

MONITERING THE PROCESS: ORCHESTRATING THE INSPECTORS,
CONTRACTORS, ARCHITECTS AND ENGINEERS

2005 Joint Fall Meeting
Section of Taxation
and
Section of Real Property, Probate and Trust Law
San Francisco

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Third Party Professionals, Schedules and Budgets

The construction process can be viewed like a team sport, with a captain or quarterback, being the developer, and a host of assistant coaches, working together towards the common goals of on time, within budget completion of a project. The developer may begin the process by finding a piece of land on which to construct a new project, or a building available for renovation. The developer may have an engineering or construction background, or may have experience in development, which provides enough knowledge to conceptualize the project, and derive a good estimate of what can be built on the project site.

Certain developers are known for their area of expertise and stay focused in their area for their entire careers. There are shopping center developers, office tower developers, office park developers, residential subdivision developers, apartment developers, hotel developers, and “mixed-use” developers, creating environments for multiple types of uses on a project site. Some developers seem to have a sixth sense at finding property that is well located for development, and can visualize the final product fairly easily. Other developers may plod along more slowly and rely more extensively on other members of the team for input and analysis. Most construction projects involve at least a triumvirate of professionals, consisting of an architect, a civil engineer and a general contractor. In some projects, the general contractor will either hire an architect, or has one on staff, and will provide the design services in lieu of the architect, as part of a “design-build” contract. The role of each of these professionals, and their relationship to each other and to the lender, is crucial to the success of a project.

Usually, once the loan process has commenced, the project engineering and architectural design are complete, or nearly so, because so much of this work needs to be done in order to obtain governmental approvals accompanying the permit process, and because the project budget is dependent on obtaining construction bids and pricing based on fairly definite plans. Even though much of the design work is complete, the architect and engineer are still essential to the completion of the process.

The Architect. The architect’s role, or scope of service, includes:

1. Conceptual design, followed by detail design and preparation of working drawings and specifications, which are given to contractors during the bidding process
2. Administering the bidding process; and
3. Construction contract administration.

In most standard AIA construction contracts, the architect has the primary role of overseeing the draw process to insure that the project is proceeding on schedule and within budget. Section 4.2 of AIA form A201 (1997 edition) states:

“The Architect will provide administration of the Contract as described in the Contract Documents, and will be an Owner’s representative (1) during construction, (2) until final payment is due and (3) with Owner’s concurrence, from time to time during the one-year period for correction of Work as described in Paragraph 12.2.”

Section 4.2.2 elaborates:

“The Architect, as a representative of the Owner, will visit the site at intervals appropriate to the state of the Contractor’s operations (1) to become generally familiar with and to keep the Owner informed about the progress and quality of the portion of the Work completed, (2) to endeavor to guard the Owner against defects and deficiencies in the Work, and (3) to determine in general if the Work is being performed in a manner indicating that the Work, when fully completed, will be in accordance with the Contract Documents.”

The architect reviews and approves applications for payment, interprets matters of performance under the Contract Documents, and reviews the work for consistency with the plans and specifications. The architect also is the first line of adjudicating disputes between the owner and the general contractor. Section 4.4.1 of A201 states that most claims be “referred initially to the Architect for a decision. An initial decision by the Architect shall be required as a condition precedent to mediation, arbitration or litigation” of claims. The architect is supposed to play an “impartial” role as judge and jury in these cases, but in practice, it may be hard to avoid partiality towards the side of the owner, who is, of course, paying for the architect’s services.

As author of the plans and specifications, the architect would like to retain a level of control over their use to prevent other projects being constructed with the plans without the architect’s employment and without other compensation to the architect. AIA Form B141 (1992) provides that the plans and specifications prepared by the Architect “are the instruments of the Architect’s service for use solely with respect to [the project] and unless otherwise provided, the architect shall be deemed to be the author of these documents and shall retain all common law, statutory and other reserved rights, including the copyright.” The owner is granted permission to use the plans and specifications for the project, but not for other purposes. However, Section 9.5 provides that neither the owner nor the architect may assign the agreement (and consequently, the rights thereunder), without the consent of the other. Furthermore, Section 9.7 states that “[n]othing contained in the Agreement shall create a contractual relationship with or a cause of action in favor of any third party against” the architect.

As the source of the bulk of construction funding, and as a potential owner of the project, the lender is rightfully concerned that the architect perform its services, in part, for the lender’s benefit. More particularly, the lender wants the right to use the plans and specifications, and the right to continuous performance by the architect, if the lender takes over the project. The lender also wants to be able to rely on the architect’s work as being in compliance with all applicable laws, and ideally, to be a third-party beneficiary to the architect’s contract to enforce the owner’s rights against the architect for improper design. Finally, the lender wants assurances that any lien rights which may be in favor architect for work performed which precedes the date of the loan be waived, or subordinated, to the lender’s security instrument.

The lender relies on three basic written agreements from the architect to accomplish these goals. The exact format may differ in differing jurisdictions, but the concept is the same, as follows:

1. Continuation Agreement. This is an agreement by the architect to provide continuous service upon the lender’s request, for which the architect will be entitled to compensation at the rate set forth in the architect’s contract. The lender may also request that the architect provide written notice of any default by the owner under the architect’s contract, and that the architect agree not to amend the contract without the lender’s prior written approval.

2. Architect's Certification. This certificate is addressed to the lender and states that the architect has prepared the plans and specifications in accordance with all applicable laws, ordinances, rules and regulations. Specific sections may address matters particularly to zoning, utility and access, and wetlands or other Federal regulatory issues. The architect may also be requested to state which governmental permits will be required to commence and complete the entire project.

3. Lien Waiver and Subordination Agreement. This agreement generally provides for a waiver of lien rights for work arising prior to the date of the loan, and for lien subordination for work to be performed after the date of the loan.

The following are examples of consents to assignment, continuation agreements and certifications which might be requested from the architect.

