

TIPS ON CONSTRUCTION LOAN PROCEDURES

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PRIOR TO CLOSING

1. Carefully review the documentation prior to closing. You cannot change the deal after it is closed.
2. Prepare a checklist and complete it. This will make it easier to check for performance of assigned tasks by all parties. The checklist should include all relevant documentation and who is responsible for providing each document.
3. Do the budget analysis with an eye toward seeing that the job can be completed within the budgeted amount. Watch for front loading of the budget by putting extra amounts up front and less at the end. There is a danger that there will not be enough money to complete the project. Spot front loading by comparing budgeted percentages to standard percentages.
4. As part of the document preparation checklist, specify the detail of the breakdown of work descriptions for the American Institute of Architects (AIA) G-702 requisition form. Do not allow the contractor to submit a draw request for concrete work alone. Require a breakdown of ready-mixed concrete, rebar, forming labor, finishing labor and so on.
5. Circulate the checklist and documents to all sides of the transaction before closing.
6. Pay particular attention to the soft costs in the project. Hard costs should stay within standard percentages depending on the type of project and construction methods used. When reviewing the construction budget, the percentage of construction costs going to specific hard costs categories should be compared to the standard percentages.
7. Determine whether the project will be completed for the amount specified in the construction cost estimate. Note the disclaimers in the certification by the inspecting engineer that the project can be completed within the cost estimate.

THE ARCHITECTURAL CONTRACT

8. The architectural contract should be reviewed with particular attention to the rights and duties of the owner and architect, and their compliance with contractual obligations.

9. The basic services to be provided in the preliminary consultation phase, design phase, bidding or negotiating phase, and construction phase should be reviewed. Any additional services to be provided should also be reviewed.

10. The commencement and termination provisions should be reviewed.

11. The ownership of all drawings and documents should be determined. The plans should be assigned to the lender in the event the lender must complete the project.

12. The dispute resolution and insurance provisions should be reviewed.

13. Be familiar with the AIA forms for construction contracts.

a. Lump Sum Contracts. The contractor bids for the whole amount of the contract. The contractor takes the risk of overruns, except for change orders. The contractor keeps the savings, if costs are under the bid amount. The advantage here is that the owner and developer know the costs up front. The disadvantages include: over-confidence regarding cost control; bid amounts are usually inflated; contractors are encouraged to use inferior materials and workmanship; contractors are reluctant to give solid numbers up front; the creditor and the owner are not in control of the project; and there are frequent change order problems.

b. Cost Plus Percentage or Set Fee Contracts. Sometimes these contracts have a guaranteed maximum amount. They are often used in renovation projects because the developer does not know how much work will be required until work has commenced. The advantage here is that they can provide quicker start-ups. The disadvantage is that they lack incentives for cost containment by the contractor. These types of contracts are frequently used by excavation subcontractors.

c. Guaranteed Maximum Price. This is the most common type of construction contract. Change orders will raise the maximum price. The disadvantage is that the guaranteed maximum price can be inflated. It is important to define savings and how much savings will be used. In other words, if the contractor is able to complete the project for less than the maximum price, the use of the savings must be specified in the contract.

d. Construction Management Contracts. These contracts are often referred to as value engineering contracts. The owner pays a fee, usually a percentage of the construction costs, for a person knowledgeable in construction to attempt to make cost savings in the construction. The construction manager is often the owner's on-site representative.

14. Look at the key elements in construction contracts.

a. What does the contract price include and exclude?

- b. When does the project start and finish? Is there enough interest reserved to cover the construction period?
 - c. How and when is retainage paid?
 - d. What are the savings provisions and how are savings split?
15. How is the contractor going to be paid? What are the cutoff dates, billing dates and payment dates? All payment, completion and retainage provisions should be reviewed.
16. Specify who pays for what types of insurance including builder's risk and liability insurance.
17. Review the contract for default and termination provisions. How can the owner and contractor back out of the contract?
18. Review liquidated damages and incentive provisions in the construction contract.
19. Review the construction contract for assignability by the contractor. Determine whether the contractor can assign the contract to another contractor without the owner's consent.
20. Do the homework of checking up on the contractor and construction manager. Are they usually on time, within budget, experienced, credit-worthy and with good references?
21. Consider obtaining the AIA qualifications statements from the contractor. This will indicate the size and types of projects the contractor has completed.
22. Review mechanic's lien provisions and subcontracting arrangements.
23. Review the status of plans and specifications at the time of completion of the contract. If the drawings are not completed when the contract is signed, it is likely that there will be significant change orders.
24. Check for site protection and security provisions, especially for stored materials.

