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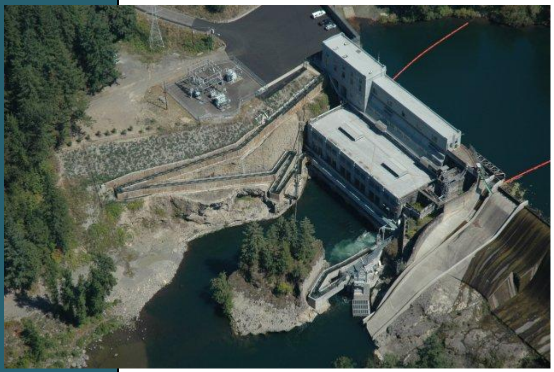
Guide to Construction Financing

Second Edition



AGC of America

THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

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ACKNOWLEDGEMENTS

The AGC Guide to Construction Financing was originally written in 1999 by Gary Humes, an attorney with AGC of America associate member law firm Arnold & Porter LLP, Washington, DC. The 1999 Guide was a product of the AGC Construction Financing Committee.

In 2009, AGC of America created a Construction Financing Guide Task Force in order to update the 1999 Guide. The following is a product of this Task Force.

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INTRODUCTION

Why should contractors care about construction project financing?

One of the major hurdles that almost any owner faces in a construction project is financing the construction and other development costs. More and more, contractors are finding themselves involved in the financing process. Indeed, complete lack of involvement is almost impossible to avoid on today's projects. The owner may look to the contractor for anything from "free" pre-construction services (a form of "soft money" financing) to direct equity investment in a project. Lenders, endeavoring to reduce financing risks, will look directly to the contractor for various assurances, certifications, and agreements regarding the construction of the project and its completion. Contractors, seeking new business opportunities or higher profits, will on occasion participate directly in the financing or development of a project.

A construction loan is simply a loan made on the security of a real estate mortgage (and perhaps other collateral), the proceeds of which are disbursed periodically (usually monthly) to pay the hard and soft costs of construction. They can be among the most complex real estate loans (compared to land acquisition loans or permanent loans, for example), and intimately involve the activities of the construction contractor. Understanding construction financing can help a contractor provide additional value to its clients and enhance its competitive position. Involvement in the financing process, however, is fraught with risks, which a contractor must understand if it is to protect its profitability.

This Guide explains the construction financing process, and points out some of the opportunities and pitfalls for the contractor.

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1. SOME MORAL TALES

The brief scenarios below illustrate some of the opportunities and pitfalls associated with the construction financing process. The scenarios are based on actual incidents, although they have been simplified and modified for our purposes.

A. The contractor as investor

A small contractor was looking for opportunities to expand its business. It was introduced to a developer with a few small projects under his belt, whose next project was to be in the downtown area of a nearby city. The project—a small mixed-use office and residential building on the edge of a growing office district—seemed to have great potential. The developer (whose day job was as a law professor at the local university) had already acquired the site and seemed to know the real estate business. A local bank was prepared to finance the project. Eager to land the job and seeing the possibility of greater profits, the contractor agreed to reduce its usual fee in exchange for a small equity interest in the project.

The contractor finished the project on time and on budget, and was paid the agreed amount, which was funded mostly by the bank. Unfortunately, the real estate market had cooled by the time the building was finished, and the developer never obtained a single tenant. The developer was unable to keep up payments on the loan or to obtain other financing, and the lender foreclosed. As the building was vacant and the market was down, the foreclosure proceeds were not enough to pay off the bank's construction loan.

Still seeking to be made whole, the bank sued its borrower for the difference. The contractor was surprised to find itself named in the complaint. Consulting with its lawyer, it found that the equity investment agreement that it had signed with the developer had made it a "general partner" of the owner/borrower—and thus fully responsible for repayment of the construction loan.

The contractor eventually settled with the bank, but not without incurring substantial legal bills and paying an amount to the bank far exceeding the contractor's fees on the project.

B. Read the contract

A contractor successfully completed several projects for a new client. When the next project came along from the same client, the contractor signed the same form construction contract without a thought. This time, the project ran into trouble, the owner missed two monthly payments to the contractor, and the contractor stopped work. The lender took over the project and the construction contract. Exercising its rights under the contract, the bank directed the contractor back to work and agreed to be responsible for future payments to the contractor. However, the bank declined to make up the two missing payments, saying that it had already paid the corresponding amounts to its borrower. The contractor read the contract carefully for the first time, and saw that it was not at all clear that the contractor was entitled to the skipped payments. Although the contractor and the bank ultimately reached a compromise on the matter, it was not without cost to the contractor.

C. Helping the owner obtain financing

A contractor and its client had worked together successfully on a number of design-build projects. This time, however, the client was unable to obtain financing as the project costs were too high. Discussing the matter with the client, the contractor agreed to change the project delivery method to Construction Management At-Risk, engaged in an extensive value engineering exercise without fee, re-phased the project to shorten the construction schedule by two months, and was able to provide the client—and the lender—with a guaranteed maximum price based on very preliminary design documents. The project was successfully financed and completed. The client was pleased, and the contractor earned a fair fee.

2. UNDERWRITING CONSTRUCTION LOANS

In determining whether to extend a construction loan, the lender will *underwrite* the borrower and the project. Underwriting is essentially an assessment of the borrower's and/or the project's ability to repay the loan, based on such factors as:

- The owner's creditworthiness
- The market feasibility of the project, and the likelihood that it will generate sufficient revenues (in light of its other anticipated capital and operating costs) to repay the loan as scheduled
- The value of any collateral, such as a mortgage, guarantees, or the like (discussed below)
- The qualifications and expertise of the participants, including the owner, architect, and contractor

Not surprisingly, in a construction loan, a key focus of the underwriting is on the construction and the contractor. The lender will carefully review the plans and specifications for the project, often relying on a third-party expert. Cost estimates will be carefully reviewed, especially if a construction contract has not been executed. If a construction contract is in place, it will obviously be helpful if it is on a stipulated sum or guaranteed maximum price basis. Lenders know that contractors and borrowers alike sometimes front-end-load the hard and soft costs of a project. The contract price and fees will be carefully evaluated, especially if the owner and contractor are affiliated with each other. Adequate retainage is essential, and any below market arrangements will be scrutinized carefully. Similarly, the lender will pay careful attention to both the contractor’s and the borrower's contingencies.

In the underwriting stage, the contractor should be prepared to help the owner address issues related to the contractor. Is the contractor bonded or bondable, or does it have access to a meaningful corporate or parent guarantee? Especially in busy markets, might it be stretched too thin? What other projects will it have under way at the same time?

How much recent experience does the contractor have with this type of project? And what is the particular experience of the contractor team being proposed for this type of project? If it is to serve its client well, the contractor should not only be prepared to answer these questions; it should actively assist the client in putting an appropriate package together that anticipates these lender concerns. There are other areas in which the contractor can help the client support its loan application. These include:

- Construction budgets and cash flow projections
- Construction schedule
- Qualifications of participants
- Selecting the project delivery system
- Establishing a reasonable GMP at an early stage in design
- Feasibility and constructability reviews
- Value engineering
- Demonstrating an ability to work with the design professionals involved in the project

The underwriting of the loan necessarily involves analysis as to the maximum amount the lender is prepared to loan for the project, at what interest rate, and for what duration. Construction lenders rarely loan 100% of a project's costs; rather, they require that the owner and/or its investors contribute some of their own funds to the project.

