

Construction Loan Documents that Actually Work!

By: Richard G. (Chip) Sander¹

Virtually all residential construction lenders understand the rewards inherent in residential construction lending—higher margins and greater returns. However, most lenders who originate construction loans for any period of time understand the risks, as well. The key to successful construction lending is to mitigate the risk while benefiting from the higher returns.

Risk can, and should, be mitigated in a variety of ways, which include (i) identification and selection of appropriate borrowers; (ii) the ability to reject general contractors who don't meet defined criteria; (iii) controlled disbursements; and (iv) regular collateral inspections.

Another inherent risk that is often overlooked and as a result, leaves the lender exposed, is the ability of the lender to mitigate risk by means of the lender's construction loan documents. By setting forth appropriate language in the loan documents, the lender can protect themselves both legally and, perhaps more importantly, set the borrower's expectations.

The Construction Loan Agreement provides the best mechanism for construction lender's to mitigate their risk through the loan documents. Based upon years of experience and a certain amount of "scar tissue," the following recommendations are prophylactic measures which are effective in addressing construction lending risks.

A. Inspections for Benefit of Lender Only.

Prudent lending practices mandate that the collateral be inspected periodically to ensure that the value of the collateral is commensurate with the amount of the Construction Loan Funds which has been disbursed. In addition, loan documents typically impose the cost of the inspections on the borrower. As a result, borrowers often have an expectation that the inspection is for their benefit and that any construction deficiency is the responsibility of the lender since the lender's inspector failed to identify the deficiency.

Language should be included in the Construction Loan Agreement which provides that inspections performed by the lender shall be for the purpose of protecting the security for the loan and for the lender's benefit only. Lender is not

continued on page 2

Residential Construction Lending in Texas

By: Steven E. Kennedy², Esq.



Texas has some of the most complex mechanics lien laws in the country. As many of you know, in 1997, yet another statutory layer was added for residential construction. "Residential construction" is now a statutorily defined category for construction with special rules that control lien rights, construction lending, and disbursement of construction funds on such projects. For the purpose of the Texas lien laws, a "residence" is defined as a single-family house, duplex, triplex, or quadruplex, or a unit in a multi-unit structure used for residential purposes that is owned by one or more adult persons and intended to be used as a dwelling by one of the owners. Although the laws have been on the

continued on page 3

Construction at a Glance

	2001	2000
Permits* (Aug.)	859	824
Monthly Housing Starts* (Sept.)	1,574	1,537
Monthly New Home Sales* (Sept.)	864	924
Unemployment Rate (Aug.)	4.9%	4.1%

*Thousands of units

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Construction Loan Documents (con't)

required to make inspections of the improvements and Borrower, the general contractor, and any other subcontractors, or any third parties shall not rely on lender's inspections but may make their own inspections during the course of construction of the improvements. Finally, language also should be included to reflect that the inspection shall not include any review of the quality of the services or materials used in the construction improvements.

B. All Notices to Borrower Are to Be Forwarded to Lender.

Many states provide by statute that if a subcontractor or supplier has not been paid, the subcontractor or supplier shall provide written notice to the owner. In addition, it is not uncommon for the unpaid subcontractor or supplier to contact the borrower, even if there is not a statutory requirement, and inform them that they have not been paid. Under these circumstances, it is important that the lender be provided with the notice regarding the unpaid subcontractor and/or supplier.

Language should be included in the Construction Loan Agreement which requires the borrower to provide the



lender with all notices, liens, orders, trapping letters, and/or documentation of any kind, from the general contractor and/or any sub-contractor, supplier, governmental authority, or any third-party which reflects or relates to any claim or deficiency concerning or relating to the construction. The Construction Loan Agreement should provide a name and address for the lender to ensure that the individual who is responsible for monitoring such notices receives all forwarded notices. Lenders must avoid notices being sent to the branch office, which are typically stuffed in a drawer by clerical personnel who don't appreciate the significance of such a notice (it happens!).