CONSENT TO ASSIGNMENT
(LETTERHEAD OF ARCHITECTURAL FIRM)

_____, 2005

Regional Bank
Atlanta Real Estate Division
5436 Peachtree Dunwoody Road, N.E.
Atlanta, Georgia 30328
Attention: Michael O' Callahan

Re: Construction of 44,000 square foot office building near Ft. Lauderdale International Airport, Ft. Lauderdale, Florida (the "Project")

Ladies and Gentlemen:

Under an agreement (the "Contract") with Office Developer of Ft. Lauderdale, Inc. (the "Borrower"), we are the architects for the construction of the above referenced Project and are preparing plans and specifications therefor (the "Plans").

We understand that the Contract and the Plans will be collaterally assigned by the Borrower to you in connection with the construction financing for the Project. In consideration of your closing such financing, and as an inducement to you to do so, we hereby consent to such conditional assignment and agree that, in the event of a default by the Borrower under the terms of any of the instruments evidencing, securing, or governing your loan, including, without limitation, the construction loan agreement between you and the Borrower, (1) we shall at your request provide such architectural, design and consulting services as required by our Contract with the Borrower with respect to the construction of the Project, provided that we are compensated at the rate provided in such agreement for all services rendered at your request, and (2) you shall be entitled to use the Plans, as they may be subsequently amended, and including all shop drawings, working drawings, and related papers, for purposes of completing construction of the Project, without payment of additional fees or charges to us except as described in the foregoing clause (1).

We acknowledge that this agreement shall be binding upon us, notwithstanding that the Borrower may be indebted to us; and we further acknowledge that we shall have no right or claim against you with respect to any compensation which may be owed to us by the Borrower (except that, as described above, you shall be responsible for compensating us at the rate provided in the Contract for services rendered at your request after the Borrower's default under the Loan).

Sincerely,

(Architectural Company Name)

By: _____

Title: _____

ARCHITECT'S CERTIFICATE

(LETTERHEAD OF ARCHITECTURAL FIRM)

_____, 2005

Regional Bank
Atlanta Real Estate Division
5436 Peachtree Dunwoody Road, N.E.
Atlanta, Georgia 30328
Attention: Michael O' Callahan

Re: Construction of 44,000 square foot office building near Ft. Lauderdale International Airport, Ft. Lauderdale, Florida (the "Project")

Ladies and Gentlemen:

In connection with the completion of arrangements between you and Office Developer of Ft. Lauderdale, Inc. (the "Borrower"), with respect to the construction financing for the above referenced Project, we hereby certify, to and for your benefit, the following:

1. We are architects duly licensed and in good standing under the laws of the State of Florida. We have been retained by the Borrower as architects for the Project.
2. We prepared or supervised the preparation of certain plans and specifications for the Project (the "Plans"), which plans and specifications are more particularly identified on Exhibit A attached hereto.
3. The property on which the Project is to be constructed (the "Site") is zoned _____ under the applicable zoning ordinance of _____ County, Florida. Under such zoning classification, the intended use of the Project for _____ is permitted as a matter of right.
4. We have examined all applicable materials relative to those types of zoning restrictions and requirements sometimes referred to as use, dimensional, bulk and parking restrictions and requirements which relate to the _____ zoning district and have determined that the following requirements and restrictions are applicable to the Project:

	Zoning Requirements	Project Specifications
Density:		
Height Limitation:		
Maximum Floor Area Ratio (or other type of bulk restrictions):		
Front Yard Setback Requirements:		
Side Yard Setback Requirements:		
Rear Yard Setback Requirements:		
Parking:		

5. The Plans comply with all applicable federal, state, and local laws, rules, regulations, and ordinances relating to the construction of the Project, including, without limitation, zoning restrictions and requirements, and fire codes and ordinances, environmental laws, rules and regulations, and any laws, rules, and ordinances relating to the elimination of architectural barriers to the handicapped (including the Americans With Disabilities Act); and, in our professional judgment, the Project, if constructed in accordance with the Plans, will likewise comply with all such applicable federal, state and local laws, rules, regulations, and ordinances relating to the construction thereof.

6. Satisfactory methods of access to and egress from the Project and adjoining or nearby public ways are available, sufficient to meet the reasonable needs for the Project and all applicable requirements of public authorities. Sanitary water supply, storm sewer and sanitary sewer facilities and other required utilities (gas, electricity, telephone, etc.) are likewise available, sufficient to meet the reasonable needs of the Project and all applicable requirements of public authorities, at or within the lot lines of the Site. No easements over land of others are required for such means of access and egress or for any such utilities.

7. We have reviewed the locations of all easements, rights-of-way, subsurface rights and the like in force relating to the Site, and the Plans have been prepared so that the Project will not encroach over, across, or upon any such easements, right-of-way or subsurface rights and the like, except as may be permitted by the terms of any documents establishing or governing such easements, rights-of-way, subsurface rights and the like.

8. The following permits, licenses, approvals and the like ("permits") are all the permits required for the construction of the Project.

Issuing Agency	Type of Permit

It is the opinion of the undersigned that the foregoing permits have been or will be duly issued in the ordinary course of construction of the Project.

Sincerely,

 (Architectural Company Name)

By: _____

Its: _____

[AFFIX CORPORATE SEAL]

The lien waiver and subordination agreement should be drafted in compliance with the particular jurisdictional and title requirements. Sometimes, when monies are owed to the professional, the professional will be reluctant to provide a lien subordination without payment, and in such cases, subordination will be conditioned upon receipt of the outstanding balance, or other agreed upon sum, which amount should be paid as part of the closing disbursements and reflected on the closing statement.

Finally, the architect's contract should be signed by the borrowing entity as "owner" and if it is not, the contract should be assigned to the borrower, with written consent of the architect.