The ratio of the maximum amount of the loan to the total project costs is frequently called the *loan-to-value ratio.* Loan-to-value ratios are frequently 70% or less, and vary according to lender, the type of project, and other factors, and are one of the key benchmarks for underwriting the loan. Another underwriting benchmark is the *debt service coverage ratio,* or the ratio of projected cash flow (after expenses other than loan payments) to the amounts required to pay principal and interest on the loan on a periodic basis. Debt service coverage ratios always exceed a multiple of one, and a typical range might be from 1.2 to 1.6.

As part of its underwriting package, the lender will likely require *pro forma budgets* and *cash flows.* These *pro formas* will show the sources and uses of funds for the development of the project, as well as cash inflows and outflows on a monthly or other periodic basis.

If and when it is determined that it is prepared in principal to make the loan, the lender and the borrower will enter into a *loan commitment.* The commitment letter will set forth the basic terms of the loan, such as the amount, the interest rate, the repayment schedule, the collateral, and the like. It will also set forth some of the key terms of the loan documents and conditions to funding of construction draws, such as receipt of satisfactory appraisal, environmental reports, title insurance policies, land surveys, and the like. These conditions will also typically include review and approval of the construction contract.

It is important to keep in mind that:

- the construction company needs to act as an underwriter for the loan in order to assess the risk of the owners' financial health as well as the financial health of the lending facility.

- you may request copies of:

    - personal financials

    - credit reports

    - bank strength ratings (www.bankrate.com)

- you should:

    - pay close attention to underlying contractual terms.

    - understand the underlying strategy of the construction loan and how it is being financed and the game plan for repayment of the loan.

    - get your surety involved early and use them as the hammer for transparency of the loan information – it is not uncommon for the surety to request this type of information and typically it will remove the contractor from the line of fire if the surety is making it a requirement for bonding support.

- the construction company should use the same diligence and underwriting as a bank would use at the beginning—the construction company is lending money to the client in the form of work completed without payment.

- the contractor should make certain that the owner or someone on his or her team has sufficient experience in the project being considered. If not, it might be prudent to explore hiring an outside resource.

Red Flags

- Incomplete plans and specs

- Owner caused delays

- Payment slow-down or default

- Heavily layered financing with no strong lead

- Inexperienced owner

- Deferred development fees

- Change in lender involvement
- Changes in communication (owner becoming more distant)
- Adversarial posturing by the owner
- Reluctance towards transparency of financing
- Abnormal invoicing requests
- Cash infusion requests of the Contractor by the Developer/Owner
- Delays in approving/paying change orders

3. DEBT FINANCING

At a minimum, construction financing will involve at least three players—the owner, the lender, and the contractor. Beyond this, the situation can become very complicated as owners seek to lower their financing costs and achieve other objectives.

A. Sources of construction loan financing

Commercial banks and thrifts dominate many segments of the construction lending market. Especially for larger projects, construction lenders include foreign and domestic pension funds, insurance companies, and *real estate investment trusts (REITs).* For specific types of projects, federal, state, and local government authorities, such as the state and local industrial development authorities, housing finance agencies, the National Consumer Cooperative Bank and other agencies can play a significant role. *Mortgage brokers* frequently play a useful role in arranging financing.

B. The traditional construction loan

In its simplest and most basic traditional form, a construction loan consists simply of a bank lending money to a developer to construct a project. The basic terms of the repayment obligation are set forth in a *promissory note.* These terms include the *principal amount,* or total amount borrowed, the interest rate, and the repayment schedule, including the *maturity date* by which the loan must be repaid in full. For a typical construction project, the principal amount will significantly exceed the total construction cost, and will also include land acquisition costs and soft costs such as design and consulting fees, and financing fees.

- *Interest, principal, maturity date, and other terms of the loan*

The interest rate may be either fixed, which means that it is a specified annual amount (such as 10% per year), or it may be floating or variable, which means that it is periodically recalculated by the bank on a regular basis (such as monthly), by adding a specified amount to a specified index rate. A common index rate is the prime rate, which is a published rate that a bank offers to its more creditworthy customers. Most banks set their own prime rate and adjust it periodically. Despite its name, the prime rate is not necessarily the lowest rate that a bank offers; so most banks prefer the term "base rate" instead. This is the term that you will see more frequently in most modern loan documents. Other index rates include LIBOR, or the London Interbank Offered Rate, which is the rate at which banks make funds available to each other on the London interbank market. LIBOR is lower than the prime rate, and is frequently encountered in larger commercial projects. One might also encounter the federal funds rate as an index rate. The federal funds rate is the rate charged on overnight federal funds transactions by members of the Federal Reserve System.

The interest rate is computed from the index rate by adding a fixed margin specified in the loan documents. Most commonly, the interest rate will be specified as a certain number of basis points above the index rate. A basis point is 1/100 of a percentage point, so that 100 basis points equal one percent.

As projects under construction typically do not generate income (an exception would be the construction of a housing development, which generates income as houses are sold), interest on a construction loan will be accrued during the construction period. The accrued interest during the construction period (often called construction period interest) is therefore included in the amount borrowed and paid off after the construction period. In effect, the lender is funding the borrower's interest payments during the construction period.

Most construction loans involve little or no scheduled repayment of principal during the construction period. The rate at which principal is scheduled to be repaid is referred to as the amortization rate. A loan in which the principal balance is gradually reduced to zero by the maturity date is referred to as a fully amortizing loan. A loan that is not fully amortizing will have a significant portion of the original principal amount due and payable at the maturity date. This final payment of principal is often referred to as a balloon payment.

Because of the greater risks associated with construction projects compared to projects that are already completed and operating, construction loans typically bear relatively high interest rates, and are converted to permanent loans, which bear a lower rate of interest, when the project is completed. Thus, a large construction project might initially be financed with a three-year construction loan, to be followed by a 10-year (or longer) permanent loan when the project is complete.

Frequently, the permanent loan is pre-arranged at the same time as the construction loan, so that the construction lender will know that there is another lender ready to step in and pay off the construction loan when the project is complete. The permanent loan under these circumstances is called a take-out loan, or just a takeout. The obligation of the takeout lender to fund its loan is usually predicated on certain specified conditions having been met regarding the project.

A variation on the type of construction loan described above is a loan that covers not only the construction period itself, but also a brief follow-on period during which the project will lease up or otherwise achieve the anticipated level of normal post-construction operations, which may take a few years. Such a loan, which may have a term of 5-7 years or so (including the construction and follow-on stabilization periods), is called a mini-permanent loan, or *mini-perm.*

The promissory note merely sets forth the basic repayment obligation of the borrower. Provisions setting forth the lender's obligation to make construction period advances, the borrower's nonmonetary obligations during the term of the loan, and other matters are set forth in the *loan agreement.*

- *Mortgages*

In addition to being satisfied with the general creditworthiness of the borrower or the project, the lender will usually require additional *security;* that is, additional assurances of repayment beyond the mere promise of the borrower that is embodied in the promissory note. This security can take several forms, and frequently a single loan will be secured with multiple forms of security.

