them across the loan documents and related negotiations. External counsel therefore must be able to step back and view the transaction as a whole and focus on understanding the client’s operations, organization, and particular needs, as well as the current state of the Project. External counsel must then ensure that the loan documents conform to those needs and the parties’ agreement. In doing so, external counsel provides insight on what terms are market in the industry and locality, what risks may be real versus theoretical and which risks are more dangerous to Borrower. In addition, outside counsel can leverage its resources and expertise in the field and locality, such as pre-existing relationship with Lender counsel and title companies to facilitate smoother and more expedient negotiations and timely closings.
III. Types of Financing

Construction loans come in a variety of different forms.

A. Construction-to-Permanent

If there is a “classic” approach to construction lending, it may be the construction-to-permanent loan. A traditional model is a construction loan that is “taken out” by permanent financing once the project is complete. The construction loan usually has a higher interest rate given the increased risk involved with lending when the collateral has not been built. Parties can combine the construction and permanent into a construction-to-permanent loan, which acts as two loans in one. The Borrower borrows the money to fund the construction project, which the bank (or perhaps a different take-out lender) then converts into a permanent loan after construction is complete. Interest is usually accrued during the construction phase and then added to the permanent loan. Lenders will be more comfortable with this approach if projects (or portions thereof) are prepaid or pre-leased to assure that revenue will be generated after substantial completion sufficient to service the permanent loan debt.

B. Mini-Perm

If the future net operating income to be generated by a project is less certain, such as with speculative building or where or the Borrower has a limited track record, Lenders may be unwilling to commit to traditional permanent financing. The Borrower will need the chance to generate occupancy to produce stabilized rental revenue before a Lender becomes comfortable with underwriting a permanent loan.

The solution may be the “mini-perm,” short for mini-permanent financing. To fill the gap and afford a Borrower time to generate stabilized occupancy and revenues, the parties may enter into a min-perm that a Borrower uses to refinance the construction costs until the net operating income of the property has been stabilized. A typical term is three to five years. The mini-perm loan
would be used to pay off the construction loan or construction expenses and give the property time to develop a sufficient history for it to qualify for permanent financing.

C. Second-Lien Financing

Second-lien financing is rarer than the previously mentioned types of financing, but growing in popularity. Primary lenders often require a Borrower to maintain a certain amount of equity in the project, lending only up to a certain percentage (65% to 80%, typically) of the property’s value. Second liens offer a Borrower more leverage by offering financing junior to the primary loan. A second-lien is a much riskier endeavor to a Lender, however, usually resulting in higher costs of capital and a shorter repayment schedule than a traditional permanent loan. Second liens will require the approval of the senior lender and the second lien lenders will want to match the covenants and conditions of the senior financing documents. The senior and second lien lenders will most likely enter into an inter-creditor agreement to govern the interrelationship of their respective rights.

D. Equity-Related Financing: Mezzanine Financing and Preferred Equity Investors

Like second liens, mezzanine financing and preferred equity investors are methods to secure additional leverage beyond a primary loan. Unlike traditional loans, mezzanine financing is not secured by the property but instead secured by an ownership percentage in the Borrower. If a Borrower defaults, a mezzanine Lender likely will exercise its ownership rights and may take control of the project. Because the Borrower/Sponsor may lose control of the project, however, primary Lenders may be skeptical of mezzanine financing given its potential impact on the continuity of the project and the lender’s relationship with its customer. Assuming mezzanine lending is approved by the senior Lender, senior and mezzanine lenders will also typically enter into an inter-creditor agreement to govern their respective rights.

Preferred equity is an alternative to mezzanine financing with several advantages. Preferred investors get an enhanced rate of return and the right to accelerate repayment and potentially take
over control of the Borrower on a specified maturity date. Unlike mezzanine financing, preferred equity funding typically does not trigger the need for any inter-creditor agreements. Preferred equity investors typically dilute, but do not foreclose on, the Borrower’s equity. While preferred equity will be subordinate to debt in an insolvency proceeding, the remedies of the preferred equity holders will not be delayed by automatic stay in a bankruptcy proceeding involving the Borrower.

E. Joint Venture Arrangements

Joint venture arrangements are project-specific structures that create a project vehicle entity that has access to the resources of each venture partner. This spreads the risks and rewards among the members in proportion to the members’ interests. This allows for better utilization of expertise, talent, capital, and resources, and may enable the members to take on projects that would otherwise be out of reach. Joint venture arrangements typically involve capital members responsible for greater contribution of equity and operating members that contribute the talent and expertise and, in most cases, less equity. Project financing terms such as equity contributions, re-payments, returns and profit distributions are then be built into the joint venture operating agreements. Similar to the other lending relationships discussed herein, where the equity contributions are uneven, those member or members contributing the majority of the equity will typically be concerned with ensuring sufficient control of the project, just as lenders would, while the operating member that is responsible for the day-to-day operations and management of the project will be concerned with having the flexibility to make decisions expediently and efficiently and with minimizing administrative burdens on its activities. Where Members lack foreclosure rights, alternative remedies—such as rights to oust the operating-member or a development manager affiliated with such member for failure to perform, to force a sale of the project, to trigger a buy/sell procedure, or transfer interests in the Borrower—will be negotiated by the parties and outlined in the joint venture agreement.
F. Municipal Development Incentives

The availability of public financing incentives to private development varies greatly by jurisdiction. A large array of public financing structures are potentially available, including economic incentive grants (which may be conditioned on the achievement of defined metrics such as persons employed, taxes generated, etc.); “soft loans” (i.e., loans which are deeply subordinated and may be forgiven over time); tax abatements, credits, or refunds; infrastructure cost support; waiver of construction or development fees; and municipal leases of portions of the project. These can be important sources of augmenting the return profile and/or mitigating the risk to the private capital providers, but will rarely if ever obviate the need for private financing. Each supplier of private capital will need to obtain the appropriate agreements with the public incentive providers to define the relative rights of the private and public sector participants.