C. Releases by the Subcontractors and Suppliers.

It is common practice for construction lenders to include in the Construction Loan Agreement a provision

that contemplates that the lender shall be responsible for the collection of unconditional releases as a condition precedent to construction loan fund disbursements.²

Such language sets a high bar for the performance of the lender or the lender's fund control agent. In the event that a release is not collect-



ed, the lender has almost certain liability. Accordingly, a lender can mitigate this problem by (i) shifting to the borrower ultimate responsibility to collect releases; (ii) stating that the Lender, at its discretion and for the protection of its collateral, may require from the general contractor, the appropriate subcontractors, third-parties and/or suppliers, unconditional construction lien releases, as lender believes is necessary to ensure that the construction is proceeding properly; and (iii) stating, should borrower desire unconditional construction lien releases, it is incumbent upon borrower to obtain such releases.

D. Lender May Accept Telefaxed Signatures and is Not Liable for Fraud.

In this day of modern communication, information is exchanged on a regular basis by means of telefax. In order to expedite the funding of disbursements, it is common for general contractors to supply lenders with draw requests and other information via telefax. Although utilization of facsimiles is efficient, it also allows for the possibility of fraud by unscrupulous general contractors. Accordingly, the Construction Loan Agreement may address this issue by providing that the lender shall not be liable for any fraudulent act by the general contractor, any subcontractor and/or any supplier from the use of telefaxed signatures. It is also prudent to expand this provision to include fraud and/or wrongful acts of any kind or nature whatsoever by the general contractor, subcontractor and/or any supplier.

E. Borrower's Choice of General Contractor.

Once a problem arises, it's amazing how the borrower has a memory lapse that he/she selected the troublesome general contractor. Often times, in the mind of the borrower, the difficult, incompetent or unscrupulous general contractor is the lender's responsibility. This expectation is fueled by the lender's cursory review of the general contractor's credit, insurance and/or licensing. Borrowers seem to interpret the lender's cursory investigation to mean

²Lien laws vary from state to state. Accordingly, before utilizing language set forth in this article you should have local legal counsel review the language to ensure compliance with state law.



Construction Loan Documents (con't)

that the lender has undertaken the duty to ensure that the general contractor will build their house on time, to specification and on budget. To mitigate this risk, language should be included in the Construction Loan Agreement stating that it is understood that the general contractor, architect and/or engineers have been selected by borrower, after borrower's independent investigation and decision. We also recommend that language be included which provides that the lender makes no representations regarding their competency or financial status, and is not liable for the borrower's selection of the general contractor, architect and/or engineers.

These provisions by no means provide for bullet proof loan documents, but they do assist in addressing issues which commonly arise in the construction lending context. Incorporating these concepts into your Construction Loan Agreement will help create loan documents that actually work!

Residential Construction Lending in Texas (con't)

books for over four years now, many lenders, and most residential construction contractors, are conducting business with little regard for these new requirements. Following is a summary of the recent changes to Texas law that affect lenders for residential construction and those who oversee the disbursement of construction funds.

The new Subchapter K of Chapter 53 of the Texas Property Code, /53.257 through /53.259 covers most of the new procedures, but new requirements are also found in recent amendments to the Texas Constitution. Texas Property Code Chapter 41-dealing with homestead construction, Chapter 27-dealing with contractor liability, and Chapter 160-dealing with construction trust funds, also come into play. The Texas Statutes can be accessed on the internet at: <http://www.capitol.state.tx.us/statutes/statutes.html>. The Property Code is found at: <http://www.capitol.state.tx.us/statutes/pptoc.html>. The new law requires an extensive disclosure statement set out at Texas Property Code /53.255 to be provided by the contractor and lender. The disclosure required under this section provides a basic outline of Texas lien law for the text of /53.255 is set out at the end of this article.

The Retainage Requirement

Lenders should be aware that the Texas Property Code requires the owner to retain 10% of the contract price until 30 days after completion of the work. The statutory disclosure statement, noted above, includes advice to the owner about the required retainage.

Lenders should be aware...

Contractors, however, are reluctant to agree to retainage on residential projects, since many of their subcontractors and suppliers will not agree to wait until final completion for full payment. Although, it is common practice for residential contractors to talk owners out of such retainage, lenders should get a written waiver from the owner acknowledging that failure to comply with the statutory requirement may subject them to liability for lien claims that could be limited by withholding the required retainage.