As construction projects involve real estate, a *mortgage* is almost always employed as security. Also called a *deed of trust* or a *trust deed,* depending on the geographic location of the project, the mortgage is a separate document that is filed (or *recorded)* in the land records of the jurisdiction in which the project is located. Upon default under the promissory note or loan agreement, the lender is entitled to foreclose on the property in accordance with the terms of the mortgage and state law. The property is then advertised and sold to the highest bidder, frequently the lender itself.

Projects that are foreclosed in mid-construction or following construction, but before they are fully leased up or otherwise operating as intended, rarely, if ever, generate enough proceeds in the foreclosure sale to repay the loan in full. Depending on the terms of the loan documents and state law, the borrower may remain liable to the lender for any shortfall. In these instances, lien filings by the contractor may be too far down in the hierarchy to be effective in getting paid if there is simply not enough money to satisfy all debtors.

Therefore, try to get a 2nd mortgage position on the project. While it may not help if the project is underwater you will at least be ahead of general lien claimants if there is any money. Even a 3rd mortgage position might help. (This could possibly create unexpected liability however).

C. Single-purpose entities and guarantees

The owners of many real estate projects are *special-purpose* or *single-asset* entities established exclusively for the project at hand. These entities, as their names suggest, have no significant assets other than the project. These entities are established most frequently to insulate their owners from liability. They also protect the current project from being jeopardized should a common owner run into financial difficulties on unrelated activities.

The types of entities that are frequently employed as single-purpose entities for real estate projects include *general partnerships, limited partnerships, limited liability companies, and trusts.* In addition to liability concerns, the choice of entity is usually driven by tax considerations.

General partnerships are often not favored for real estate development projects because each general partner is personally liable up to the full amount of the partnership's obligations (and not just his or her *pro rata* share), including the full amount of any construction loan. This type of liability is called *joint and several liability.* This liability extends to the partners' personal assets, and is not just limited to the partnership's assets.

The liability of limited partners in a limited partnership (which will also include at least one general partner to manage its affairs), the members of a limited liability company, and the beneficiaries of a trust is limited to their share of the entity's assets—e.g., the construction project itself. Their personal assets are not at risk for the project beyond what they may have invested in the project.

Because of the limited liability nature of many of these special-purpose entities, construction lenders often seek personal *guarantees* from the owners or principals of the entity. Occasionally, the guarantees of others with an interest in the success of the project—including the contractor—are also sought. The purpose of these guarantees is not only to provide an additional source of repayment if the borrower defaults on the loan, but also to ensure that those on whose skills and financial wherewithal the lender is relying for the successful completion of the project have an economic incentive to remain fully involved. Most frequently, these guarantees are joint and several, are for the full amount of the loan (plus costs of collection), and last for the duration of the loan, although more limited guarantees are sometimes negotiated.

Lenders often obtain many other types of security, including the familiar payment and performance bonds. One that is frequently encountered is the *letter of credit.* A letter of credit is simply an agreement by a financial institution—usually a bank—to be responsible for the specified financial obligations of another. In effect, the bank is adding its credit to that of the borrower. For this, the bank charges an annual fee—typically one-half to 1-1/2%—and requires a countervailing balance in an account at the bank, or other security. One sometimes hears of loans as being either *recourse* or *non-recourse.* A loan is "recourse" if the lender has the right upon default not only to foreclose on the collateral, but also to look to the borrower and/or its partners or other principals for repayment. Conversely, a "non-recourse" loan is one in which either the borrower and/or its partners or other principals are not liable; the lender's only remedy is to the collateral and those to whom it has recourse. Construction loans are almost always made with full recourse to the borrowing entity, and frequently require guarantees or other recourse to its principal owners.

LLCs, LPs, and LLPs
Use extra caution with LLCs , LPs, LLPs.

- Get the social security number and names of all members of the LLC/partner/guarantors (this is important, but very difficult to get once challenges arise)

- Ask for personal financial statements from the principal members, etc. if an LLC

- Do credit reports, court record searches, and Universal Commercial Code (UCC) searches on the entity and its primary members. UCC fillings are require for securitized or collateralized transactions

- Get personal guarantees (but this is only as good as the character and financial strength of the members)

- Consult your attorney if asked to provide guarantees on the loan or to be a partner in the project

Public Private Partnerships (PPP)
A simple, although not universal, definition of a Public Private Partnership ("PPP") is that it is a contractual arrangement between a public sector agency and one or more private sector companies, usually formed to design, build, finance, maintain and operate a specific project for a determined period of time. PPPs combine the capital and expertise of the private sector with the management and oversight of the public agency to provide these services. PPPs can effectively finance, manage and operate projects, while minimizing taxpayer costs and risks. Although PPP's are not likely to replace traditional financing, it is generally recognized that they offer a long-term sustainable approach to improving infrastructure, enhancing the value of public assets, and making better use of taxpayers' money.

PPPs come in all sizes and types, which make it difficult to group them together into a single category. However, there are a few common characteristics which most PPPs share:

- It involves two or more participants, with at least one being public and one private.

- Each participant is a principle, capable of negotiating on its own behalf.

- Each participant brings something to the partnership.

- A partnership implies that there is shared responsibility for the activities and outcome.

A few practical ways to improve a project's chances of success include:

- Assurance that workable legislation is in place to entice private sector investments.

- Sound organization planning—technical and financial ability on the part of the investor.

- Promoters must be evident and their commitment to carry out the project must be unquestionable.

- Thorough analysis of the project's economic and financial viability.

- Avoidance of unreasonable risk allocation.

- Establishment of an effective project management structure.

For the contractor, success can best be defined as achieving an acceptable risk-weighted return within a satisfactory time frame. To accomplish this, the contractor must execute a disciplined and staged risk management process, and be willing to exit the process if the targeted return cannot be achieved. PPPs transfer risk from the public to the private sector. An appropriate risk transfer strategy needs to be developed as part of the planning process.

There are several web sites which provide resources to assist contractors who want to learn more about PPPs. These include:

- AGC of America – Public Private Partnerships (www.agc.org/ppp)
- Deloitte & Touche USA LLP – “Closing the Infrastructure Gap: The Role of Public-Private Partnerships” (www.deloitte.com)
- National Council for Public-Private Partnerships – “PPPs: A Contractor/Developer’s “How To” Guide” (http://ncppp.org/resources/papers/prieto_howtoguide.pdf)

Best Practices

- Know your owner/developer and the structure of your owner’s organization.
- Familiarize yourself with the “pay when paid” or “pay if paid” laws in the states in which you are conducting business.
    - The AGC State Law Matrix outlines state laws that may impact public and private construction projects including payment laws and the penalties for violations. This resource is updated annually and can be found at www.agc.org/statelawmatrix.
- Be a pure CM—let client hold the contracts instead of being at-risk—particularly if you operate in a pay when paid state (as opposed to a pay if paid) state.
- If there is a subcontractor that comprises a significant portion of the contract, consider having the owner hold the contract with that sub in an effort to reduce pay when paid exposure, if applicable.
- Be aware of “creative financing” practices.
- Be cautious of an owner’s request for upfront deposits from the contractor or “investments” in the project.
- Be careful investing in projects as part of the remuneration for the work to be performed.
- Know and understand the default terms within the loan documents.
- If possible, execute a pre-construction services document prior to moving forward with a contract. This helps to identify any potential problems prior to being contractually bound to the owner.
- Perform title or lien searches at the onset and periodically throughout the project.
- Consider researching the owners of the entity and the entity or predecessors for prior lawsuits or problems. Your attorney can assist with this.
- Be familiar with any land or property use restrictions that could impact financing on the project.
- Be familiar with the title company used and do some due diligence—make sure it is not a related entity to the developer or the owner.
- Within your company, you may need to have an enforcer behind the scenes to stick to policy on payment terms, contract terms, or confirmation of financing issues (many times you can utilize your bonding company very effectively as your enforcer).
- You should always request open access to all loan documents and full transparency of funding sources and uses throughout the project.

