

Truth in Lending Disclosures for Construction and Home Improvement Loans *By: Marc Lifset*

1. Overview

The federal Truth in Lending Act¹, and Regulation Z² provide special rules for multiple advance construction and home improvement financing ("Construction Loans"). This article provides a brief overview of those rules.

2. Combined or Separate Disclosures Permitted

Regulation Z § 17 (c)(6) states the basic rules for Truth in Lending disclosures for Construction Loans.³

A creditor's disclosure treats a series of advances under a construction loan agreement to extend credit up to a certain amount as a single transaction, or the creditor treats and discloses each advance as a separate transaction.⁴

When a multiple-advance loan to finance the construction of a dwelling may be permanently financed by the same creditor, the creditor may treat the construction phase and the

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Changes in the Florida Mechanic's Lien Laws

By: Marc S. Metzgar

For a construction lender, Florida's mechanic's lien laws are the most straightforward yet treacherous in the country.

The straightforward part is that the law transfers liability upon the recordation of a legally correct Notice of Commencement prior to the start of construction. In theory, by recording a Notice of Commencement, all subcontractors and suppliers who have not directly contracted with an owner are given constructive notice as to the owner of the property and the construction lender. In order for any subcontractor and supplier to then file a lien, they must give notice of their presence to the owner and lender. This information can be obtained from the Notice of Commencement. The courts strictly enforce these procedures.

The treacherous part of the statute holds a construction lender liable for treble damages if the lender does not ensure a

legally correct Notice of Commencement is recorded prior to the start of construction or recordation of the construction loan. If construction started prior to the lender's involvement and the general contractor of record has already recorded a Notice of Commencement, the construction lender must ensure the earlier Notice of Commencement is rescinded by recording a Notice of Termination and filing a new Notice of Commencement.

As of July 1st 2002, Florida statute 713.13 has changed the Notice of Commencement form. Specifically, service by fax is no longer an option and has been eliminated from the form.

When completing the Notice of Commencement a few things should be noted. Section 9 on the statutory form expires automatically within 12 months unless otherwise specified. Due to the fact that construction projects often exceed a one year construction term, it is prudent to specify a later date of completion. Section 6 on the form requests the lender's name, address and phone number. Note, the specified address must be the location where the lender manages the construction process as this is the address where subcontractors and suppliers will forward the Notices to Owner. To be doubly safe, the identical lender information should appear again in Section 8 as a designee in order to receive the Lienor's Notice as provided in Section 713.13 (1)(b) of the Florida Statutes.

Following these simple rules and using the new form will assist a lender in complying with the law when originating and servicing construction loans in Florida.

About the Author

Mr. Metzgar is the Executive Vice President and one of the original founders of Granite Loan Management. He has over 25 years of direct real estate experience both in residential and commercial construction. In addition, many of his efforts are focused on analyzing the mechanic's lien laws in each state. Mr. Metzgar can be reached at 888.456.4888 or marc.metzgar@graniteloan.com

Construction at a Glance

	May, 02	May, 01
Monthly Housing Starts	1,733	1,604
Permits-1 Unit*	1,267	1,232
Monthly New Home Sales*	1,028	884
Unemployment Rate	5.8	5.6

**Thousands of Units*

¹ 15 U.S.C. §§ 1600 et seq.

² 12 C.F.R. Part 226

³ 12 C.F.R. § 226.17(c)

⁴ 12 CFR § 226.17(c)(6)(i); Comment 17(c)(6)(3)

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permanent phase as either one transaction or more than one transaction.⁵

These rules are not mutually exclusive.⁶

A creditor also may give either one combined disclosure for both the construction financing and the permanent financing, or a separate set of disclosures for each phase. This rule is available whether the consumer is initially obligated to accept construction financing only or is obligated to accept both construction and permanent financing from the outset. If the consumer is obligated on both phases and the creditor chooses to give two sets of disclosures, both sets must be given to the consumer initially, because both transactions would be consummated at that time.⁷



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Appendix D of Regulation Z provides an optional procedure that creditors may use, to estimate and disclose the terms of multiple advance construction loans when the amounts and timing of advances are unknown at consummation of the transaction. Appendix D reflects the approach taken in § 226.17(c)(6). The chart that accompanies this article outlines the use of Appendix D. (See insert)