Disbursement Statements

Signed disbursement statements are required of the prime contractor and the lender.¹ The prime contractor is to provide the owner with a statement that lists the bills or expenses that the prime contractor says have been paid or will be paid out of payments made or payments requested, prior to the receipt of requested funds. The contractor is not required to include in the statement bills or expenses for which they have already obtained a valid waiver of lien, if the statement includes a written representation that the balance of any funds that are not itemized will be paid to subcontractors or suppliers who have provided a waiver or release of lien to the prime contractor as reimbursement for expenses incurred, profit, or overhead. This requirement is outlined in the required Disclosure Statement under the "MONITOR PAYMENTS" heading.²

From the lender's point of view, there is a significant difference in the Texas Property Code requirements for disbursement disclosure depending on whether funds are disbursed directly to the contractor or directly to the owner. If funds are disbursed directly to the owner, there is no requirement for disclosure from the lender. If the lender advances funds directly to the prime contractor, the lender is required to "obtain the signed disbursement statement from the contractor" that covers the



¹Texas Property Code/53.258

²Texas Property Code/53.255(b)



Texas (con't)



funds for which the original contractor is requesting payment and to provide the owner with a statement of funds disbursed by the lenders since the last statement was provided to

the owner.³ Note that the statute requires the lender provide to the owner the “lender’s disbursement statement” that the lender has “obtained from the contractor” prior to disbursement. As long as the lender has an agreed upon system in place that provides for the borrower to receive a copy of the contractor’s disclosure statement that they have “obtained from the contractor” the mechanics that are used to set up this procedure are probably somewhat flexible. Since the statute requires that the lender provide the disclosures to the owner, it would be advisable for the lender to document that the disclosures were made in accordance with a written agreement. Any method that gets the information into the hands of the owner prior to disbursement would probably pass muster under the statute.

Because the statute requires that the lender enclose a copy of the disbursement disclosure prepared by the contractor, the lender should insert a paragraph in the disbursement disclosure to the owner that reads substantially as follows:

Also attached is a copy of the disbursement disclosure prepared by the contractor, which we are required by the Texas Property Code to provide to you. However, please be advised that the lender is not responsible for the accuracy or completeness of the information contained in the attached contractor’s disbursement disclosure.

Lenders should probably also include language as follows:

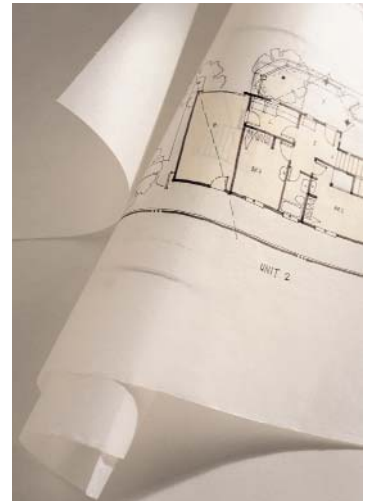
The following is the information required to be provided under the Texas Property Code in connection with, and prior to disbursement of payments for the contractor’s current payment request on the above-described project.

No disbursement should be made unless the contractor has provided the lender a disclosure statement acknowledged by the owner. Therefore, unless the contractor has forged the owner’s name to the disclosure statement, the owner should know that a disbursement has been requested and is imminent.

Bills Paid Affidavits

The contractor is required to furnish a final bills paid affidavit. Such bills paid affidavits should also be required for progress payments. A contractor or subcontractor providing an affidavit of bills paid may face substantial penalties, both civil and criminal, and be personally liable in the event that the affidavit contains false or incorrect information.⁴ A person who “intentionally, knowingly, or recklessly” makes a false or misleading statement in an affidavit stating that all subcontractors and suppliers have been paid commits a Class A Misdemeanor that may be punishable by fine up to \$4,000.00 or one year in jail or both. Any person signing such an affidavit may be personally liable for any loss or damage resulting from any false or incorrect information in the affidavit. The personal liability appears to arise whether the incorrect information is provided intentionally or not.