- Continually monitor and verify funding availability as compared to the cost to complete (or budget) for the job.

- Maintain a feel for the industry health for the type of construction you are performing—both economically and geographically.

- Need to open and maintain a clear line of communication between the contractor, owner, and lender.

- Watch for unusual financing requirements or owners asking the contractor to participate up front to help finance – it could be Ponzi scheme or a similar fraud.

D. Other types of debt financing

The myriad of requirements of borrowers and projects have lead to many other types of lending structures beyond the traditional construction loans described above. However, many, if not all, of the elements of the traditional construction loan described above will be incorporated into these more complicated structures. Some of the more typical structures are described below.

Tax exempt bonds are a mechanism by which state and local authorities can issue bonds and make the sales proceeds available to certain types of real estate development projects at a lower financing rate than would otherwise be available for that project. The bonds are sold in a *public offering* arranged by an *underwriter,* or are issued in a *private placement* to a small number of investors, usually institutions or other sophisticated investors. The bonds are simply a promise to repay the money loaned by the bond purchasers (or investors) on specified terms and conditions, as with any other loan.

Tax exempt bond financing is available only to certain types of projects and borrowers, such as certain manufacturers, private businesses located in federally-designated enterprise communities, health care providers, utilities, colleges and universities, and other non-profit cultural, civic, professional, educational, and other organizations qualifying under Section 501 (c)(3) of the Internal Revenue Code. For these types of projects, interest payments on the bonds are not subject to federal income tax in the hands of the bond purchaser (it may also be exempt from state income taxes, depending on the circumstances). Because the interest on the bonds is free of federal income taxes, the bond purchasers are willing to accept a lower rate of interest than they would if they had to pay taxes on the interest income (as would typically be the case), and hence, tax exempt bonds provide a relatively low cost source of financing. Typically, they can reduce a project's interest costs by 2% or more per year. Thus, a project that might otherwise be financed at 7% per year can be financed at 4%-5% per year. As interest costs are a very significant component of a project's overall costs, the result in savings can be significant.

Although a state or local public entity is the issuer of the bonds in order to afford them with tax exempt status, the authority is typically not responsible for the repayment of the bonds. Rather, the bondholders look only to project revenues, the owner of the project, and/or other collateral or security (frequently a letter of credit posted by a bank associated with the owner) for repayment of the bonds. Tax exempt bond financings are significantly more complex than traditional construction loans, involve many more players, and must comply with a series of complicated federal income tax requirements, as well as state and local requirements. Accordingly, the legal, accounting, and financing costs tend to be relatively high. As a result, tax exempt financings are not feasible for very small projects, and they are most effective for projects of significant size.

Key players in the typical tax exempt bond financing, in addition to the owner that develops the project and the governmental authority that issues the bonds, will include the *bond trustee,* which will act as a single point of contact and representative for multiple bond purchasers, the *underwriter,* which is responsible for marketing the bonds to investors, the *credit enhancer* (may be a *letter* of *credit bank),* a *bond insurer,* or other financial institution that provides additional security for the repayment of principal and interest on the bonds (in the form of a letter of credit, bond insurance, or the like). In the typical tax-exempt bond financing, the contractor will deal with the project owner just as it would in the more traditional construction financing. However, because of the complexity of the transaction and the multiple players involved, it is especially important that the contractor, working with its client, address any lender-related construction issues as early as possible in the process. Request and review all documents related to the bond issuance.

Taxable bonds are structured similarly to tax exempt bonds, except that because of the nature of the project, the type of borrower, or otherwise, income on the bonds is not exempt from federal income taxation.

Project financing is a type of financing typically used to refer to large infrastructure or public works projects. In the real estate context, the entire "project" is financed-that is, the construction loan is but a part of the land acquisition and land development financing. The creditworthiness of the project is underwritten on the merits of the project (and its projected revenue stream) alone, rather than the creditworthiness of a particular borrower.

Market and feasibility studies, analysis of projected budgets and cash flows, and the qualifications and experience of the participants are crucial to underwriting these types of financing.

Tax Increment Financing - or "TIF;" as it is generally known, is a powerful financing tool for suitable projects, and is frequently encountered in urban areas. TIF is premised on the fact that a real estate development project generates additional real estate and sales taxes above and beyond the taxes generated by the land in its undeveloped state. Under TIF, the developer may use this incremental increase in taxes to support additional project financing, in lieu of paying such amounts to local governments. Under most TIF programs, this is accomplished by the issuance of tax exempt bonds by an instrumentality of the local government, and the payments to the instrumentality of all or a portion of the increased taxes. The proceeds of the bonds issued are then provided to the developer to finance its project.

Assume, for example, that a development project would generate an additional $1 million in annual tax revenues. All or a portion of this amount would be payable annually to the bond issuer in lieu of increased real estate and sales taxes. The bond issuer, in turn, would issue tax-exempt bonds supported by this revenue stream, the amount of the bonds being determined by the coverage ratios and interest rates then required by the market. The proceeds of the bonds, or some agreed-upon portion of the proceeds, would be provided to the developer to supplement its equity and traditional debt funding sources.

A *synthetic lease* is a complicated, accounting-driven financing structure that permits the borrower to keep a project (and its associated liabilities) off its books for financial accounting purposes, but to have the project on its books for federal income tax purposes (for example, depreciation deductions).
A synthetic lease is characterized as an operating lease for financial accounting purposes, but as a mortgage loan for federal and state income tax, bankruptcy, and other purposes. Synthetic leases are typically used by publicly traded corporations, for which the accounting treatment of assets and liabilities can be very important. The interest rate is typically based on LIBOR or the federal funds rate, the term is 5-7 years, and the developer/user guarantees a substantial portion of the debt.

In synthetic lease transactions, a special purpose entity, frequently a *trust,* will be established solely for the purpose of the project to hold title to the property and develop it. The trust borrows the money to finance the construction, and (as the trust has no personnel or resources of its own) appoints the intended developer/user of the facility as its agent to enter into the construction contract and other agreements relating to the construction and development of the property.

The principal significance of a synthetic lease financing from a contractor's perspective is that the construction contract is entered into not by the client entity that you would expect in a more traditional borrowing, but by the trust or other special entity as agent for the client. Thus, instead of the contractor entering into a construction contract with "Acme Manufacturing Company," it will enter into the contract with "Acme Manufacturing Company, as agent for the Acme Real Estate Trust 1999-1."

