

CONSTRUCTION LAW

Default of Construction Loan Poses Challenges for Lender

The present economic crisis has resulted in stalled construction projects and related borrower defaults under their construction loans. In response, lenders have been compelled to make critical decisions as to the best course of action to protect their collateral and ensure repayment. Rather than immediately declaring a default under the loan documents, many lenders have opted to negotiate loan workouts with their borrowers which, if properly structured, can salvage the project and maintain the viability of the construction loan. This article will address the key issues a lender should consider in approaching a construction loan workout.

Special Problems

In the case of a construction loan, as opposed to a conventional acquisition or permanent loan, the problems facing the lender resulting from a default are intensified, and the lender faces an even greater challenge than it would in a conventional loan. In the absence of a personal guaranty, the lender, holding an unfinished project as collateral, will have far more limited options for repayment through a sale of the collateral, whether after acquisition by a deed in lieu of foreclosure or through a foreclosure sale. The lender is potentially at risk from contractors ceasing construction and filing liens, vandalism, tenant threats to terminate leases (or purchasers of condominium units or single family homes



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cancelling agreements of sale) and the loss of a permanent loan commitment. And, due to the current frozen credit market environment, the construction lender faces the added risk that no substitute permanent financing, on economically acceptable terms, is available, even if the project can be completed on a timely basis.

Defaults under construction loans may result from poor construction management, deficient design, project planning or budgeting, force majeure events; malfeasance or the inability to secure permanent financing or inadequate rentals or condominium unit sales. The nature of the default will guide the workout process.

Faced with a loan default, the lender must choose which of two routes to follow: pursue its remedies for the default or work out the loan. If, after careful consideration of the potential risk (including cost and time) in pursuing remedies under the loan documents, the lender concludes that the best option is to keep the borrower in place and allow it to continue construction of the project to completion, the lender will then

need to determine the time and economic relief the borrower requires to complete and carry the project, as well as the security or additional collateral the lender should seek in the workout negotiations.

Fundamental Elements

Due to space limitations, we will address only the most fundamental elements of a construction loan workout.

A. Modification of Documents

Modifications of the borrower's design and construction contract may be required due to increased costs and time due to the borrower's default. In this regard, the lender's construction consultant is particularly important. The consultant is responsible for monitoring the progress of construction and reviewing contractor requisitions. Any proposed revisions to the construction contract, the budget or the schedule necessitated by the workout must be reviewed by the lender's consultant in conjunction with the borrower's architect and contractor. To the extent the workout results in modifications of the design and construction contracts, appropriate amendments should be executed. The lender should also confirm the effectiveness and enforceability of the "will serve" letters executed by the architect and contractor at the time of the initial loan closing.

B. Extension of Maturity Date

Regardless of the cause of the default, the maturity date of the loan will, no doubt, require extension. The lender should allow the borrower reasonable time to complete construction of the project, meet leasing and sales agreement

conditions, and/or obtain permanent loan financing (or the necessary equity infusion) or the sale of the project. However, the lender should proceed cautiously in granting the extension in order to ensure the lender that it continues to hold the "time trigger" in the event the project does not proceed as planned or, if market conditions improve, to allow the lender to take advantage of future exit strategies (e.g., foreclose or exercise other remedies).

C. Restructured Debt Service

The lender may also need to consider economic relief, such as a reduction in the interest rate or deferral of the interest payments (with interest accruing and paid upon maturity) and, in some cases, forgiveness of principal or interest may need to be considered in light of the overall objective to maximize the lender's realization on the loan.

D. Additional Capital

In many instances, in order to carry the project through the current market, where there are few refinancing or sale options, and to pay for additional construction costs, or to allow the borrower time to meet leasing or sales conditions which would enhance the project, additional capital will be required. More often than not in today's marketplace, the construction lender will desire to limit any further exposure to the project and the real estate market, and will want to avoid funding any additional capital that may be needed. In such instance, as part of the loan workout, the lender will need to consider providing the borrower more flexibility to obtain mezzanine loan financing or joint venture equity financing, which may involve admitting a new controlling (or jointly controlling) developer, or granting considerable rights to a new mezzanine lender or equity provider. The lender may even be forced to consider subordinating part of its loan to payments due a subordinate lender or an equity provider (which concept is, traditionally, heresy in the mortgage lender world).

E. Additional Compensation or Security

The loan workout should also serve as the lender's opportunity to ensure that it is adequately compensated and fully secured. In being asked to

extend the term of the loan, reduce its originally expected return on its investment and/or increase its risk of the borrower's non-payment, the lender may seek to offset such risk with increased compensation and/or security. A lender may agree to recover forgone interest or principal in later payments, which are contingent upon the happening of subsequent events (e.g., the sale of certain condominium units, satisfaction of leasing contingencies or permanent mortgage financing contingency), and may even consider "shared appreciation" in the event of a sale or refinancing of the property at a later date or additional interest payments in the event of sale or refinancing. If the borrower has not provided a personal guaranty at the origination of the loan, the lender may consider requesting such a guaranty as part of the loan workout. In addition, if available, the lender may seek cross-

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collateralization with other loans or additional collateral for its construction mortgage loan (e.g., mortgage on other property).

F. Enforcement Mechanisms

Depending upon the severity of the default (or impending default), the workout may range from merely a mortgage modification to a declaration of default and the institution of foreclosure proceedings (or an action on the note) simultaneously with a forbearance or "standstill" agreement. In the case of a mortgage modification, care should be taken to comply with Lien Law §22 in order to maintain the lien priority of the construction loan, by filing the modification and the requisite Lien Law affidavit with the county clerk.

In the event the workout agreement will be accompanied by the institution of legal proceedings, an appropriate stipulation should be executed confirming, among other things, the forbearance of the lender pending the performance of borrower's loan obligations; the ratification of the loan documents; the presence of the default; the jurisdiction of the court; the waiver of defenses; and borrower's consent to the relief sought in the action upon its default under the workout agreement. If appropriate, the stipulation may contain the borrower's consent to the appointment of a receiver upon a new default. However, the lender should proceed with extreme caution in exercising that remedy in order to avoid creating claims of lender liability which might arise from the assertion of undue control over the project.

Conclusion

A successful construction loan workout will address the problems facing the borrower in completing the project on time and within budget. In accommodating the borrower in this manner, the lender should ensure that it is adequately secured and possesses enhanced enforcement mechanisms should there be a further loan default.