The Civil Engineer. The civil engineer's role generally includes preparation of a site plan, grading plan, drainage plan, and utility plan. While the construction lender will require a full set of plans and specifications, the attorney's review may be more limited in scope, and often may only include the site plan. However, in practice, review of the grading plan, drainage plan and utility plan, in conjunction with the site plan, survey and title commitment, provides great benefit towards the attorney's understanding of the layout of the proposed improvements, and the necessity for easements for utilities, access or drainage.

An engineer's contract usually is not as formal as the contract for the architect or the contractor. It may consist of a short letter agreement, or other non-standard form created by the engineer. The engineer may be under contract with the architect, in which case, the architect's contract will include engineering services. While the same considerations present in the architect's situation apply to the engineer, the need for continuous performance is usually absent following the commencement of construction. Nevertheless, it is prudent to obtain a consent to assignment and continuation agreement from the engineer unless the engineer is under the architect's contract.

An engineer's certificate is also appropriate, despite some overlap with the architect's certificate, because duplicating certifications may reveal inconsistencies which require further investigation. The certification should discuss utilities in sufficient capacity for use of the proposed improvements, without the requirements of easements.

An engineer's certificate is as follows:

[CIVIL ENGINEER'S CERTIFICATE]

[LETTERHEAD OF ENGINEERING COMPANY]

_____, 2005

Regional Bank
Atlanta Real Estate Division
5436 Peachtree Dunwoody Road, N.E.
Atlanta, Georgia 30328
Attention: Michael O' Callahan

Re: Construction of 44,000 square foot office building near Ft. Lauderdale International Airport, Ft. Lauderdale, Florida (the "Project")

Ladies and Gentlemen:

In connection with your proposed construction loan to Office Developer of Ft. Lauderdale, Inc. (the "Borrower") for the above referenced Project, we hereby certify, to and for your benefit, the following:

1. We are Registered Engineers in good standing under the laws of the State of Georgia. We have been retained by the Borrower for the drainage, grading, and paving plans and the designs of all other site work for the Project as described in Item 2 below.

2. We prepared or supervised the preparation of the plans and specifications for site work construction with respect to the Project more particularly identified on Exhibit A attached hereto (the "Plans and Specifications").

3. The location of the buildings which we understand are planned to be constructed on the Project and the site conditions are such that provisions of law relating to the filling, dredging, excavation, or other usage of lands classified as wetlands or lands which are subject to flooding or have thereon standing or moving bodies of water are not applicable to the construction of the Project. The Project is not located in an area having special flood hazards according to the flood hazard boundary maps used by the United States Department of Housing and Urban Development in connection with the National Flood Insurance program.

4. The property on which the Project is located does not serve any adjoining property for drainage. Further, design conditions are such that no drainage of surface or other water across the property of others is called for or indicated by the Plans and Specifications.

5. All grading, drainage facilities, and other site work described in the Plans and Specifications have been designed to comply with all applicable federal, state, and local laws, rules, regulations, and ordinances relating to the design of site work and facilities as described therein, including, without limitation, applicable zoning, building, subdivision, and environmental laws, rules and regulations.

6. Satisfactory methods of access to and egress from the Project and adjoining or nearby public ways are available, sufficient to meet the reasonable needs for the Project and all applicable requirements of public authorities. Sanitary water supply and storm sewer and sanitary sewer facilities and other required utilities (gas, electricity, telephone, etc.) are likewise available, sufficient to meet the reasonable needs of the Project and all applicable requirements of public authorities, at or within the lot lines of the Project. No easements over land of others are required for such means of access and egress or for any such utilities.

7. Sewage from the Project will be disposed of via connection to [describe sewer system], which connection and all connecting lines have been approved and permitted by the [describe permitting authority] and all other governmental authorities with jurisdiction thereof.

Sincerely,

(Civil Engineer Company Name)

By: _____
Title: _____

The General Contractor and the Construction Contract. The general contractor is the tactical commander of the project, coordinating the various professionals and subcontractors and the ordering of materials, so that work is commenced on time, proceeds in accordance with the construction schedule, and within budget, and is completed on time. Imagine starting a project from the ground up, without any experience in hiring and coordinating subcontractors for the specific components of a project, and trying to sort through the myriad of information obtained in the bid process from subcontractors of varying degrees of experience and reputation, knowing that the amount of time available to make a decision is limited by the constraints imposed by the end-user, whether a tenant, purchaser or lender. The phrase "time is money" has particular pertinence in the construction arena, where delays increase interest carrying costs, can potentially result in penalties for late delivery of premises, or even worse, cause loss of the lease or purchase altogether. The general contractor is chosen because of its familiarity with the process and because of its experience with a group of subcontractors and materialmen who can deliver on time and within budget. The general contractor is both a generalist, meaning it has general oversight experience and abilities which will facilitate construction of the project, and a "general" with the power and responsibility over the subcontractors and materialmen required to motivate them to get the job done when needed.

The construction contract between the general contractor and the owner is a comprehensive contract with implications beyond the contractual undertakings between the two parties. It also serves as the framework and blueprint for construction of the project, including payment obligations, change order

procedures, performance controls, and default and remedies provisions. It specifies in detail the scope of the work to be performed, according to a timeline or schedule, at a specified cost.

The basic components of the construction contract are:

1. The scope of the work to be performed by the contractor;
2. The price to be paid for the work; and
3. The time period for completion of the work.

The scope of the work may be generally defined, but with particular reference to a set of architectural and engineering plans and specifications. The work is likely to exclude certain specific areas of work, such as work associated with rectifying unsuitable soils, or work associated with governmental compliance if the contractor is relying upon the architect's work and is not a design/builder. The definitions of Work and Contract Documents from the AIA Document 201 – 1997 (General Conditions of the Contract for Construction) contain the following instructive language:

“The Work shall consist of all items specifically included in the Contract Documents as well as all additional items of work which are reasonably inferable from that which is specified in order to provide complete systems, complete the Work in accordance with the Contract Documents, and produce the intended results. In the event of a conflict between the Agreement, as modified hereby, and any of the other Contract Documents, the Agreement shall control.”