Swaps, hedges, and other interest rate risk management techniques are complex financial arrangements by which a borrower can manage its interest rate risk. Thus, an owner that obtains construction financing on a floating rate basis but would rather have the certainty of fixed interest payments, can "swap" its interest payment obligations, through a facilitating bank, with another borrower ("the counterparty") that prefers to swap its fixed rate interest obligations for variable rate obligations. A "hedge" is simply a financial mechanism that permits a borrower, for a fee, to protect itself against interest rates rising above a specified limit.

Mezzanine Financing is a combination of debt financing and equity financing. It offers a company the ability to raise cash without immediately giving up ownership. Mezzanine financing yields a much higher rate of return to the lender, in the 20% to 30% range, than traditional bank financing. While the mezzanine financing is not secured by hard assets of the company, in the event of a default, the mezzanine lender may convert its loan to an equity or ownership position.

As with all financing, it is important for the contractor to understand the sources of the loans, the triggers for default by the owner, the seniority or hierarchy of the debt, and where the contractor's position is in that hierarchy.

Red Flags

- Any abnormal invoicing request, e.g. when a client asks you to build or invoice additional items "off-line"

- Big developer fees

- The lender may (or may not be) your ally. They may be very willing to sit back and allow you to finish the project even if they know it is upside down. They don't want an unfinished project on their hands. Think defensively towards both the client and the lender.

- Ask to see the budget, revised budgets and proforma for the project – be sure there are sufficient interest reserves and contingencies.

- Have someone other than the PM be the hammer if necessary. If the PM gets too comfortable with the client it is hard for some PMs to be assertive enough. Know when you need a "bad cop" to step in.

- Get a joint check agreement with the lender or direct payment from lender so money does not go thru client or developer's hands.

- Don't allow the lure of the next big project promised by the client to interfere with your insistence on assurance of payment on the current project.

- Don't let the unsigned CO's build up and be sure lender agrees there is enough money before doing the work for a very large change order. Some loan documents or disbursement agreements require the lender to be aware of CO's over $25,000 for example. While this usually puts onus on the general contractor and can create problems if the lender must sign off on CO's quickly to keep work on track – it can also provide assurance to the contractor that the project has sufficient funds to pay for the added work without putting the loan "upside down".

- Be aware that all project funding may stop if the lender determines that the project costs, including interest, are greater than the loan limit.

- Get an authorization letter at beginning of project to be able to communicate with the lender directly both at the start of the project and ongoing.

- Insist that clauses remain intact that require the client to maintain adequate financing and to notify you if there is a change in financing.

- Ask to be part of the disbursing agreement – review the terms carefully.

- Be aware of how accumulating interest by the lender can push the job upside down especially if it gets delayed. Keep in touch with the lender.

- Tighten up the timelines in the contract as to number of days to receive payment, stop work, notice clauses.

4. EQUITY FINANCING

As mentioned above, the typical construction lender will require that the owner or investor group fund the construction project in part with investments. The mortgage or any other collateral does not secure repayment of these equity funds. The equity investment also reduces the maximum loan requirement below 100% of the total project costs. Finally, the owner and/or its investor group risks the loss of all of its equity investment if the project is not sufficiently successful to repay the equity after the debt is paid in full. This has the effect of focusing the owner/investor's attention on the project success, including repayment of the construction loan.

Equity may be contributed by the owner group itself, or may be raised in a *private offering* from a small group of sophisticated investors, or from a larger group of smaller investors in a *public offering.*

Best Practices

- Obtain and review copies of the executed Loan Agreement and Documents and all amendments and additions.

- Know and understand the language in the loan documents that will cause the loan to be in default.

- Obtain confirmation of financing for significant change orders prior to performing the work.

- Understand the financing strategies (i.e. tax credits) to upstream investors, phased sell-out requirements, etc.

5. THE LENDER AND THE CONTRACTOR

A. Assignment

Typically, a construction lender will ask an owner to "conditionally" or "collaterally" "assign" to the lender the owner's rights under the construction contract. This means that if the owner defaults under the construction loan, the lender can (but is not required to) step into the owner's shoes and require the contractor to complete the work on the same terms and conditions as the contractor agreed with the owner. The ConsensusDOCS Standard Agreement and General Conditions Between Owner and Contractor (ConsensusDOCS 200) and AIA General Conditions of the Contract for Construction (AIA A201-2007) address this issue as follows.

The ConsensusDOCS 200 provides in Section 13.1 that "[n]either the Owner nor the Contractor shall assign their interest in this Agreement without the written consent of the other except as to the assignment of proceeds." Similarly, section 13.2.1 of the 2007 edition of A201 prohibits the owner from assigning the construction contract to a lender (or others) without the contractor's consent.

There are similar or identical provisions in other standard contracts, such as Section 14.1 of the ConsensusDOCS 500, Standard Agreement Between Owner and Construction Manager, (See also AIA A121/Cmc 2003 and AIA A133-2009. Note that the AIA A121 will no longer be available as of May 31, 2010.).

The ConsensusDOCS 200 permits an owner to assign the construction contract without contractor consent "to a wholly owned subsidiary of Owner when Owner has fully indemnified Contractor or to an institutional lender providing construction financing for the Project as long as the assignment is no less favorable to the Contractor than this Agreement." Section 13.2 of the 2007 edition of A201 permits the owner to assign the construction contract to a "lender providing construction financing" without the contractor's consent, and requires the contractor to "execute all consents reasonably required to facilitate such assignment." The lender must assume all of the owner's "rights and obligations under the Contract Documents."

The contractor should be aware of two key points in connection with assignment provisions. *First,* it is highly unlikely that a prudent lender would make a construction loan without a provision authorizing assignment of the construction contract to the lender, as completing the project as originally contemplated may well be the best approach to maximizing the value of its collateral. Thus, even if the construction contract is written on older or non-standard forms that prohibit assignment to a lender without the contractor's consent, that provision is likely to have been modified, or the lender will insist that it be modified as a condition to making the loan. Second, the provision is not completely clear as to the lender's responsibility for payments to the contractor that were due, or are for work performed, prior to the date that the lender takes over the construction contract.

From the contractor's perspective, it would be wise to clarify this point. The contractor should also be concerned if the bank/lender is not experience/sophisticated in construction lending.

B. Agreement to complete

Matters such as the lender's right to take over the construction contract in the event of an owner's default (discussed in the previous section) are frequently addressed in an "Agreement to Complete and Assignment of Construction Contract," or similar agreement directly between the lender and contractor. The provisions that a lender may seek in such an agreement include:

- The contractor's agreement to complete the project in accordance with the terms of the construction contract, upon receipt of a notice from the lender that the owner has defaulted under the construction loan. Such a provision may expressly state that the contractor must continue to perform under the contract notwithstanding that the lender will not be responsible for paying for work performed prior to the date that the lender takes over the project. (The owner is still responsible for these payments, but as the owner is in default at this point, that is likely small consolation to the contractor.)

- An assignment to the lender by the contractor (to be exercised by the lender only upon the owner's default under the construction loan) of the contractor's rights in permits, shop drawings, and the like.

- An agreement by the contractor that it will not exercise any of its remedies under the construction contract upon the owner's default, until it has given the lender notice and 30 days to cure the default.