3. Special Rules

3.1. Right of Rescission

Truth in Lending gives homeowners the right to rescind certain credit transactions. A loan secured by the consumer's primary dwelling is subject to the right of rescission if the proceeds are not used to acquire the dwelling. Any transaction to construct a principal dwelling (including manufactured homes and houseboats)⁸ is a residential mortgage transaction. All are exempt from rescission.⁹

To lighten disclosure obligations, a lender may treat construction or home improvement loans as one transaction. New disclosures need not be made for subsequent advances when the loan is treated as one transaction. No new rescis-

sion rights arise so long as the appropriate notice and disclosures are given before consummation of the transaction.

For example, the creditor extends credit for home improvements secured by the consumer's principal dwelling, with advances made as repairs progress. As permitted by § 226.17(c)(6), the creditor makes a single set of disclosures at the beginning of the construction period,



rather than separate disclosures for each advance. No further TILA disclosures are required. The right of rescission does not arise with each advance.

Similarly, if any part of the loan proceeds will be used to finance the "initial construction" of the consumer's principal dwelling, the transaction is a residential mortgage transaction.

In either case, if a transaction meets the definition of a residential mortgage transaction and the creditor chooses to disclose it as several transactions under § 226.17(c)(6), each one is considered a residential mortgage transaction, even if different creditors are involved.¹⁰ However, if the creditor treats the advances as separate transactions, the right of rescission applies to each advance.¹¹ Then only the transaction that finances the acquisition of the dwelling is exempt.

3.2. Special Computation Rules

Regulation Z also provides special rules for computing the APR for construction loans when points are charged,¹² the consumer pays finance charges subsequent to closing, or the creditor mandates interest reserves.¹³

3.3. Timing of Payments

Regulation Z Section 226.18(g) requires creditors to disclose the timing of payments. The Official Staff Commentary provides two options for disclosing a payment schedule that commences upon completion of construction: If the beginning payment date is unknown the creditor may use an estimated date and label the disclosure as an estimate pursuant to § 226.17(c). Alternatively, the disclosure may refer to the occurrence of a particular event, for example, by disclosing that the first payment is due "30 days after the

⁵ 12 C.F.R. § 226.17(c)(i)

⁶ Comment 17(c)(6) – 3

⁷ Comment 17(c)(6) – 2

⁸ Comment 2(a)(19) – 2

⁹ Comment 23(f) – 1

¹⁰ Comment 2(a)(24) – 4

¹¹ Comment 23(f) – 6

¹² Comment 17(c)(6) – 5

¹³ Comment App. D – 5

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first loan disbursement.¹⁴ This information may also be included with an estimated date to explain the basis for the creditor's estimate.¹⁵

4. Variable Rate Construction Loan Disclosures

Regulation Z § 18(f) requires certain disclosures at the time of application and on the closing date for variable rate loans. Closed-end variable-rate transactions that are not secured by the principal dwelling (such as vacation homes), or are secured by the principal dwelling but have a term of one year or less are subject to the disclosure requirements of § 226.18(f)(1).¹⁷ Section 18(f)(2) covers disclosures at the time of application and on the closing date for closed-end variable-rate transactions that are secured by the consumer's principal dwelling and have a term greater than one year.¹⁸



Variable rate mortgage loans covered by Section 18(f)(2) also are subject to special disclosures at the time of application under Section 19(b) ("Program Disclosures").¹⁹

During the term of variable rate mortgage loans covered by Section 19(b), under Section 20(c), the creditor also must give the Borrower notice of changes in the interest rate or the monthly payment amount resulting from changes in the Index ("Adjustment Notice").²⁰

In determining whether a construction loan that may be permanently financed by the same creditor is covered under Section 19(b), the creditor may treat the construction and the permanent phases as separate transactions with distinct terms to maturity, or as a single combined transaction. For purposes of the disclosures required under Section 18(f), the creditor nevertheless may treat the two phases either as a separate transaction or as a single combined transaction in accordance with section 226.17(c)(6).²¹

To lighten disclosure obligations, a lender may offer one-close construction-to-permanent loans by following a few simple rules: (1) Set a twelve-month maximum on the

construction phase; (2) treat the advances as a single transaction; and (3) disclose the construction and permanent phases separately.