“The Contract Documents consist of the Agreement between Owner and Contractor (hereinafter the Agreement), Conditions of the Contract (General, Supplementary and other Conditions), Drawings, Specifications, Addenda issued prior to execution of the Contract, other documents listed in the Agreement and Modifications issued after execution of the Contract.”

Items not included in the Contract Documents are therefore outside of the scope of the work and the costs associated therewith becomes the responsibility of the owner. If the definition of work is overly expansive, and includes items that are not within the contractor's knowledge or control, then the contractor may be responsible for costs of construction in excess of the agreed contract price which arise in connection with work which was not included in the bid. In the above-quoted definition of “Work,” there is included “additional items of work which are *reasonably inferable*” from what is specifically included in the contract drawings, recognizing that every nail and screw cannot be specified, and certain items which are readily noticeable to the prudent contract are to be included in the bid price.

The AIA Form 201 – 1997 Section 4.3.4 excludes “conditions encountered at the site which are (1) subsurface or otherwise concealed physical conditions which differ materially from those indicated in the Contract Documents or (2) unknown physical conditions of an unusual nature, which differ materially from those ordinarily found to exist and generally recognized as inherent in construction activities of the character provided for in the Contract Documents.” An experienced contractor will specifically also exclude moist or unsuitable soils or rock, which can add great cost and require additional time to rectify.

The contract price, or “Contract Sum,” may be established in one of several basic formats, the lump sum, “cost plus fee,” and guaranteed maximum price. Generally, if the price is lump sum or guaranteed maximum, the owner will pay more as a “hedge” against unknown or unforeseen costs that would be reimbursable in a “cost plus fee” contract scenario because the risk of these unknown costs is effectively shifted to the contractor. The contractor increases the overall

price to cover this risk. If the contractor is able to reduce costs, the contractor's profit will be increased because the cost of the work is not a factor in the overall payment due the contractor.

The "cost plus fee" contract states that the contractor will be paid for the cost of each itemized portion of the work, plus a fee, usually framed as a percentage of cost, which fee represents profit and "general conditions" or overhead costs of the contractor. The reviewer is required to pay particular attention to the detailed definition of the "cost of work" because items that are not included in the definition are not reimbursable. The "cost plus fee" contract is usually used when the plans and specifications are not complete and a lump sum cannot be accurately determined. This type of contract is problematic from both the owner and lender perspective. A complete budget cannot be established, and therefore, the risks inherent in completing the project without increases in loan amount are greatly increased.

A more palatable approach is the "cost plus fee" with a guaranteed maximum price ("GMP"), whereby the contractor guarantees that the total cost of construction will not exceed the GMP. The risk of excess costs is thereby shifted to the contractor.

Regardless of a lump sum or GMP, many contracts contain "allowances," which are unit prices included in the contract sum which, if exceeded, become the responsibility of the owner. As mentioned above, costs of unforeseen conditions, or unsuitable soils, may also be specifically excluded from the price to keep the risk of increased costs squarely on the owner. For these, and other reasons, the construction budget used to determine the construction loan amount should include a healthy contingency line .

Invariably, circumstances arise during the course of construction which require changes to the plans and specifications, or require more time or cost to complete than originally anticipated. The agreement of the contractor and owner to modify the construction contract to accommodate needed changes, commonly referred to as "change orders," are changes in the scope of the work, which may increase contract time or contract price. These modifications or amendments to the construction contract may be either expressly agreed upon by the owner and contractor, or authorized or mandated by the construction contract, as is with the case of concealed conditions or *force majeure* under AIA Form 201. Construction change directives are orders of the architect or contract administrator authorized under the construction contract which have the effect of modifying the construction contract in the same manner as a change order without the complete agreement of the owner and contractor. Change orders and construction change directives may impact either or both of the cost of construction or the construction schedule, and therefore may have implications beyond the face of the construction contract. The construction lender needs to be informed of all prospective changes in the construction contract, and the right to approve material changes.

The lender's review of the construction contract should begin with the obvious issues. Make sure that the name of the owner and the borrower are identical, and if not, arrange for the assignment of the construction contract to the borrower, with the written acknowledgment and consent of the contractor. Review the contract price and payment terms to find out if they match up with the construction budget to be attached to the construction loan agreement. Retainage, the amount withheld from each progress payment or "draw request," should also mirror the language in the construction loan agreement. The purpose of retainage is to provide financial incentive for the contractor to expeditiously prosecute the construction project, with its full attention. If all of the contractor's profit and overhead are paid with each draw, the contractor may be more likely to stall a job, or default under the contract when it reaches

an impasse with the owner or finds more lucrative projects. Retainage is a powerful financial incentive to induce the contractor to diligently complete the work. Typical retainage amounts are ten percent (10%) of each draw, sometimes reducing to five percent (5%) or less once a material portion of the work is complete. A lender may agree to forego retainage on certain items that do not impact construction, such as general conditions or even stored materials, which must often times be paid in advance. The completion date and schedule for construction should also be reviewed to verify that they are in accordance with the stated loan terms, and more importantly, external factors, like lease or delivery requirements.

As in the case with an architect and engineer, the lender will require the agreement of the contractor to continue working on the project upon the lender's succession to the owner's interest following a loan default. The contractor will be rightfully concerned that it be paid for all work, and in the default scenario, it would not be unusual for the contractor to be owed money for work performed prior to the lender's succession to the project. It is very difficult to motivate a contractor to work when it is behind on payments. However, generally the lender will have already disbursed loan proceeds for the prior work, even though the owner may not have applied payments to the contractor, as directed by the loan documents. If the lender is required to pay the contractor the delinquent payments, it will disburse additional loan proceeds for work which was ostensibly already covered by prior draws.