G. Due Diligence & Underwriting

Due diligence for construction lending is often more extensive than for other types of loans due to increased risks. It involves analyzing information about collateral that does not yet exist. Lenders want to know that the Borrower, contractors, and design professionals have the skill and experience to manage and support the project. Lenders will explore the feasibility of the project, including reviewing project plans, budgets, project schedules, utilities, environmental issues, and permits and approvals, to name a few and its environment, including demographics, infrastructure, transportation and regional market and industry trends. Lenders will also want to confirm that the Borrower and guarantors can financially support any shortfall or continuation of the project if it costs more and/or takes longer than anticipated. So Lenders will examine financial statements, tax returns, and other sources of liability, along with equity and other sources of funds.

It is worth noting that there are different considerations involved when exploring financing for vertical versus horizontal projects. Office buildings and other vertical projects are concerned
with pre-leasing in order to forecast a future revenue stream. In contrast, horizontal projects are looking for commitments to purchase permit-ready lots as they become available. In other words, the revenue streams and timing of revenue generation are different. Horizontal construction also involves other considerations that differ from vertical, including utility availability, different contractors for different phases of the development, public infrastructure issues, etc.

To underwrite construction loans, Lenders will look at several factors to address some of the due diligence items outlined above, including net operating income, loan-to-value ratio, loan-to-cost ratio, and debt service coverage ratio. Net operating income will focus on future revenue, and lenders may impose pre-leasing requirements (vertical) or pre-development purchase commitments (horizontal). Loan-to-value ratios again involve the ratio of funds lent to the value of the project, which is again a challenge because the project to be constructed does not yet exist. Loan-to-cost ratios are an additional tool where the Lender will evaluate whether the Borrower or guarantors can meet any shortfall. Finally, debt service coverage ratio is concerned with providing adequate confidence that the revenues from a project can service both all necessary project and operating costs and the costs of the debt service.

IV. Loan Negotiation & Documentation

A. Key Documents

The documents required for a construction loan will vary to some extent depending on the loan structure and the unique circumstances of the project, including the project delivery system. The project delivery system is the contractual approach used in the planning, design, management and construction of a project and can include “design-bid-build,” in which Borrower contracts with the architect and with the general contractor separately and the design is completed before being sent out for bid; “construction-manager-at-risk” or “CMAR,” in which Borrower contracts with the construction manager to provide pre-construction services in conjunction with the design and then
serve as the general contractor; or “design-build,” in which Borrower contracts with one party for the design and construction of the project.

1. Promissory Note

The promissory note sets forth the basic payment terms such as the loan amount, interest rate, and payments to be made during the loan. Construction loans are typically interest-only, and most traditional lenders charge an interest rate that is indexed to a floating prime rate that adjusts daily. Often, however, the Borrower is able to hedge its interest rate risk by entering into a swap agreement with the lender or another eligible counterparty. Interest may be considered a soft cost that is built into the loan amount and paid out of loan advances. If the loan is a mini-perm loan, there will usually be a “conversion date” at the scheduled completion of construction, at which point the loan converts from the construction phase to the permanent phase (conditioned upon certain requirements set forth either in the promissory note or the construction loan agreement). However, if such conditions are not met at the conversion date, the loan becomes due in full. Additionally, the promissory note will typically contain any prepayment penalties for prepayments of principal, late charges for delinquent payments, payment by the borrower of attorneys’ fees and other collection costs, and the default rate of interest (usually 6% - 8% above the normal interest rate, or the highest rate allowed by law) applicable after a default occurs under the loan documents.

2. Construction Loan Agreement

Unlike a permanent term loan in which all of the loan proceeds are advanced at closing, a construction loan is funded in a series of advances or draws as construction progresses. Therefore, the Construction Loan Agreement is in many ways the “backbone” of the loan documents because it sets forth, among other things, the procedures and requirements for each advance, including the initial advance, the anticipated timeline of construction and deadlines for completion of certain milestones, and parameters with regard to the project budget and loan-to-value ratios. In short, it
sets out how the loan is administered. The section below examines in further detail some typical provisions found in a construction loan agreement.

3. **Deed of Trust or Mortgage**

A traditional lender will almost always take a lien on Borrower’s interest in the ‘dirt,’ whether fee simple (if Borrower owns the land outright) or leasehold interest (if Borrower leases the land under a ground lease). The type of security instrument—i.e., deed of trust, mortgage, or deed to secure debt—and the availability of remedies thereunder will of course depend on the law of the state where the property is located. When available, Lenders almost always prefer a non-judicial foreclosure or sale due to the convenience and comparatively lower costs, and the security instrument will grant Lender these rights and will usually require Borrower to waive any appraisal or redemption rights to the extent permitted by state law. The security instrument will often include an assignment of rents and leases to the extent applicable.