The construction phase is treated and disclosed as a single advance loan with a twelve-month term.²² The payment schedule would be disclosed: "Repayment: One payment of principal of (Loan Commitment Amount) on (Permanent Mortgage Date). Interest on the amount of credit outstanding will be paid monthly." Program disclosures are not required. The permanent phase TILA disclosures simply are those to be made if the loan did not have a construction phase.

About the Author

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Lien Releases, Problems and Payment Practices in Washington State

By: Kerry Lawrence

Last Quarter's article addressed Mechanic's Liens and notice requirements in Washington State. This article will address lien releases, common problems with them, and payment practices. Previously we noted that lien releases were the construction equivalent of getting title to a car. This article will discuss some of the practical applications of lien releases to reduce the risk of loss during construction.

The starting point for lien releases and prudent payment practices is to know what subcontractors are working on the project, and who is supplying materials, equipment or professional services to the project.

For single family residential construction, suppliers of materials, equipment and professional services only have lien rights for those materials, professional services or equipment supplied in the ten days preceding the "Notice to Owner" as discussed in the last article. For non-residential projects, the "Notice to Owner" is retroactive 60 days. For this reason it is far more important on commercial projects for the general contractor, owner, and lender to keep close track of material deliveries.

¹⁴ Comment 226.18(g)

¹⁵ See, Comment 17(a)(1) – 5(iii)

¹² C.F.R. § 226.18(f)

¹⁷ Comment 18(f) – 1

¹⁸ Id

¹⁹ 12 C.F.R. § 226.19(b). The disclosures required by this section are relatively simple.

²⁰ Comment 20(c) – 1

²¹ Comment 19(b) – 1

²² See Appendix J, Paragraph(c)

Lien Releases, Problems...(con't)



Most subcontracts used in Washington State allow the general contractor to require each subcontractor to provide a list of all suppliers of materials, professional services and equipment during the application for payment period. Before authorizing payment, it is good practice to require the subcontractor and all subcontractors to submit invoices and shipping receipts for major material deliveries. In one recent litigation case handled by our firm, an electrical subcontractor applied for payment for over \$300,000 worth of light fixtures. The general contractor and the architect simply glanced at the large volume of light fixture boxes in the electrician's storage area and authorized payment. Unfortunately, only the large volume (but low cost) standard commercial fixtures were in the storage area. They had also applied for payment for very high cost specialty light fixtures, which were not delivered. The subcontractor was paid for all light fixtures (both delivered and undelivered), spent the money on other costs, became insolvent and went bankrupt without paying for the specialty fabricated fixtures. The loss was almost \$200,000.

It is also important to review the invoices or shipping receipts to know what amounts of materials are accounted for by the lien releases that are received. In another case, the roofing subcontractor was supplying monthly lien releases from a well-known supplier of roofing materials. Unfortunately for the general contractor, the subcontractor

was buying only low cost miscellaneous materials from that supplier, and was purchasing the bulk of the materials from another supplier. The roof went on quickly, and the subcontractor was paid before the major supplier sent the "Notice to Owner". The loss to the general contractor was over \$100,000.

Another problem faced on construction projects is the timing and proper wording of lien releases. It is very typical for suppliers to speak in terms of "payment received for amounts due." Most material supplier's credit terms are "2% ten, net thirty." Suppliers typically will invoice the subcontractor for materials delivered through the last day of the month, with payment due the 30th of the following month. If the owner and general contractor are following the standard payment practice of asking for forward priced applications for payment on the 28th, and receive lien releases dated the 25th of the month stating that the supplier has received payment "for all amounts due", there may be a large balance outstanding that will be past due on the first of the following month, before checks are issued.

As an example, payment for materials delivered between March 1 and March 31 only becomes due on April 30. If the owner or general contractor the following month receives a lien release dated April 25 stating the account is "current" they will probably not realize that there may have been no payment for materials delivered in March. Similarly, a lien release from that supplier stating they have been "paid in full for all sums due through April 25" is not a release for materials that were delivered during March.