One compromise to this thorny problem is to allow the contractor to retain its rights against the owner notwithstanding the owner's removal by the lender. This can mean legal action against the owner, but should not include other remedies under the construction contract, such as work stoppage. Another compromise involves more wisdom on the lender's part. The lender does have mechanisms in place to monitor somewhat the application of draw proceeds. A wise lender knows that the contractor needs to be paid for work performed, regardless of the owner's failure to pay, and might agree to make the contractor whole even though it means making additional, unanticipated proceeds available. The lender presumably has rights against the owner, personal guaranties, and in some cases, payment bonds, to assist in cost recovery. A preferred approach however would be for the lender to pay the contractor only for work done at the lender's request.

The contractor can furnish the lender other agreements as well which are equally pertinent. These agreements may include:

1. Notification of owner defaults, which gives the lender time, and leverage, to prepare for taking over the job or to pressure the owner into making payment;
2. Notification of required or requested changes in the construction contract, which can increase cost and time and may not be incorporated into the budget or construction schedule.

An example of a contractor's consent to assignment and agreement is as follows:

[LETTERHEAD OF GENERAL CONTRACTOR]

_____, 2005

Regional Bank
Atlanta Real Estate Division
400 Lakeside Commons, Suite 400
5436 Peachtree Dunwoody Road, N.E.
Atlanta, Georgia 30328
Attention: Michael O' Callahan

Re: Construction of 44,000 square foot office building near Ft. Lauderdale International Airport, Ft. Lauderdale, Florida (the "Project")

Ladies and Gentlemen:

Under an agreement with Office Developer of Ft. Lauderdale, Inc. (the "Borrower"), dated _____, 2003 (the "Contract"), _____ (the "Company") has been employed to provide general contracting services in connection with the construction of the Project, all in accordance with plans and specifications prepared by _____.

In consideration of your closing a construction loan (the "Loan") for the construction of the Project and as an inducement to you to do so and to make advances thereunder, the Company (A) consents to the conditional assignment of the Contract to you for the purpose of allowing you to administer and enforce the Contract as the "Owner" thereunder in the event of any default by the Borrower under or with respect to the Loan, and (B) agrees that in the event of any default by the Borrower under or with respect to the Loan, the Company will, upon your written request, provide continuous performance under the Contract provided that the Company is compensated as provided in the Contract for all services rendered at your request pursuant to the Contract.

The Company further agrees that in the event of any default by the Borrower under the Contract, the Company shall give written notice of such default to you at your address above, or at such other address as you may from time to time by written notice to us designate, and that you shall have the right (but not the obligation) to cure any such default on behalf of the Borrower for a period of thirty (30) days from the receipt of such notice of default.

The Company further agrees that without your prior written consent it shall not (a) amend, alter, change, or add to the plans and specifications pertaining to the Contract in any material respect or any respect involving a cost or savings greater than \$5,000 in any instance or \$25,000 in the aggregate, or (b) make or agree to any material changes in the terms of the Contract or the scope of the work to be performed thereunder. The Company acknowledges and agrees that if you elect, in the event of any default by the Borrower under or with respect to the Loan, the Company will complete the construction of the Project pursuant to the Contract and in accordance with the plans and specifications approved by you, with only such material changes in the Plans as you have expressly approved or may expressly approve.

Nothing herein shall be construed to impose upon you any duty to see to the application of the proceeds of the Loan by the Borrower, and the Company further acknowledges that you are obligated under the construction loan agreement respecting the Loan only to the Borrower, and that the Company is not a beneficiary thereof. The Company has executed this agreement to induce you to make the Loan and to advance funds under the Loan to the Borrower and the Company understands that you would not do so without the Company's execution and delivery of this agreement.

Nothing in this agreement shall limit the right of the Company to enforce its rights to payment under the Contract against the Borrower for work done by the Company on behalf of the Borrower.

Sincerely,

(Construction Company Name)

By: _____
Title: _____

Lien Waivers and Subordinations. Since all of the third-party professionals are performing work prior to closing, which work generally gives rise to inchoate lien rights affecting the secured property, lien waivers and/or subordinations should be required and obtained. Some jurisdictions have laws which prohibit prospective lien waivers, and if

so, lien waivers for work to date, prospective lien subordinations for future work, should be obtained. It is not unusual for some of these professionals to be owed substantial sums at this time, and conditional waivers or subordinations, requiring payment as a condition to the lien waiver or subordination, are acceptable, as long as payment of the stated amount is made at or prior to closing.

Practical Considerations. When the loan process begins, the owner will begin to assemble the array of pre-closing due diligence required. The earlier these items are delivered to the lender and its counsel, the smoother the closing process will be. Early delivery helps ensure that any issues will be uncovered with less anxiety than would be the case if uncovered just before or at closing. Many borrowers deliver the array of third-party documents directly to the lender, assuming that the lender and its construction consultant will review the documentation in the same light as the closing attorney, which is not the case. Having numerous sets of eyes look at the same documentation provides differing perspectives, and uncovers different issues, which help assure that the process will be smooth and accurate.

Many of these third-party professionals are not adept at reviewing the lender's pre-closing documentation. The closing attorney should present herself or himself as open to discussion on the issues, and initiate conversation if there is any hesitation by the professional to execute the documentation. The attorney should convey an attitude of someone who is part of the team, not an obstructionist, by stating that the documentation is not designed to impose liability, but only to reveal issues that may not be otherwise apparent from the plans and specifications. As such, revision of the pre-closing documentation should be assisted. Such assistance can often times vitiate the need of the professional to include its own counsel in reviewing the documentation.