Typically, the security instrument will also set forth Borrower’s covenants, representations, and warranties with regard to the property, including maintenance, types and amounts of insurance, payment of taxes, environmental conditions, and Lender’s lien priority. Borrower’s counsel should ensure that the provisions of the security instrument do not conflict with the other loan documents, particularly because the security instrument usually sets forth certain events of default and Lender’s accompanying remedies, in addition to (and often encompassing) those set forth in the loan agreement. The priority of the security instrument is of paramount importance to Lender, and Lender will want evidence of its lien priority throughout the loan administration process, often by requiring lien waivers or title status certificates. However, these requirements are often set out in the loan agreement, rather than the security instrument.
4. Guaranties

Lenders may require one or more types of guaranties. One type of guaranty unique to construction loans is the completion guaranty, which guarantees that the construction project will be completed lien-free and within the time periods established under the loan documents. If Borrower fails to complete the project, Lender usually has the option of either (i) requiring the guarantor to step in and take over construction, or (ii) taking over construction at the guarantor’s expense. The guarantor should confirm that they are only required to complete construction if Lender funds the remaining loan proceeds, but Lender will often only agree to fund the remaining proceeds if the loan is brought back into balance and there are no other defaults under the loan documents. Generally, the completion guaranty automatically expires upon completion of construction (typically defined in the loan documents and tied to the issuance of a final certificate of occupancy).

Lender may also require a repayment guaranty, sometimes in addition to a completion guaranty. A repayment guaranty may be full recourse or limited recourse, although full recourse guaranties are more common in construction loans than other types of loans. In a full recourse guaranty, the guarantor is personally liable for repayment of the full amount of the loan. A limited recourse guaranty (also called a “bad boy” guaranty) is one in which the guarantor is liable for losses incurred by Lender due to the Borrower’s failure to properly maintain the property or to apply property net operating income to debt service (and perhaps a specified percentage of the principal and interest in addition (a “top guaranty”)), or in some cases, the entire amount of the loan if particularly egregious events occur (“springing full recourse”).

5. Assignment of Construction Contract and Design Documents

Completion of the project requires the cooperation and efforts of third-party design and construction professionals, and Lender wants to be sure that it has the requisite assignments and agreements in place to permit it to step in and complete the project as planned, if necessary. Thus,
depending on the project delivery system, Borrower will most be required to assign its rights in and to any contract with the architect, the plans and specifications prepared by the architect, and the construction contract. Lender will also require that the architect, contractor, and other construction professionals in privity with Borrower sign consents acknowledging such assignments and agreeing to perform under their respective contracts and transfer any necessary intellectual property rights if Lender takes over construction. Lender may also require other related provisions in such consents, such as the subordination of any liens of the design or construction professionals, agreement to give Lender copies of any notices provided to Borrower, and agreement not to perform work under any change orders without Lender's prior written consent. There may be additional assignments and consents required depending on the circumstances of the project—i.e., if there is a property management agreement in place, or if Borrower has engaged a project manager to act as its representative with respect to construction.

6. **Environmental Indemnity Agreement**

Lender may require an environmental indemnity agreement to be signed by Borrower or a guarantor, in which such party makes certain representations and warranties with respect to existing environmental conditions on the property, agrees that all activities at the property will comply with environmental law, and indemnifies Lender against liability arising from any environmental matters associated with the property. The primary reason that the environmental indemnity is contained in a separate agreement is that often the parties will negotiate as to the scope of the representations and warranties made, the breadth of the liabilities indemnified, and the time period covered by the agreement. Lender may require an escrow account, reserve amount, letter of credit, or other arrangement to have some level of assurance that Borrower or the guarantor has the financial resources to pay for environmental claims if they occur.
B. Key Provisions in Construction Loan Agreement

As mentioned above, the construction loan agreement often contains the most salient loan terms and is often the subject of the most intense negotiation. This section examines examples of several key provisions one would expect to find in a standard construction loan agreement, considers such provisions from the perspective of both Borrower and Lender, and, in some instances, features suggested modifications that each party might want to consider.

1. Budget

It is easy to see why the budget is one of the most heavily negotiated terms in a construction loan. The loan budget will represent a subset of the overall project budget which allocates all sources of funds from both loan and equity sources to uses for various aspects of the project. The lender will typically require that all equity funds be expended before loan funds are advanced. However, in some instances, a Borrower may be able to negotiate a pro rata application of equity and debt funds, at least after certain initial costs such as land acquisition are funded out of equity. The budget allocates proceeds of the loan to “line items” for specific trade categories of materials and labor that will be required to complete the project. These will, in turn, be divided into “hard costs,” i.e. costs of the type paid to a general contractor under a standard construction contract and “soft cost,” i.e. other costs such as land acquisition, loan fees, interim interest, design fees and development and project management fees. The developer/sponsor will normally be entitled to monthly development fees out of the loan budget in specified monthly amounts over a term of months as an aspect of the soft cost. For the Borrower, the budget limits the amount of flexibility the Borrower has to respond to unexpected costs associated with a particular line item in the budget. For the Lender, the budget should, ideally, match the outstanding loan balance against the progress of the Work to control the Lender’s risk at various stages of the construction. It is in the interest of each party to make the budget as accurate as possible, but the dichotomy between the Borrower’s need for flexibility and
the Lender’s desire for certainty throughout construction leads to a highly contentious debate about what the “accurate” budget looks like. Additionally, the parties should take precautions to ensure the budget approved by Lender comports with the budget set out in the construction agreement with the general contractor.