More appropriate wording for progress payment releases is:

"The undersigned does hereby release all mechanics lien, stop notice, equitable lien, labor and material bond rights against the above-described project for all materials, services, labor, supplies, equipment purchased, whether furnished by or for us and delivered or used on the above premises up to and including March 31, 2002. This release is for the benefit of, and may be relied upon by, the owner, the prime contractor, the construction lender, and principal insuree on any labor and material bond."

Lien Releases, Problems... (con't)

Prudent lenders have procedures in place for assuring that the Application for Payment fairly represents the value of the work performed and materials delivered. Typically, this begins with a schedule of values allocating the project cost to the various job activities. The architect, or another knowledgeable construction professional, should verify that the schedule of values is a reasonable forecast of the actual values, and does not “front load” the funding. When the monthly Application for Payment is received, the owner’s architect initially verifies the percentage of completion of each item on the schedule of values before the Application for Payment is provided to the lender. The lender typically has one of its employees, or a third party, review the Application for Payment and inspect the project to make sure that the work and material applied for has been performed and delivered. As noted earlier with reference to the light fixtures, verification of work performed is generally easier than verification of materials delivered.

While very infrequent, contractors have been known to receive payments and simply abscond with them. It is more common for a contractor to apply money received to pay debts for which they are personally liable, wait 90 days for the bankruptcy preference period to run, then file for bankruptcy. Far more commonly, a general contractor receives the money, and with good intentions to “make it up later” uses the money to pay old debts on another project, the proverbial “robbing Peter to pay Paul,” and ultimately fails, leaving a number of unpaid liens. This is where direct payment to subcontractors and suppliers can significantly reduce risk. An alternate approach to reduce the above problem, although not frequently used, requires the general contractor to submit with the Application for Payment a listing of all subcontractors, suppliers and professional service providers and the amounts to be paid to them. On disbursement day, the general contractor arrives at the office of the disbursing party with the checks for all of those parties in the amounts indicated in unsealed envelopes with stamps on them. After reconciling those checks against the Applications for Payment, the disbursing office takes those contractor checks and deposits them in the mail while delivering to the general contractor the check for the total amount of the disbursement. While this will not stop the outright theft of the money by the contractor who uses the money to fly to a country with no extradition treaty, it will significantly reduce the “robbing Peter to pay Paul”.

While virtually no system is foolproof, there are simple practical steps that can be taken to significantly reduce the risk of loss due to unpaid lien claimants, or overpaid contractors.

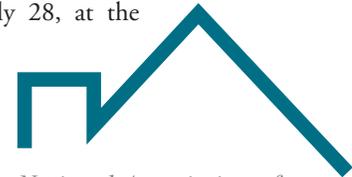
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NARCL Sponsors Construction Seminar at the SEBC

By Richard W. Nirk

The National Association of Residential Construction Lenders (NARCL) is excited to announce that they will sponsor a seminar at the South Eastern Builders Conference (SEBC) commencing July 24 through July 28, at the Orange County Convention Center in Orlando Florida. The title of the seminar will be “Free Construction Money: The ABC’s of Construction-Perm Lending” with a goal of educating builders in the benefits of construction to permanent financing.



*National Association of
Residential Construction Lenders*

The seminar will be organized as a panel discussion that will include a representative from the National Association of Homebuilders (NAHB), a Construction Risk Mitigation Company, a well-know local Florida builder and a NARCL member. Each group will provide insight into Construction to Perm Lending. A lender moderator will duly assist in questions and answers from the audience. This seminar will provide key information about construction lending and is a continuous effort on the part of NARCL to provide education to the builder and lender communities.

About the Author

Richard W. Nirk is the current Executive Director of NARCL and a construction consultant with Excell Management Group, Ltd.

Industry Briefs

- William Renner, Director of Single Family Finance for the National Association of Homebuilders, has joined the National Association of Residential Construction Lenders (NARCL) as a Director.
- Guardian Mortgage Documents announces that they have a cost effective and efficient construction loan documentation delivery system available via the Internet for construction lenders.
- Granite Loan Management will host two Construction Risk Mitigation Seminars titled “Construction Lending Best Practices” on October 10th in Chicago, Illinois and November 7th in Dallas, Texas.

**For more information contact:
www.graniteloan.com**

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