CHANGE ORDERS

25. Change order provisions should be explicit and detailed in order to minimize this common source of problems. Change order procedures should be clearly specified in advance of closing. A contractor has based the contract on information available at the signing of the contract. Any change in specifications may entitle the contractor to a change order. Other reasons for change orders include the following:
- a. The owner may request the elimination or change of some feature in the building.

- b. Unforeseen delays may require additional time to complete, i.e. strikes, shortages.
- c. Incomplete plans and specifications at the signing of the contract may result in design changes.
- d. Value engineering change orders may be made at the suggestion of the construction manager.
- e. Tenant requested changes may result in design changes. Hotel operators are frequently requesting change orders.
- f. The weather may cause delays or may be a reason for expediting construction.
- g. Governmental regulations may delay construction.
- h. Errors or omissions in the design or construction work may result in more work.
- i. Field conditions, such as rock levels, may result in higher excavation costs.
- j. The need to speed up the project, for external reasons such as securing a marketing niche, may result in higher labor costs.

26. When reviewing change orders, keep an eye on the interest reserve and any possible delay in refinancing. Costs for change orders should come out of the loan contingency, which is the owner's money, not out of the contractor's contingency built into the contract.

27. Change orders should be written documents signed by all parties. They should not be oral. Change orders should be within the general scope of the work. They should not change an office building to a hotel building. That is not a change order but a new contract. Any cost of time adjustment must be specified in the change order.

28. Sources of payment for a change order include the following:

- a. The hard cost contingency in the loan. Soft cost savings can be credited to the hard cost contingency for additional change order funds.
- b. Additional owner's equity.
- c. Increased Debt. The loan amount can be increased or a second mortgage could be allowed.

29. What is the loan to value ratio? Can it support a higher loan to cover contingencies and change orders? Note this at the outset of the loan.

30. Documentation for change orders should include:

- a. An executed change order;
- b. A revised plan;
- c. A revised cost estimate.

31. Avoid cost overruns in change orders by:

- a. Paying for good plans and specifications;
- b. Employing reputable architects; and
- c. Using a reasonable time frame for completion of the project.

CONSTRUCTION PROGRESS INSPECTORS

32. Consider construction progress inspectors. These are generally engineers or architects. Select a progress inspector depending upon their knowledge of the construction process and their knowledge of how construction processes are related to lending.

33. Construction inspectors can be a buffer between the creditor and borrower. The inspector can be the designated bad guy. When there are many participating lenders, it may be desirable to have one person responsible for progress inspection.

34. Construction inspectors should be able to help advise the creditor on how to control the flow of funds to a job to keep progress efficiency. Either too great or too little cash flow can be detrimental to the project.

35. The checklist for an internal or external construction progress inspector should include:

- a. Defining the scope of the project.
- b. Pre-closing review of plans and specifications.
- c. Checking for square footage, counting the number of units, parking spaces, zoning requirements, counting the number of floors, reviewing the loan commitment, reviewing building code adherence, checking soil tests and checking utilities.
- d. Checking that architectural plans and specifications are assigned to the creditor so that if the creditor needs to complete the project, a new set of plans will not have to be purchased.

The construction contracts and subcontracts should also be assignable to the creditor in the event the creditor needs to complete the project.

e. Checking environmental issues, specifically looking for asbestos in rehabilitation projects, and soil and ground water contamination in sites where hazardous substances may have been stored.

36. Field inspections should include discussion of the work completed, explaining the reasons for delay, reviewing quality control procedures and reviewing requisition forms.

STORED MATERIALS

37. A common problem area is stored material. What provisions are there for payment of stored materials, particularly off-site stored materials? Suppliers and subcontractors may require deposits for the stored materials. A bill of sale should be obtained, and insurance on the items, if they are specific to the project. The items should be stored securely and distinctly.