Below is an example of one provision concerning the budget that is usually included in a typical loan agreement:

Lender reserves the right to make Advances which are allocated to any of the designated items in the Approved Budget for such other purposes or in such different proportions as Lender may, in its sole discretion, deem necessary or advisable. Borrower may not reallocate items of cost or change the Approved Budget without the prior written consent of Lender. Advances against the contingency line item on the Approved Budget shall be made only for such purposes as Lender may hereafter approve.

Although this is a standard provision in any construction loan agreement, it presents issues for Borrower. The first sentence grants Lender sole discretion to advance funds in different proportions and for different purposes than has been designated in the approved budget. The Borrower is unlikely to be successful in negotiating this provision because Lender will likely insist on retaining control over the funds it is advancing.

The second sentence prohibits Borrower from reallocating items of cost without the Lender’s consent. This is problematic for the Borrower, who generally wants to apply all savings to cost overruns or other line items of the project. Despite the heavy negotiations of the budget, the Lender assumes the budget is inadequate and expects the project to go “over-budget” eventually. A loan agreement that provides for the liberal reallocation of savings to cost overruns does little to encourage strict adherence to the budget. The Lender, concerned with future overruns, does not want the Borrower or the contractor getting too comfortable with current savings, and limiting the amount of the budget that may be reallocated during the project helps keep costs on track and may even encourage additional savings. In the spirit of compromise, however, it is not uncommon for
Lenders to agree to allow between 5% and 10% of the budget to be reallocated without Lender’s consent.

In addition to reallocation, the contingency allowances are a heavily negotiated portion of the construction loan budget. For the Lender, the contingency line item is a security blanket to cover the unknown costs that lie in wait of the project. For the Borrower, the contingency is a pool of unusable resources – money tied up for nothing, bringing little to no value to the project. As illustrated in the example provision above, the Lender wants absolute control over the contingency reserves. As the project continues, however, the Borrower will argue that at least part of the contingency is excessive and should be available to cover overruns. A fair position here is for pro rata application of the contingency funds upon completion of key stages or milestones of the construction project. For example, the Lender may agree to reallocate 50% of the contingency funds upon completion of 50% of the project.

Due to the fact that full cost engineering will in most cases delay the competitive start of a project, Borrowers will want to utilize allowances and/or unit costs for many line items of the budget or to allocate amounts to budget line items based on estimated rather than firm subcontractor bids. This greatly increases the risk of cost overruns to the construction lenders and, as part of the initial advance requirements, astute lenders will require that a high percentage of the loan budget be backed up with firm bids.

2. Change Orders

A typical loan agreement will usually contain a provision similar to the following:

Borrower shall deliver to Lender revised, sworn statements of estimated costs of the Project, showing any requested changes in or variations from the original Approved Budget, as soon as such need for any such changes is known to the Borrower. Any such changes shall be subject to the approval of Lender, in Lender’s sole discretion and Borrower shall not consent or agree to any change in the Plans, the Construction Contract, or the Project without the prior written consent of Lender.
As already discussed, the Borrower needs flexibility to react to unknown and unforeseeable issues and to respond to changes in applicable laws or regulatory regimes, the economic environment, tenant requirements, or its own business goals and demands. For these reasons, the Borrower wants freedom to revise the approved plans and specifications or to modify the scope or the work required. The Lender, on the other hand, wants certainty, and after the deal is struck and its risk assessment of the project is complete; the Lender wants zero surprises. For this reason, the Lender wants to minimize the changes that may be made to the construction work and the project without its approval. To accommodate the simple fact that the Borrower cannot know what unexpected forces will require such changes, the Lender will agree that some changes will be allowed but only if the Borrower can deliver sufficient evidence to the Lender that the changes do not increase the lender’s risk profile. Some lenders will even agree, on the front end, to waive these approval requirements with respect to certain changes that do not exceed a certain dollar threshold, provided that the cumulative effective of such changes, in the aggregate, do not exceed a certain dollar value. This front-end waiver gives even more freedom and flexibility to the Borrower and, to some extent, may also serve as a benefit to the Lender who may not want to hold up construction for minor changes or get bogged-down with excessive paperwork. As a general matter, the Lender will often require that the architect and the general contractor agree that no change order shall be effective until the Borrower has obtained the Lender’s prior written consent.