- An agreement that no change order is effective without the bank's consent.

- A confirmation of the guaranteed maximum price (if any).

- An agreement that any loan proceeds disbursed directly to the contractor will be held by the contractor in trust and will be used first to pay project costs and the contractor's fee.

- An agreement authorizing the lender's inspector to inspect all plans, etc. in the contractor's possession and relating to the project.

- A confirmation by the contractor that the plans and specifications as they currently exist are sufficient to enable the contractor to complete the work.

- A confirmation that all utilities necessary to operate the project are available for immediate use without the need for offsite easements.

- A certification that all necessary permits have been obtained from local utility companies or municipal authorities to ensure that the necessary utilities will be available to the project upon completion.

- Rights to review/approve subcontracts.

These sample provisions were drawn from Agreements to Complete typically used by two major national banks active in construction lending. Many, if not most, of these provisions should be unacceptable to the contractor, depending on the circumstances. Many of the provisions described above deprive the contractor of rights it has under its construction contract (such as the right to stop work if payments are not current), require it to certify matters that may not be within its knowledge or expertise (such as the confirmations relating to utilities), or pose the risk of unduly delaying the work (such as the requirement that no change order is effective until it is approved by the lender).

Although a construction lender has legitimate concerns that can and should be addressed in such an agreement, as with every such agreement, the contractor should scrutinize carefully exactly what it is committing to, with the assistance of legal counsel if necessary. It is also important to respond to these types of lender requests in a manner that assists the client. When a contractor can anticipate that a construction lender will be asking for a direct agreement with the contractor on a particular project, the contractor should give an early "heads up" to the client that the contractor will require ample opportunity to respond to and negotiate the lender's requests.

All too frequently, the contractor is not presented with (or does not review) the lender's requests until just before the loan closing or initial funding, and finds itself in the awkward position of not adequately protecting its own interest, or risking delaying the loan closing or funding. Frequently, the owner pre-commits to the substance of these Agreements to Complete in its construction loan agreement. Regardless of when or whether the lender, contractor, or owner is responsible for putting the contractor in this position, it is not helpful in terms of owner/contractor relations, and the contractor should work proactively to ensure that these issues are dealt with well in advance when everyone is under less pressure.

C. Loan agreement requirements

Construction loan agreements typically contain requirements relating to applications for payment submitted by the contractor, approval of change orders, and the like. Among other matters, owners will typically agree to obtain certain certificates from the architect and contractor as a condition to interim or final disbursements of loan proceeds. As with the "Agreements to Complete" discussed in the preceding section, the contractor may find that its client has pre-agreed to various matters on behalf of the contractor, such as providing a certificate from the contractor that the contractor cannot properly give, that are awkward or impossible to comply with. For example, one occasionally sees loan agreements in which the owner has committed to provide with its final draw request a certification from the contractor that the project as completed complies with "all local zoning and building laws, ordinances, and regulations," a matter that is more properly within the purview of the architect, not the contractor. As before, the contractor does itself and its client a service if it anticipates these issues and discusses them in advance with the client. A simple and effective approach is periodically to remind the client that the contractor should be given an early opportunity to review proposed construction draw and provisions in the construction loan agreement before it is finalized, to the extent that they relate to the contractor or its work.

Some lenders will request that the contractor sign a Subordination Agreement. It would be prudent to have your attorney review this as to the impact it could have on your place in the hierarchy of payment which can hinge on several factors including state laws. At a minimum the contractor should demand notice of any default on the loan and of any problems with the financing.

Request a copy of the Owner's Builder's Risk policy and review it with your insurance broker. This is a critical piece to help you get paid in the event there is an insured loss during construction.

6. DOES THE OWNER HAVE THE FINANCIAL CAPABILITY TO COMPLETE THE PROJECT?

Both the ConsensusDOCS and AIA standard contract documents contain owner financial information provisions; however, the ConsensusDOCS 200 contains provisions that many contractors view as more advantageous to contractors and subcontractors than the 2007 A201. Specifically, ConsensusDOCS allows contractors to request necessary project financing information from the owner not only prior to construction, but also during the construction phase. AIA has a provision similar to ConsensusDOCS for obtaining project financing information prior to the start of work, but places potentially onerous restrictions on access to such information once construction has begun.
Section 2.2.1 of the 2007 edition of A201 entitled the contractor to request and receive "reasonable evidence" that the owner has sufficient financial arrangements in place to fulfill its obligations to the contractor, and suggested that absent such assurances, the contractor would not be required to start work. The document provides that if such assurances are requested and not given, the contractor is not required to commence or continue the work. In addition, the owner cannot "materially vary" its financing arrangements for the project without prior notice to the contractor (although the contractor's consent to these changes is not specifically required-just notice).

Thus, under the ConsensusDOCS 200 as unmodified:

- The owner must give you "evidence of Project financing" prior to the contractor "commencing or continuing the Work." At a minimum, these assurances might include a letter from the owner describing its debt and equity financing for the project, specifying the amount and source of the financing, and describing any material conditions to the disbursement of funds. A contractor might also ask for a copy of the loan commitment or loan agreement, and equity financing documents, or a statement from the lender or equity sources indicating the availability of funds.

- If the contractor does not receive these reasonable assurances, it may be justified in not commencing (or stopping) the work.

- The owner cannot materially change its financial arrangements without telling the contractor in advance. This does not necessarily mean, however, that it must always tell the contractor when it fails to have access to sufficient funds to complete the project. For example, although the original financing arrangements may remain in effect, the project costs may have increased in the interim beyond the funds committed, or the requirements for the continuing disbursement of those funds may not have been met.

- Consider requesting project financing information by referring to the ConsensusDOCS 290 Guidelines for Obtaining Owner Financial Information and the related 290.1 Owner Financial Questionnaire, or another owner information questionnaire. The ConsensusDOCS 290 Guidelines provide a wealth of information, including steps to ensure a financially trouble free job and sources of information. The ConsensusDOCS 290.1 Questionnaire provides a simple and straightforward way for owners to provide the necessary project financial information to contractors.

- In any event, consider asking the owner for the entire project budget, including its proposed sources and uses of funds, and its cash flow projections. Evaluate these budgets for their apparent achievability.

- If the owner cannot give you reasonable assurances on an ongoing basis that it has sufficient financial resources in place to complete the project, you may be entitled to stop work.

Owners, especially those who are more sophisticated, frequently modify these provisions of the standard contract forms. Thus, when presented with the owner's proposed construction contract for your review, you should be sure that it entitles you to receive the information that you believe you will require to feel confident about the project's financing, both at the commencement of construction and on an ongoing basis. Many owners will argue that their financial arrangements are private matters that are no business of the contractor. Nonetheless, the contractor does have a legitimate interest in assuring that it will be able to complete the work and will be paid for it, and must make a judgment as to what information it will require from the owner to feel comfortable in this regard. Even if the standard ConsensusDOCS and AIA provisions are unmodified and your contract includes the more favorable ConsensusDOCS provisions, you should proceed cautiously before stopping work, or declining to commence construction. As with any legal document, the contract provisions described above are not free from ambiguity and are subject to legal interpretation in the event of a dispute. Before taking any drastic steps under these provisions, you should consult with your lawyer.