Analysis from Lender's Inspector. The lender's inspector usually is a professional who has been in the construction industry as an engineer or an architect, and has the responsibility for oversight of the construction project from start to finish. The inspector is the lender's eyes and ears on the ground. He will review the initial plans and specifications in conjunction with the construction budget and provide a general opinion as to the ability of the project to be completed within budget on a line item by line item basis. The inspector begins by receiving a complete copy of the plans and specifications, and a copy of the construction contract, which should be accompanied by a budget. The inspector will also make periodic visits to the construction site and converse with the job superintendent and other contractors on the job as part of the draw request process. As each draw is requested, the inspector may be asked to insure that the project is doing well, qualitatively and quantitatively, within budget, and can be completed with remaining loan funds, and that the work which has been claimed to be finished is in fact work in place. If not, an additional equity infusion may be required from the borrower. The inspector receives copies of various field tests and analysis and daily reports and logs, including geotechnical tests. A good inspector will initially review the status of project approval from the several governmental agencies which might be involved. Governmental involvement varies from locality to locality. The inspector insures that the project is being constructed in accordance with all applicable governmental codes,

ordinances and regulations, and in accordance with the plans and specifications. The inspector also tries to determine the location of utility lines and drainage which is necessary for the project to operate after completion.

Payment and Performance Bonds. Many projects require that the contractor be “bonded,” and require as a condition to closing that a bond be issued in favor of the lender, usually pursuant to a so-called “dual obligee” rider to a payment/performance bond. Contractors usually will not object to a bonding requirement because the cost of the bond will be included in the contract price. Owners, however, will resist the extra cost, and might try to limit bonding requirements to major subcontractors, being those whose contract price is in excess of a threshold, usually in the hundreds of thousands.

1. The payment bond guaranties the payment of sums due under the construction contract to potential lien claimants. State lien law should be reviewed with the terms of the payment bond to make sure that the owner is covered (and lender, as “dual obligee”) as well as second and third-tier subcontractors who may not have direct privity of contract with the contractor.

2. The performance bond guarantees performance of the work. If issued separately from the payment bond, for the full contract sum, it should provide coverage for full performance regardless of cost (if both are written on the same document as a “payment and performance” bond, effective coverage may be limited to the amount of the payment bond). The performance bond does not guaranty the completion date or payment of delay damages, or penalties or claims by third parties. Therefore, it should specify how much time the surety has in which to respond to a default by the owner.

3. Be careful of circumstances that might cause an inadvertent waiver of the surety’s obligations. Under some states’ law, a change in circumstances that increases a surety’s risk can release the surety. The bond should contain an express waiver of notice of these changes, which include:

- (a) Changes in material terms of the contract;
- (b) Changes in payment terms;
- (c) Extensions of time; and
- (d) Changes in developer’s ownership entity.

Also, in some states, a discharge of the principal, as might occur in bankruptcy, might allow a discharge of the surety.

Appraisals. For internal auditing and governmental regulation purposes, nearly every construction loan will require, in advance, an appraisal, prepared by a qualified, bank approved appraiser, indicating that the value of the improvements, as completed, will be high enough to support the underwriting criteria of the lender. You might find loan amounts defined in terms of “loan to value” or “loan to cost,” in each case indicating that the amount of loan proceeds available for construction will be not more than a specified percentage of either the total value of the contemplated improvements or of the

total cost. The appraisal may seem like a speculative venture because no one has a perfectly crystal ball in which to gaze and verifiably arrive at a future value.

It has been said “ask for the appraisal you want and you shall receive,” meaning that appraisals have a knack of uncovering the required appraised value to support loan amount regardless of the circumstances. While there is some truth to the notion that appraisals often support underlying loan value requirements, it is not true that they are always on target. If an appraisal is delivered with a low value, the borrower will be asked to contribute more equity, either in the form of cash or other collateral, or in the form of deferred fees contained in the loan budget to lower the actual amount of loan which may be disbursed until higher project value is attained.

Appraisers generally employ three methods: The “cost” approach, the “income” approach and the “market” approach. The appraiser is generally asked to reconcile the differing values obtained using each of these methods to arrive at a truer value. The cost approach uses the anticipated costs of constructing the project as the basis for value. One problem with the cost approach is hidden or soft costs which can inflate the cost without really add to true value. These costs may be development fees, professional fees, or overhead and profit.

The income approach uses presumed income following presumed lease-up and stabilization, and derives value based on capitalization rates (“cap rates”) which institutional investors might use to estimate returns on investment if the project were purchased for cash. For example, if the institutional investor wants a 10%, cash-on-cash return on investment, and the project is generating \$200,000 of income a year, then the value of the project, using a “10-cap” rate, is \$2,000,000 ($\$200,000 / .10\%$). The market approach seeks comparable sales figures for projects in the same general vicinity and similar to the project being constructed. Appraisers have a network of information which allows them to closely derive income figures from those of similar projects. Using these sales figures, and with knowledge of the income produced by each project, the appraiser can arrive at a capitalization rate of return, or “cap rate,” which can be used to market the project after completion. If the cap rate, as so derived, is lower than the market currently demands, then the lender will want to lower its exposure by lowering the amount of the loan, and thereby requiring more equity, as a condition to funding the loan. The rate of return expected by institutional investors is factor of market forces at the time, such as the Treasury bill rate, interest rates, bond rates, and stock market activity. A good construction lender may focus on the “income” approach from a good, well-placed appraiser. The lender may then look at comparable sales and change certain assumptions when calculating different financial scenarios, like increase the vacancy to lower income or change interest rates to increase debt load. The disadvantage of using “cap” rates to determine market value is that they may fail to take into consideration property-specific issues, like life expectancy of materials or condition of the property. Also neglected in this approach is any expected appreciation of the asset, the risk inherent in the transaction, which is higher with shorter-term leases or non-credit tenants, and the leverage that is obtainable by financing a portion of the purchase price.

Project Budget. The project budget is an overall budget of the entire project cost, from start to finish. It is distinguished from the construction budget, which includes only those expense items which involve actual construction. The budget is ideally segregated into its various components or “line items” which permits more detailed analysis. Budget items may be further divided into “hard” costs and “soft” costs. Hard costs are those costs which are associated with materials and labor used in the improvements, such as concrete, plumbing, steel, and brick. Soft costs are other fees and charges not directly related to actual construction, such as permit fees, attorneys’ fees, title insurance charges, loan origination fees, and development fees.