3. Insurance

Another key area of dispute in the negotiation of the terms of any construction loan is insurance. There are two big sub-issues under the insurance umbrella. The first sub-issue is the practical elements of the insurance required to be maintained by Borrower, its contractors, and Borrower’s affiliates and guarantors, including the types and amounts of policies to be obtained and maintained, the agency ratings of the insurers, the notice requirements with respect to cancellation,
and deductible amounts. “Builder’s risk insurance” is a specialized line of insurance designed to cover the risk of loss to partially completed construction projects. With highly qualified Borrowers, the issue of self-insurance can even arise. Lender wants to make sure that the insurance carrier is reputable and will pay any and all claims quickly and in-full. While a Borrower shares these concerns, Borrowers are also wary of the impact insurance premiums will have on their cash flows. Flood insurance, for example, can be very expensive for a risk the Borrower may perceive as relatively low. However, these practical issues are usually resolved quickly and to the general satisfaction of both parties. An example of a general insurance provision is as follows:

Each of Borrower and Parent shall keep its insurable properties adequately insured at all times by financially sound and reputable insurers; maintain such other insurance, to such extent and against such risks, including fire and other risks insured against by extended coverage, as is customary with companies in the same or similar businesses operating in the same or similar locations, including public liability insurance against claims for personal injury or death or property damage occurring upon, in, about or in connection with the use of any properties owned, occupied or controlled by it; and maintain such other insurance as may be required by law. Each of Borrower and Parent shall cause all such policies to be endorsed or otherwise amended to include a "standard" lender's loss payable endorsement, in form and substance reasonably satisfactory to Lender, which endorsement shall provide that, from and after the Closing Date, if the insurance carrier shall have received written notice from Lender of the occurrence of an Event of Default, the insurance carrier shall pay all proceeds otherwise payable to any Loan Party under such policies directly to Lender; cause all such policies to provide that neither any Loan Party, Lender, nor any other party shall be a coinsurer thereunder and to contain a "Replacement Cost Endorsement" without any deduction for depreciation, and such other provisions as Lender may require from time to time to protect its interest; deliver original or certified copies (or certificates evidencing the same) of all such policies to Lender; cause each such policy to provide that it shall not be canceled, modified or not renewed (a) by reason of nonpayment of premium upon less than 10 days' prior written notice thereof by the insurer to Lender giving Lender the right to cure defaults in the payment of premiums, or (b) for any other reason upon less than 30 days' prior written notice thereof by the insurer to Lender; deliver to Lender, prior to the cancellation, modification or nonrenewal of any such policy of insurance, a copy of a renewal or replacement policy (or other
evidence of renewal of a policy previously delivered to Lender). Further, Borrower shall cause the General Contractor to maintain such insurance to such extent and against such risks as is customary with companies in the same or similar businesses operating in the same or similar locations, including public liability insurance against claims for personal injury or death or property damage occurring upon, in, about or in connection with the Project, as may be required by Lender, and to furnish evidence of same to Lender.

The second sub-issue relating to insurance is the issue of how insurance proceeds are applied after an insured claim is made. After a loss or casualty, the Borrower’s first priority is to repair and restore the project and keep pushing the project forward to completion. Further, losses and delays associated with a casualty generally cause a construction loan to fall out of balance (i.e. the remaining unpaid costs of the Project exceed the loan proceeds not yet advanced by Lender). This can constitute a default under the construction loan agreement and trigger guarantor obligations. So application of the insurance proceeds to repair and restore the project (and the loan to value ratio) is crucial to the Borrower. In an attempt to avoid throwing good money after bad, the Lender, however, will always want the option to apply the insurance proceeds to the outstanding balance of the loan and walk away from the project relatively unscathed. However, even though lenders often require this as a term of the loan (which may be found in the construction loan agreement or the applicable security instrument), there is a significant chance that the Lender, in the name of customer relations, will not exercise this option and will instead allow the proceeds to be used to restore and repair the damage.

4. Retainage

A typical retainage provision may contain the following language:

With respect to the portion of each Advance that is to be used to pay costs of development or of construction of the Improvements Lender may, at its election, retain (a) all amounts permitted to be retained by owner under the terms of the Construction Contract less amounts to be funded by the Development Incentives, plus (b) the amount or amounts necessary to pay any claims of persons who may have sent notices thereof to Borrower in accordance with [Sections
Retainage is often the subject of statute, as the law attempts to protect subcontractors from nonpayment. In effort to secure its collateral and protect the priority of its lien, the Lender will require that some designated portion of each advance is withheld as retainage to ensure all subcontractors are timely paid for their work so that no materialman’s or mechanic’s liens may be properly recorded against the project. In a strange twist, the Borrower’s interest often aligns with the Lender’s on this issue, and the general contractor is usually the party who creates conflict with respect to retainage because the money held in retainage can create cash flow problems for the contractor. To address this fact, the lender will often include a provision requiring the construction contract to provide for the Lender’s preferred retainage amounts. An example of this language is set forth below:

All construction contracts shall also provide that no change orders shall be effective without the prior written approval of Lender and shall provide for sufficient retainage to protect the Project against mechanics’ and materialmen’s liens.

Although the Borrower is also interested in maintaining the priority of the Lender’s lien over the project and avoiding the filing of mechanic's and materialman’s liens, this provision can be problematic for the Borrower if the construction contract is negotiated and executed before the loan agreement and does not provide for sufficient retainage. In that case, the Borrower will have to contribute cash for retainage with each disbursement of loan proceeds. It is not difficult to understand why this may be incredibly difficult for most Borrowers to accomplish.

5. **Timing of Payments**

Whenever Borrower desires to obtain an Advance of Loan proceeds for the portion of the Approved Budget allocated to the Construction Contract, Borrower shall submit to the Inspecting Architect (unless and until Lender notifies Borrower otherwise) and/to Lender such documentation as Inspecting Architect shall request with respect to such Advance, at least ten (10) days prior to
the date on which the requested Advance is to be made (“Advance Date”).