7. INVESTING IN THE PROJECT

On occasion, the contractor will be asked or tempted to invest in a real estate development project for which it is the contractor. This step should be approached with extreme caution and considered most carefully, and should generally be avoided. Any such request by the owner should be treated as a "red flag," suggesting that it does not have more traditional and sophisticated sources of financing available to it. The contractor's bonding company in any event should be consulted. From the owner's perspective, the lender underwriting the construction loan will be concerned that performance from replacement contractors will not be available, and any arrangement that contemplates the owner not paying the contractor in cash will raise concerns about the contractor's ability to complete the project with its own financial resources.

8. CONCLUSION

Contractors have many reasons to concern themselves with how an owner is financing its project. An owner that is unable to pay 100% of its debts or a lender that stops funding due to a project being “upside down” can constitute a serious financial risk to even the most well funded contractor. In many states, a contractor may be required to pay all of its subcontractors for work completed, even if the contractor has not been paid. A proactive approach to knowing your client, understanding the financing and the associated risks, and monitoring the financial aspects as diligently as the physical construction of the project will go a long way toward preventing financial hardship for the contractor and its business partners.

This document is intended to be a reference "to get you thinking about the risks associated with project financing" and is not intended to address all potential pitfalls of financial risk. Understanding the source and structure of project financing is absolutely critical for contractors, particularly in the turbulent waters of the current lending market. It is extremely important to ask the right questions when doing your due diligence in the initial confirmation of financing of a project, as well as the re-affirmation throughout the construction process.

GLOSSARY

Accrued Interest—Interest that is earned on a loan, but is added to the principal balance instead of being paid as earned.

Amortization—The payment of principal (as opposed to interest) on a loan. Amortization reduces the outstanding principal balance.

Appraisal—A formal evaluation, often by a Member of the Appraisal Institute (MAI), valuing a property. Property values are based on a consideration of replacement cost, sales prices of comparable properties, and an income analysis. Real estate lenders almost always require appraisals.

Balloon Payment—The principal payment that remains to be paid at the maturity date of a loan, in addition to the regular periodic payment.

Base Rate—The more modern term for "prime rateH-the published rate that a bank or other lender charges its more creditworthy corporate customers, but not necessarily its best rate. A blended prime rate charged by the larger banks is published each day by the Wall Street Journal in its "Money Rates" column, and is often used for reference in loan documents.

Basis Points—A "basis point" is 1/100 of a percentage point. Basis points are frequently quoted when stating the interest rate of a loan above a specified index interest rate. Thus, a loan may be stated as having an interest rate of "LIBOR plus 75 basis points."

Bond Insurer—Bond insurance is a form of additional security for tax exempt bonds. The bond insurer issues a policy insuring the timely payment of principal and interest and principal on the bonds. Only a few large insurers are active in the bond insurance market. And they evaluate carefully the creditworthiness of the projects that they insure. They also typically require some collateral in the event that they are required to pay out on the insurance.

Bond Trustee—The bond trustee acts as a representative of the numerous bond holders in a bond financing.

Broker—Real estate transactions may involve both a mortgage broker-who finds the financing-and a real estate broker-who finds the property or the tenants. Brokers can be very helpful in facilitating the development aspects, depending on the level of their expertise and commitment, but a contractor should be very careful that he is dealing with the broker only to the extent and on matters authorized by the client.

Cash Flow—The periodic rate at which cash is generated or consumed by a project.

Certificate—A formal written statement as to specified factual matters. A certificate is a formal document and the contractor must assume that it will be relied on by the recipients, and hence that the contractor will be held legally responsible for its contents.

Collateral Assignment—A legal instrument that entitles the assignee to step into the shoes of one of the parties (the "assignor") upon specified events, such as the default of the assignor under a loan agreement. Upon an assignment, the other party to the underlying agreement (for example, the contractor under a construction contract) would be required to perform for the benefit of the assignee.

ConsensusDOCS—The first and only standard contract documents endorsed by 22 leading construction industry associations. The documents are written to incorporate best practices while fairly allocating risk to the party best able to manage it. ConsensusDOCS offers a catalog of 90+ documents covering all methods of project delivery.

Construction Loan—A loan, typically secured by the real estate involved, to finance a construction project with periodic disbursements of the amount borrowed as construction costs are incurred.

***Construction Lender*—**The lender under a construction loan.

***Construction Period Interest*—**Interest that accrues on a construction loan while a project is being constructed, Typically, this interest IS not paid as accrued by the borrower, but rather is added to the principle balance of the loan, for repayment after the construction period.

***Credit Enhancement*—**A mechanism to enhance the creditworthiness of a project, and hence reduce the interest rate on a loan. A third party to the lending transaction provides credit enhancement, for a fee, and the credit enhancer takes security from the borrower in the event that it must pay out under the credit enhancement. Credit enhancement is common in bond financings. Typical credit enhancement mechanisms are letters of credit and bond insurance.

***Currently Paid Interest*—**Interest that is paid as earned, rather than accrued. Compare "Accrued Interest."

***Deed of Trust (see also "Mortgage")*—**In many states and counties, a deed of trust is used instead of a mortgage to pledge real estate as security for a loan.

***Debt Service Coverage Ratio*—**The ratio of a project's net income (before debt service) to the debt service requirements of a loan. The debt service ratio is used to evaluate the safety of a loan from the lender's perspective.

***Environmental Reports*—**Most lenders, as a condition to making a real estate loan, require an environmental report. At a minimum, a "Phase I" report will be required. A Phase I report is based on a visual examination of the property and an analysis of its historical uses and is undertaken to spot likely environmental issues. Typically, a lender does not require further environmental analysis unless the Phase I report indicates significant areas of concern.

***Equity*—**Funds invested by a borrower group (including investors) that are repaid only after loans are repaid in full (or other agreed amounts).

***Federal Funds Rate*—**The federal funds rate is the rate charged on overnight Federal funds transactions by members of the Federal Reserve System It IS frequently used as an index rate for real estate borrowings

***Fixed Rate*—**An interest rate that is fixed at a specified percentage amount, rather than fluctuating or varying on a periodic basis.

***Floating Rate*—**An interest rate that varies in tandem with a specified index rate. A typical floating rate might be specified as "prime rate plus 3%:' or "LIBOR plus 75 basis points."

***Fully Amortizing Loan*—**A loan, the principal amount of which is scheduled to be fully repaid (but for any remaining periodic payment) as of the maturity date.

***General Partnership*—**The joint carrying on of a trade or business (such as a real development project) for the profit of all concerned. All partners are liable in full for the obligations of the partnership.

***Guarantees*—**An undertaking to be responsible for the debts and obligations of another.

***Guideline on Owner's Ability to Pay*—**Joint statement developed by AGC of America, American Subcontractors Association, Inc., and the Associated Specialty Contractors (see www.constructionguidelines.org).

***Hard Costs*—**Costs paid under a construction contract for tangible items, including fees and general conditions.

***Hedge*—**A financial arrangement to reduce interest rate risk beyond certain limits.

***Index Rate*—**A specified, readily ascertainable interest rate upon which the interest rate under a specified rate is based by adding a specified margin amount. Common index rates include LIBOR, prime rate, and federal funds rates.