The construction budget given to the lender and the construction contract price must be reconciled. If the construction contract has a stipulated sum which is in excess of the amounts contained in the construction budget, the loan will be troubled at inception. If the construction contract is a “cost plus fee” contract, the budget may provide insight, but will not be guaranteed by the contractor. Similarly, if the construction budget does not have line items for matters which are not included in the construction contract price or its allowance, the budget may likely be lower than needed. For example, most construction contracts exclude costs associated with rock and unsuitable soils. If the construction budget does not contain a line item for the possibility of these extra costs, either specifically itemized or otherwise covered with the contingency line items, then problems may arise which require additional equity from the borrower.

The following is a relatively simple, comprehensive budget for a townhome project to be developed in four phases, with site development for the entire project being funded in the first phase loan:

Loan Amount:	Land (four phases):	\$ 5,300,000
	Site Development (four phases):	2,400,000
	Hard Cost (site, commercial, Phase I):	8,800,000
	Soft Cost (close, commercial, Phase I):	<u>2,200,000</u>
	Total:	\$18,700,000
	Less: Up Front Borrower Equity:	<u>(3,600,000)</u>
	Net Loan Amount-Phase I:	\$15,100,000

You will note that the “loan to cost” is 81%, that is, the lender is requiring the borrower invest 19% as equity, with the lender funding the balance. The specific costs associated with each line item are not broken out, which makes analysis by the attorney more difficult. However, in this case, the construction consultant hired by the lender had access to all line item costs and verified their accuracy. The line item for land was the acquisition cost for the land purchase, which needs to be analyzed for hidden items which might deflate value, like commissions to the purchaser or its affiliates, or purchase money financing.

The following is a more comprehensive budget of the overall development broken out by total cost and by per square foot cost:

	Cost/SF	Cost
Property Acquisition	\$20.34	\$6,000,000
Building Construction	\$77.97	\$23,000,000
Permits, Taxes, and Fees	\$0.92	\$270,622
Management and Overhead	\$1.02	\$300,000
Development Fee	\$5.08	\$1,500,000
Hard Cost Contingency	\$2.52	\$743,798
Architecture, Engineering	\$2.71	\$800,000
Insurance	\$0.86	\$255,000
Marketing & Sales	\$8.47	\$2,500,000
Legal and Accounting Costs	\$0.59	\$175,000
Financing Costs	\$10.17	\$3,000,000
Soft Cost Contingency	\$1.02	\$300,000
Total	\$129.08	\$38,078,161

Note the inclusion of both soft cost contingency and hard cost contingency line items.

The following is a general budget for a high-rise office project accompanied with parking deck and acquisition budget items:

Debt Structure	%	Total Project	Deck Loan Budget	Office Loan Budget
Land	8%	\$3,450,000	\$3,000,000	\$450,000
Site Work	3%	\$1,292,000	\$1,290,000	\$2,000
Office Hard Cost	37%	\$16,000,000		\$16,000,000
Parking Deck Cost	18%	\$7,900,000	\$6,500,000	\$1,400,000
Const. Contingency	1%	\$500,000	\$350,000	\$150,000
TI Allowance	14%	\$6,325,000	\$0	\$6,325,000
Soft Costs	19%	<u>\$8,154,000</u>	<u>\$1,800,000</u>	<u>\$6,354,000</u>
Loan Amount	60%	\$26,172,600	\$7,764,000	\$18,408,600
Cash Equity at Closing	40%	<u>\$17,448,400</u>	<u>\$5,176,000</u>	<u>\$12,272,400</u>
Total Costs	100%	\$43,621,000	\$12,940,000	\$30,681,000

Finally, the following is a budget for development of a small industrial office site:

Purchase Price	650,000	
Survey	7,950	
Environmental	6,750	
Appraisal	3,500	
Title & Recording	5,000	
Legal & Accounting	10,000	61,000

Financing Fees	12,820	
Sitework & Site Planning/Design	61,000	10,000
Sales Commission	39,000	10,000
Tenant Improvements	10,000	<u>37,300</u>
Leasing Commissions	10,000	118,300
Interest Reserve	37,300	
Miscellaneous Operating Expenses	1,845	522,700
Total Cost	855,165	
Less: Equity	214,165	118,300
Net Loan Proceeds	641,000	

The hard costs items are contained under the “Sitework & Site Planning/Design.” Note the many “soft” cost budget items, such as title, survey, commissions and interest, and the absence of a contingency line item.

Some budgets are further delineated by breaking down the items into components. A construction line item might have sub-categories for steel, concrete, masonry, framing, and other work items. Most construction loan agreements will require that the borrower adhere to the budget and to the line item components contained in the budget. If a line item is exceeded, and the contingency is not available, then the lender will want the leverage to require the borrower to inject additional equity to cover any shortfalls. Conversely, the borrower will want the lender to allocate any costs savings in one line item to cost shortfalls in another line item.

Construction Schedule. The construction schedule is a timeline of activity anticipated to occur during the construction process. It typically takes the form of a bar-graph, showing the various stages of construction at the time they are anticipated to commence and conclude. This allows the lender to monitor the course of construction. If the developer does not adhere to the construction schedule, it may reveal early in the construction process problems which are occurring that could impact the completion date, cost of completion, and the commencement date of underlying leases. Failure to adhere to the schedule should be a default under the construction loan agreement. Sometimes on smaller transactions, there is not a printed construction schedule and construction is tied to a completion date. In such cases, the construction loan agreement should provide an event of default occurs if the lender in its reasonable discretion determines that the project will not be completed prior to the completion date.