This is a typical example of the provision in the construction loan agreement dictating when disbursements of the loan proceeds will be advanced to the Borrower. This provision can be very important to the Borrower (and his general contractor) and is often the subject of at least some debate. In the Borrower’s ideal world, the Lender would make disbursements like an ATM machine – immediately, upon demand. As the Borrower completes each stage of the construction, it wants to quickly advance to the next stage, without spending a lot of time waiting for the Lender to fund.

The Lender, however, wants to make sure that amounts previously disbursed have been spent appropriately and new disbursements are going towards new portions of the construction project. The Lender does not want to unknowingly disburse a second round of funds for a single line item that should have already been completed. To address these concerns, the Lender will often require the project’s architect to provide certificates to the Lender confirming prior line items of work have been completed and prior disbursements have, in fact, been used for materials that have been utilized or delivered to the Project. After receiving such certificates, the Lender will need time to review and process the disbursement request. For the Borrower, who is eager to move forward with the project, each day of this review process may seem like an eternity. In addition to its eagerness to advance the project, the Borrower may be facing payment deadlines, and a significant delay of disbursement of loan proceeds by the Lender may cause the Borrower to miss these deadlines, which – depending on the type of payment missed – could trigger an event of default under the loan documents.

A good compromise position is to make the immediate disbursement of loan proceeds available for certain expenses (e.g. payment of insurance premiums) with limited or no documentation required. This position helps avoid the payment defaults described above, but allows
the Lender time to review the architect’s certificates prior to advancing additional funds. Below is a good example of this compromise position:

The provisions of this Agreement requiring submission of the documentation described in above and the required retainage specified by this Agreement shall not apply with respect to Loan proceeds to be disbursed for the items listed below, which may be disbursed in full upon submission of a Disbursement Request listing such items signed by Borrower or, upon default, by Lender, and/or the following special documentation, if any:

<table>
<thead>
<tr>
<th>Item</th>
<th>Special Documentation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lender charges (interest, fees, etc.)</td>
<td>Lender invoice</td>
</tr>
<tr>
<td>Attorneys’ fees (including Lender’s counsel)</td>
<td>Copy of statement</td>
</tr>
<tr>
<td>and Inspecting Architect’s fees</td>
<td></td>
</tr>
<tr>
<td>Real estate taxes on the Project and Land</td>
<td>Copy of bill</td>
</tr>
<tr>
<td>Insurance premiums</td>
<td>Copy of statement</td>
</tr>
<tr>
<td>Soft Costs and other indirect (non-construction) items</td>
<td>Copies of invoices or as specified by Lender</td>
</tr>
<tr>
<td>FF&amp;E</td>
<td>Copies of invoices</td>
</tr>
</tbody>
</table>

Such a provision, however, may not address all of Borrower’s concerns concerning to the timing of payments of regular draws, which could also have a negative impact on the Borrower as well as the Lender. Specifically, loan documents often contain significant conditions of advance that need to be satisfied to receive draw payments. Where the Borrower relies on draws to pay contractors, such conditions may be time consuming—and in some cases difficult if not impossible to meet. If conditions on draw payments slow down payments to contractors, the Project may be exposed to lien risk or work interruptions. These may not only cause the Borrower to default, but are also detrimental to the progress of the Project as well as the Lender’s corresponding interest. Accordingly, Lenders and Borrowers should also seek additional compromises as to the conditions of advance based on the circumstances and needs of each project.
6. **Lender’s Control of the Project**

Like the budget, the degree of Lender’s control over the project is an objectively obvious area of contention during negotiations of the construction loan agreement. To the Borrower, the Lender is a resource for money and its role should be limited to such as the business of construction is best left to the construction experts: the architect, the general contractor, and the Borrower. The Lender, however, bears the lion’s share of the risk of loss on the front end of any project. To mitigate this risk, the Lender wants to have a voice in the direction of the project because the other involved parties may not consider the Lender’s exposure when making crucial project decisions.

There are several ways in which a Lender may exercise control over a construction loan, one of which is by requiring the Borrower to deliver satisfactory documentation and reporting of the construction progress prior to the disbursement of loan proceeds, as discussed in Section 5 above. As previously discussed, the Borrower does not want to spend much time on paperwork, but the Lender can control the progress of the project by refusing to advance money until certain milestones have been achieved and satisfactorily documented.

The Lender can exert significant control over the project through the negative covenants made by Borrower in the construction loan agreement. The negative covenants of the loan agreement limit what the Borrower can do with, among other things, its business, money, and property during the term of the Loan. Below are some of the typical negative covenants that a lender may require in a construction loan agreement:

**Negative Pledge.** Borrower shall not grant, suffer or permit any contractual or noncontractual lien on or security interest in the Project, or any of its other assets, its assets, except for Permitted Liens. Parent shall not grant, suffer or permit any contractual or noncontractual lien on or security interest in any of its assets, except for Permitted Liens.

**Merger, Etc.** Neither Borrower nor Parent shall enter into any merger or consolidation.
**Extensions of Credit.** Neither Borrower nor Parent shall make any loan or advance to any individual, partnership, corporation or other entity without consent of Lender, except (a) loans and intercompany adjustments between Parent and Borrower and their respective subsidiaries occurring in the ordinary course of business, and (b) advances made to employees of Borrower and Parent for the payment by them of items for which an expense report or voucher will be filed and which items will constitute ordinary and necessary business expenses of Borrower and Parent.