38. Limit the amount that can be paid out for stored materials. As stored materials are installed, credit the stored materials account and increase the allowable future storage to the limit. In other words, if you set \$400,000 of the stored material limit, and \$400,000 of stored materials are in storage, when the contractor installs \$100,000 of the stored materials, \$100,000 of new materials may then be stored.

39. What type of stored materials should be paid for?

a. A \$10,000 deposit is requested to start weaving of carpet. This is a questionable advance deposit to make. It depends on the reputation of the weaver and the uniqueness of the carpet.

b. Money is requested for stored materials at the factory to make windows, i.e. sheet glass and aluminum frames not yet cut and fitted. Don't pay for these stored materials. They are too fungible. They might not end up in your project.

c. Prepayment is requested for pre-cast concrete pieces stored in the manufacturer's yard.

i. How are the concrete products to be delivered?

ii. What does the subcontract say, is it the same as the loan commitment?

iii. Obtain a bill of sale.

iv. Try to have the products segregated in the manufacturer's yard.

v. These items are not as fungible as glass sheets.

They may be specifically designed and manufactured for a specific project. These stored materials might be paid for with a deduction for delivery costs and erection costs.

BONDS

40. A performance bond is a promise to make somebody whole if the bonded party fails to perform. They are not often used in the private sector but frequently required by lenders.

a. Owner-builders are not likely to be bondable. However, subcontractors employed by the owner-builders may be bondable.

b. Many lenders have had a hard time collecting on bonds. For example, if the lender releases retainage too soon or doesn't monitor the loan closely enough, the bond company may have a way to avoid paying. When bond companies do pay, they may pay very slowly. Typically bonds cost about one percent of hard costs.

c. Lenders are typically more concerned about whether a contractor is bondable than about the bond itself.

d. Some lenders use letters of credit rather than bonds.

41. If subcontractors are not large enough to be bonded, an increase in retainage of up to fifteen to twenty percent may be desirable.

42. With a non-bondable subcontractor, consider paying the subcontractor weekly instead of monthly for more control, and so the subcontractor can pay his bills.

43. Keep the bond company informed at all times regarding retainage release so the bond is not lost.

MISCELLANEOUS TIPS

44. Some developers or contractors may attempt to put hidden costs into the general conditions and preliminary work. For example, overhead items which should be paid for by the developer or contractor, including new vehicles, might be billed to the owner.

45. A contingency reserve is suggested for both hard and soft costs. Typically, the reserve should be larger for renovation than for new construction, because problems may be uncovered during the renovation process. Increase contingency reserve for poor documentation, unfamiliarity with the site, or unfamiliarity with the contractor, developer, architect, or other parties.

46. Get a foundation survey before paying retainage on foundation work. This will help identify encroachments and set-back problems. Get an as-built survey at the completion of the project

to facilitate title insurance and refinancing.

47. There is commonly a holdback for rental achievement in commercial office buildings, apartments, and commercial and retail malls.

48. Review lien waivers to see if the numbers referred to in the current month's lien waivers correlate with the previous month's draw.

49. Review the punch list prepared by the architect. The punch list describes what items are not properly completed. The creditor should review the punch list to see if there is enough retainage.

50. Review the certificate of occupancy and building permits.

51. Keep the take-out lender informed of delays and cost overruns so the take-out lender will not back out of its commitment. You must balance between making the take-out lender too nervous, by telling them every little problem, and keeping them under-informed so that they will be surprised and consequently want out of the deal if the project is not completed on time for the take-out.

52. Pay close attention to the four most common problem areas:

1. Soft costs;
2. Change orders;
3. Stored materials; and
4. Retainage.

53. Differentiate between material defaults and technical defaults. For example, allowing the hazard insurance to lapse is a material default. The project could be a total loss if there is a fire or storm. However, if concrete doesn't reach design strength after 24 hours, or if the foundation survey indicates a one-inch encroachment, it is unlikely that a total loss will result. Concrete test strength can be increased by control of the 28-day hydration process, after which full strength is achieved. Adjoining land could be purchased to eliminate the encroachment, or title insurance obtained insuring against loss or damage to the encroachment.