Texas Property Code /53.259(b), requires the seller of a residential construction project to provide the purchaser, or the purchaser’s agent, an affidavit of bills paid. It is not clear whether the legislature intended this provision to apply to lenders selling properties obtained through foreclosure in Texas. Certain types of mechanic’s liens, such as those for removables, may survive a foreclosure. Any financial institution involved in the sale of a residence should take special care to determine whether any outstanding lien claims exist and to disclose those claims to the purchaser. A title search and appropriate title policy usually protects the owner from outstanding claims, however, the typical title policy usually excludes claims filed after closing. Depending on the completion date, it is possible to get a lien claim perfected even after closing that would not show up on the title search done between completion and closing.



As seen above, the Texas laws for residential construction lending are very complex. Residential Construction lending in Texas should only be undertaken with full consideration of the new residential construction contract laws and review by counsel.

³Texas Property Code/53.258(b)(1) and (2)

⁴Texas Property Code/53.259

What is the National Association of Residential Construction Lenders?

By: Richard W. Nirk, Excell Management Group, Ltd. and Jim Clegern, Washington Mutual¹

In the past five years the residential construction industry and the lenders who provide various loan programs to build homes have experienced unparalleled growth. The current opportunities for construction lenders have never been better and the future prospects are just as good.

National Association of Residential Construction Lenders

With growth comes increased demand on lender's resources including changes to credit, origination, operations, risk management and fund control. Until now, most lenders have had to rely on their own organizations to work through the difficult issues. These lenders typically turn to lending associations for assistance, but in spite of all the associations; there has never been one solely devoted to residential construction lending, until now.

A little over one year ago, a number of construction lenders were brought together by the construction risk mitigation company, Granite Loan Management (GLM), for a seminar about best practices in construction lending. During this meeting, the lenders agreed that it would be of significant value to have an organization devoted only to construction lending. As a result, the National Association of Residential Construction Lenders (NARCL) was founded.

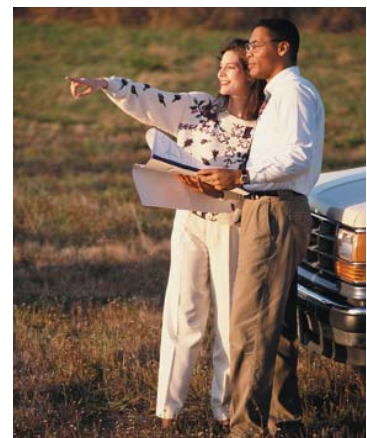


NARCL's founding members include a number of financial institutions and construction service providers such as FannieMae, Washington Mutual, Countrywide, Waterfield Financial, Chase Manhattan, Colonial Savings, GLM and others. It was the specific intent of NARCL to offer a central resource, in the residential construction lending industry.



The Mission Statement is: "NARCL is a nonprofit national Trade Association representing financial service providers in the residential construction industry. Our mission is to provide education, information, policy development, development of standards & practices for the benefit of borrowers, lenders, investors, and others in the residential construction community."

Since inception earlier this year, NARCL has established three committees; membership, education and standards to more clearly focus on the mission. The education committee will be providing best practices for lenders and the standards committee will focus on construction lending guidelines for the industry.



NARCL is working with FannieMae, who is already a member and the National Association of Home Builders (NAHB) in its efforts. Representatives of NARCL made a presentation on construction lending at the NAHB National Convention earlier this year. Going forward, NARCL will be developing

¹Richard W. Nirk is the current Chairperson and Jim Clegern is a Director for NARCL. Richard is currently a Construction Lending Consultant for Excell Management Group, Ltd. (affiliated with MAI) and was previously the National Construction Product Manager for Chase Manhattan Mortgage Corporation. Jim is with Washington Mutual and is involved in Construction Product and Risk Management. They would be happy to answer any questions that you may have regarding NARCL. Richard can be reached at (303) 486-6871 or Jim can be reached at (949) 833-6307.

relationships with the Mortgage Bankers Association (MBA) and other key regional & local groups.

This is an exciting time for residential construction lending. By giving lenders a forum to discuss best practices, NARCL can provide a means to possibly effect change. The ultimate benefit, with builders and lenders working together, is to perhaps make residential construction loans more available to consumers and at a lower cost.

If you have interest in the National Association of Residential Construction Lenders (NARCL) please contact:

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In this Issue:

Residential Construction Lending in Texas

Construction Loan Documents that Actually Work!

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