**Borrowings.** Neither Borrower nor Parent shall not create, incur, assume or become liable in any manner for any indebtedness (for borrowed money, deferred payment for the purchase of assets, lease payments, as surety or guarantor for the debt for another, or otherwise) other than to Lender, except for (a) normal trade debts incurred in the ordinary course of their respective business; (b) existing indebtedness disclosed to Lender in writing and acknowledged by Lender prior to the date of this Agreement; (c) leases of personal property which are not "capital leases" under GAAP and for which the lessor's remedy for a breach by the lessee thereunder is limited to recovery of the item leased; (d) net liabilities under Swap Agreements permitted hereunder (valued at the termination value thereof, computed in accordance with the method agreed to by the parties in the applicable Swap Agreement); and (e) indebtedness secured by purchase money security interests permitted by this Agreement which is included in the Budget.

**Transfer of Assets.** Neither Borrower nor Parent shall convey, assign, transfer, sell, lease or otherwise dispose of, in one transaction or a series of transactions (or agree to do any of the foregoing at any future time), all or substantially all or a substantial part of its properties or assets (whether now owned or hereafter acquired) or any part of such properties or assets which are essential to the conduct of its business substantially as now conducted.

**Change of Control.** Borrower and Parent shall not permit the change of control of Borrower or of Parent. "Change of control" means (a) as to Borrower, Parent ceases to own 100% of the Equity Interests of Borrower, and (b) as to Parent, [enter name of Parent’s general partner] ceases to be the general partner of Parent.

**Change in Management.** Borrower shall not permit [name of current President/CEO] to cease being the President and Chief Executive Officer of Borrower. Parent shall not permit [name of current President/CEO] to cease being the President and Chief Executive Officer of the general partner of Parent.
**Change in Nature of Business.** Neither Borrower nor Parent shall conduct any business other than, or make any material change in the nature of, its business as carried on as of the date hereof.

**Subsidiaries.** Neither Borrower nor Parent shall form or acquire any subsidiaries.

**Restricted Payments.** The Borrower shall not declare or make any dividend payment or other distribution of assets, properties, cash, rights, obligations or securities (whether as a return of capital or as a loan repayment) to any partner, member or other equity holder, except that while no Event of Default exists, Borrower may make distributions of assets to the owners of Borrower only for the purposes of paying taxes incurred as a result of the income earned by Borrower (any such payment a "Restricted Payment").

7. **Notice and Cure**

Loan documents often contain lengthy lists of event of defaults, which may include occurrences that are outside of Borrowers’ control, are overly broad, or are to be determined at the Lender’s sole discretion. For example, loan documents may provide that an event of default occurs when contractor defaults its contract with the Borrower, even though the contractor’s breach may be outside the Borrower’s control. As another example, it may be an event of default if the Lender were to at any time “feel insecure.” In the face of this uncertainty, Borrowers typically seek some form of notice and cure.

Notice and cure periods are Borrower-favorable provisions that (i) require the Lender to provide notice of any default under the construction loan agreement before such default becomes a full-fledged Event of Default, and (ii) provides the Borrower with additional time to cure any such default before triggering an Event of Default and the Lender’s right to enforce its remedies. There are two types of defaults that can be subject to notice and cure periods: monetary and nonmonetary.

While the Borrower will desire notice and cure periods for both monetary and nonmonetary defaults under the loan agreement, the Lender may be less willing to cooperate with respect to monetary defaults. From the Lender’s perspective, the loan documents provide sufficient notice in
and of themselves with respect to when payments of money are required. For example, the Promissory Note will describe when monthly payments of the loan commence, and the Borrower should not need additional notice of any missed payments if it fails to timely make any payment under the Note. Moreover, the Borrower generally knows in advance when loan payments are due, and the Lender wants to hold the Borrower accountable to the agreed upon terms for the payment of the loan without providing additional “grace periods”. For the Borrower, it is always a good thing to have flexibility to meet the changing needs and unexpected conditions of a construction project. After some negotiation, the Borrower and Lender will typically come to an agreement that may or may not include an additional notice from the Lender but that generally provides for a very short grace period for the Borrower’s failure to pay amounts due under the loan documents. Below is an example of the compromise provision for a monetary default that gives the Borrower both additional notice and time to cure:

Borrower shall default in the payment of principal due according to the terms hereof or of the Note and such default shall not have been cured within ten (10) days after Borrower has been provided with written notice thereof. Additionally, Borrower shall default in the payment of interest on Advances made by Lender or in the payment of fees or other amounts payable to Lender hereunder or under any one or more of the Loan Documents and such default shall not have been cured within five (5) days after Borrower has been provided with written notice thereof.

The Lender may be a bit more amenable to notice and cure periods when it comes to Borrower’s performance of nonmonetary covenants under the loan documents. The Lender should recognize there may be situations outside of Borrower’s control that, without a cure period, would automatically trigger an Event of Default. The Lender’s goal in making the Loan is not to put the Borrower in default; the Lender wants the project to be successful so the Lender can realize the full benefit of making the loan (i.e. its expected interest return). With this in mind, lenders are generally
open to providing reasonable notice and cure periods for nonmonetary defaults. Below is an example of such a provision:

Borrower shall default in the performance or observance of any other agreements, covenants or conditions required to be performed or observed by Borrower under the terms of this Agreement or any of the Loan Documents and such default shall not have been cured within thirty (30) days of written notice thereof from Lender to Borrower, except if Borrower cannot reasonably cure such default within such thirty (30) day period, Borrower shall have a reasonable time to cure the default provided Borrower commences to cure the default within such thirty (30) day period and diligently prosecutes such cure to completion.