Activity	Duration	2nd QTR 2005		3rd QTR 2005		
		May	June	July	Aug	S
	38 weeks/266 days					
Site mobilization	2 weeks		XX			
Site demolition	3 weeks			XX X		
Site grading	5 weeks			XXXX	XX	
Utilities	2 weeks					XX
Paving	2 weeks					XX
Foundations	5 weeks					
Framing	5 weeks					
Insulation and drywall	4 weeks					
Cabinets and trim	4 weeks					
Paint	4 weeks					
Completion	2 weeks					

Permits. The process of obtaining a permit is unique to each locality. It usually involves an initial inquiry by engineers and contractors with the local jurisdictional development authority, building department or zoning department, perhaps with the delivery of a preliminary set of plans. The governmental authority will likely request modifications, which are then incorporated into the plans and resubmitted to the authority for approval. Certain modifications may be objectionable and resisted by the developer. For instance, the requirement for construction of on-site detention facilities may involve excess cost not contemplated by the budget or may encroach upon usable acreage which would otherwise be available for vertical building improvements. Other examples include tree arborist requirements that large caliper trees be planted, or retained, during development, or department of transportation requirements that acceleration and deceleration lanes be constructed along the entrance fronting a busy right-of-way. The developer may have to sort through these and other development requirements imposed by the authority, and determine whether to contest the requirement based upon time and money factors.

Many lenders require that the building permit be issued prior to loan funding. This may present a practical difficulty when the cost of the permit is high and is to be funded out of loan proceeds. One compromise is for the professionals to issue letters

indicating that all requirements for the issuance of the permit have been fulfilled, except payment of the fee. A lender will usually agree to advance funds for closing, as long as the permit is obtained expeditiously thereafter. As with any other closing requirement which is delayed, additional funding may be withheld until delivery.

There are several different types of permits, depending on the county or municipality involved. Each development department has its own requirement. These may include sewer permits, grading or land disturbance permits, tree permits, wetlands permits from the Army Corp of Engineers, building permits and curb-cut permits.

If the property contains wetlands, or certain streams which might be entitled to Federal protection, the borrower may have to engage in a lengthy process of evaluation by an engineer and application with the appropriate governmental agency for permission for its development.

Curb-cut permits entitle the owner to actually “cut” the curb along the adjacent right-of-way for the driveway or roadway to the development. Certain state or county road authorities will grant this right at the time of the review process and no actual “permit” is required. The concern is that the driveway must be within the parameters established by the government for safety and traffic flow, such as the requirement that the driveway not be too close to an intersection. Some roads are condemned with “limited access rights” such as on some State highways to allow faster traffic. The governmental authority might require acceleration and deceleration lanes as part of the process, which takes acreage and may impact the size of the improvements which can be construction, thereby affecting cash-flow projections.

Contrary to widely held belief, the issuance of a building permit or certificate of occupancy does not ensure that the proposed plans comply with the zoning code. Governmental officials make mistakes or overlook difficulties during construction, without realizing that the project is not in compliance with zoning. Developers often wave plans and specifications with an “approved” stamp or a building permit as proof of compliance. The lender is advised to seek independent verification of zoning compliance through its own inspection procedure.

Leases. Construction of new or refurbished premises usually involves approval by the tenant of plans and specifications and completion of space within a specified time frame. Failure to obtain tenant approval to plans in such a case is an oversight that may impact the construction lender’s willingness to close the loan. However, the failure can be remedied in the tenant estoppel. Late delivery can result in penalties, abated rent, or in a worst case scenario, lease termination. In some cases, the developer might also agree to pay holdover rent incurred by the tenant in its existing location.

The lease will likely refer to an estimated completion date, failing which the landlord incurs no penalties, unless delivery is delayed beyond an “outside” completion date, whereupon penalties ensue. Delays caused by the tenant usually further extend the

outside completion date, but force majeure usually does not. It is therefore important that the construction schedule contemplate possible rain delays or other force majeure.

In the construction context, interest rates generally fluctuate, and if delays occur during periods of time that interest rates rise, the developer will incur interest costs that may not be reflected in the budget, and which may increase the cost of construction. It is therefore sometimes appropriate to include a rent modification provision, providing for increases in rent based upon increases in the interest rate. Reductions in rent are naturally not recommended.

Completion, and acceptance of the premises by the tenant are usually key events triggering the commencement of rental obligations. Landlord's should be somewhat hesitant to have rental commence upon tenant acceptance because acceptance might be delayed based upon subjective factors. A better practice is to provide for a walk-through following substantial completion, during which time a punch-list is prepared for completion by the landlord either within a short time frame, or as soon as practicable. The punch-list might be limited to items which do not materially impact use of the premises for business operations, or merely to cosmetic items.

Most parties will agree to an objective standard for determining "completion," such as the issuance by the architect of a certificate of substantial completion, and/or issuance of a certificate of occupancy by the applicable governmental authority. Temporary or shell certificates of occupancy may be initially available, pending completion by the tenant of tenant improvements. In such a case, the lease should provide that the landlord's construction obligations are complete upon delivery of the shell certificate of occupancy.

Common practice is to set forth the landlord and tenant obligations on a "work letter" which is either an exhibit to the lease, or accompanies the lease. Time periods for approvals of plans and various stages of the landlord's work may be specified, and the letter may include procedures for resolving disputes. It may also contain a mechanism for changes in the plans, initiated by the landlord or the tenant. It is important to include a provision that changes in the plans initiated by the tenant must be accompanied by payment in full of the additional cost associated therewith. If such additional cost is not paid in advance, the landlord may have no source of funding without a loan modification. At a minimum, the provision gives the landlord leverage to negotiate change orders and therefor time to request and obtain additional loan funds. A combination of payment in advance or rent increases may be the final outcome of these negotiations.

Other items that may be included are designation of a tenant representative with authority to bind the tenant, inspection rights of the tenant, and providing for tenant benefit of any contractor or third-party warranty obtained in connection with the construction.