8. **Borrower’s Representations and Warranties**

The Borrower’s representations and warranties contained in the loan documents are vital to the Lender’s risk analysis for the transaction. The Lender will rely on these representations and warranties in determining key deal terms such as Borrower’s required equity contribution and the stated interest rate of the loan.

The Borrower understands the critical nature of the representations and warranties, but some of the information requested by the Lender may be difficult to determine or quantify without the Borrower taking significant diligence measures and/or conducting substantial internal investigation. In an effort to avoid the costs (in both time and money) associated with the necessary investigations, the Borrower will try to limit its representations to its “knowledge” or some qualified version thereof.

For example, a Borrower may try to limit its representations to its “actual knowledge.” This knowledge includes only the information known by the person making the representation. In a construction loan agreement, this person is typically an officer, director, or principal of the Borrower, who may or may not be specifically identified in the document. Actual knowledge refers only to what the referenced person knows at the moment in time when the representation is made.
It does not include facts which the person should know or those facts that the person has known in the past but has since forgotten.

“Constructive knowledge,” on the other hand, includes facts that the person should know or could have known, after reasonable diligence. Constructive knowledge is knowledge attributed to a person by law and is far more stringent than the “actual knowledge” standard.1

Typically, Borrower’s want to limit their representations as much as possible but are unsuccessful in attempts to have the “actual knowledge” standard incorporated into the loan documents. Lenders will frequently require a higher standard and, at the very least, some sort of imputed knowledge whereby the knowledge of the Borrower is imputed to the person making the representations on behalf of the Borrower. Further, the Lender will not limit all of Borrower’s representations, but instead will carve out certain limited representations. Below is a typical provision from a neutral loan agreement that contains an example of such a carve-out, which is noted with italics:

**No Litigation or Defaults.** There are no actions, suits, or proceedings pending or, to the knowledge of Borrower, threatened against or affecting Borrower, any of Borrower’s members, or any Guarantor or the Project or involving the validity or enforceability of the Loan Documents or the priority of the lien thereof, except as revealed in writing, at law or in equity, and neither Borrower, any of Borrower’s members, nor any Guarantor is in default under any order, writ, injunction, decree, or demand of any court or any administrative body having jurisdiction over Borrower.

In addition to limiting its representations, Borrower will try to limit its representations and warranties by adding “materiality” qualifiers. These qualifiers give Borrower some wiggle room and flexibility with respect to its representations concerning its financial status or other malleable

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1 For a more detailed analysis on the types of “knowledge,” please see Edward J. Levin, "Best" Is Not Always Best When It Comes to Knowledge, Prob. & Prop. 44 (2016).
conditions. Below is an illustrative example of how a Borrower will use a materiality qualifier in a representation in the construction loan agreement. The materiality qualifiers are noted with italics:

**Financial Information.** The financial statements of Borrower, Borrower's members, and Guarantors previously or hereafter delivered to Lender fairly and accurately present or will fairly and accurately present the financial condition of Borrower, Borrower's members, and Guarantors as of the dates of such statements, and neither this Agreement nor any document, financial statement, credit information, certificate or statement referred to herein or furnished to Lender by Borrower, Borrower's members, and Guarantors contain or will contain any untrue statement of a *material* fact or omit or will omit a *material* fact or is or will be misleading in any *material* respect.

There has been no material adverse change in the financial condition of the Borrower, any of Borrower's members or any Guarantor since the latest financial statements given to Lender. At Lender’s request, any certified financial statement submitted by Borrower, a member in Borrower, or a Guarantor to Lender shall contain an acknowledgement that it has been prepared in accordance with cash basis accounting principles and that it is being submitted to induce Lender to make the Loan or continue to make additional Advances on the Loan.

9. **Interest Rate**

Unlike the other provisions discussed above, the interest rate of a loan is usually set out in the Promissory Note but is often a heavily negotiated term of the loan. The interest rate is, essentially, the cost of the loan. It is the primary consideration paid by the Borrower to the Lender for Lender’s loaning of the money. A well-situated Borrower with good credit can often “shop around” for interest rates, pitting lender against other lenders to get the best loan terms possible. Lenders highly desire Borrower's with good credit because these Borrower's present a low risk of Borrower default and a high risk of timely repayment. There is no magic language for setting out an interest rate in a Promissory Note or any other document, and generally the interest rate is decided long-before attorneys are engaged to begin drafting the loan documents. The interest rate is all about risk allocation, and even a Borrower with less than perfect credit can leverage other risk-reducing
factors (e.g. strong financial performance, position in the market, and Borrower’s equity contribution) to negotiate a better interest rate.

V. Conclusion

Lending is a critical aspect of the construction process. Different parties view lending from different lenses, but all parties recognize the importance of financing in getting a deal done. Parties and their counsel must understand the roles they play, the financing options available, the key components of the loan documents, and the key provisions to focus on to achieve the best results.