***Joint and Several Liability*—**A liability is 'Joint and several" when the lender or other creditor may sue all of the liable parties separately or together, each for the full amount of the debt, regardless of their responsibility or level of participation in the venture.

***Joint Venture*—**A commercial undertaking-such as a real estate development project-undertaken for profit by several individuals and/or entities that is limited in scope and duration, but not necessarily in liability of the participants. General and limited partnerships and limited liability companies are specific examples of joint ventures.

***Letter of Credit*—**A formal written undertaking usually in the form of a one or two page letter by a financial institution (usually a bank)-to be responsible for the financial obligation of a third party (typically an account holder at the bank). Letters of credit are issued for an annual fee, are frequently collateralized by the account holder, and can be drawn against simply by providing a written statement that the borrower is in default and money is owed.

***Lien*—**The right to foreclose upon property if the underlying monetary obligation is not paid.

***LIBOR*—**The London lnterbank Offered Rate, which is the rate at which banks make funds available to each other on the London lnterbank market. LIBOR is lower than the prime rate, and is frequently encountered in larger commercial projects.

***Limited Liability Company (LLC)*—**A relatively new type of commercial entity, coming into its own only in the mid 90's in most areas, a limited liability company limits the financial liability of its participants to their financial interests in the company. Like partnerships, LLC's avoid the double income taxation of corporations, and are more flexible than most partnership vehicles. Within the past few years, LLC's have become one of the entities of choice for real estate development projects.

***Limited Partnership*—**A partnership consisting of one or more general partners, who are jointly and severally liable for the full extent of partnership debts, and one or more limited partners, whose liability is limited to their respective investments in the partnership. Prior to the advent of limited liability companies, limited partnerships were frequently the ownership entity of choice for real estate development projects.

***Loan-to-Value Ratio*—**The ratio of the maximum amount of the loan to the total project cost.

***Loan Agreement*—**The formal agreement between a lender and borrower that sets forth the lending obligations, including the obligations that the borrower must fulfill to obtain future advances of loan proceeds.

***Loan Commitment*—**A preliminary, summary undertaking by a lender to finance a project on specified terms and conditions, subject to further due diligence and documentation, and payment of specified financing fees.

***Maturity Date*—**The final date on which a loan is due and payable in full.

***Mezzanine Financing*—**A simple definition of mezzanine financing is that it is a combination of debt financing and equity financing. It offers a company the ability to raise cash without immediately giving up ownership.

Mezzanine financing yields a much higher rate of return to the lender, in the 20% to 30% range, than traditional bank financing. While the mezzanine financing is not secured by hard assets of the company, in the event of a default, the mezzanine lender may convert its loan to an equity or ownership position.

***Mini Permanent Loan*—**A loan, typically 5-7 years in duration, that extends through and beyond the construction period into operation of the project, perhaps only until its operations are financially stabilized.

***Mortgage*—**The pledge of real estate to secure a loan or other obligation. If the loan or obligation is not paid when due, the mortgagee can foreclose on the property, auction it off to the highest bidder, and retain the proceeds to the extent that they do not exceed the amount of the obligation plus costs of collection.

Mortgage Broker— An intermediary that arranges mortgage loans for a commission.

Non-recourse Loan—A loan for which the borrower and/or its owners or principals that would otherwise be liable for repayment are not liable by reason of an agreement to that effect with the lender. The lender's recourse is limited to the collateral and any parties to which it has retained recourse.

Owner Financial Questionnaire—A questionnaire used by Contractors that is designed to obtain the project financing information necessary to help ensure a successful project for all parties. The ConsensusDOCS 290.1 provides a good example of a straightforward form.

Permanent Lender (see also "Takeout Lender")—The lender under a permanent loan.

Permanent Loan—A loan following the development and construction period.

Prime Rate—The published rate that a bank offers to its more creditworthy customers. Most banks set their own prime rate and adjust it periodically. Despite its name, the prime rate is not necessarily the lowest rate that a bank offers; so most banks prefer the term 'base rate" instead.

Principal Amount—The total amount borrowed under a loan.

Private Offering—An offering of debt or equity securities to a small and/or sophisticated group of investors.

Private Placement—The sale of a private offering

Pro Forma Budgets—Capital and operating budgets setting forth the projected operating and capital requirements and revenues of a project.

Pro Forma Cash Flows—The projected periodic cash inflows and outflows of a project.

Project Financing—The financing of an entire project, from land acquisition through land development and construction, based on the projected revenue stream rather than the creditworthiness of the borrower entity.

Promissory Note—An "IOU”--the written obligation to repay another a specified sum at a specified time under other circumstances. The promissory note is the key evidence of the repayment terms of a construction loan.

Public Private Partnerships (PPP)—A PPP is a partnership between a public entity and one or more private sector companies, usually formed to develop, build, maintain and operate a specific project for a determined period of time. The project is often financed by a combination of private investor funds, bank financing, and occasionally public funds. The loans are most often repaid by the user and not through the tax payers. Historically, PPPs have been used on very large projects, the most common being toll roads.

Real Estate Investment Trust (REIT)—A Real Estate Investment Trust (REIT) is a corporation or business trust that combines the capital of its shareholders (investors) to acquire or finance real estate projects. A REIT may own real estate directly (an "equity" REIT), may lend money to real estate owners (a "mortgage" REIT), or both (a "hybrid" REIT). REITs invest in a number of projects (to diversify risk) and are professionally managed. Thus, they are much like mutual funds for real estate. Shares in REITs are freely traded, often on major stock exchanges. Generally, REITs do not pay income taxes at the corporate level; rather, their investors are taxed directly on their distributions from the REIT, together with their other income. REITs often focus on particular types of property (shopping centers, warehouses, etc.) or by geographic area.

Recourse Loan—A loan that if in default, permits the lender to sue the borrower (and perhaps its principals or owners), rather than merely foreclose on the collateral.

Security—Property, such as real estate or tangible or intangible personal property, pledged to secure the repayment of a loan if the borrower does not pay as scheduled.

Single-Asset Entity—An entity established to pursue the development of a single project. The entity has no assets that are not project-related.

Soft Costs—Costs other than the actual "hard" costs of acquisition and construction (including the contractor's fees), such as design and financing costs, and other fees.

Special-Purpose Entity—An entity that is organized to own, develop, and operate a single project.

Syndication—The offering of loans or equity investments for participation by others as investors.

Synthetic Lease—A synthetic lease is a complicated lending transaction that is an operating lease for financial accounting purposes, but a mortgage loan for federal and state income tax, bankruptcy, and other purposes. It is also referred to by a myriad of other names, including "tax retention operating lease," or "TROL".

Swap—A transaction in which (in its most common form) two borrowers exchange the floating rate interest obligations of one borrower for the fixed rate interest obligations of the other.

Takeout Loan—The loan that replaces - or "takes out" - a construction loan, on pre-specified conditions.

Takeout Lender—The lender under a takeout loan.

Tax-Exempt Bonds—Bonds, the interest on which is exempt from federal and/or state income taxation in the hands of the holders, thus lowering the interest rate that they will demand.

Taxable Bonds—Bonds, the interest on which is taxable.

Title Insurance—Insurance against specified preexisting defects in title to real property.

Tax Increment Financing (TIF)—A financing tool that permits a developer to use the incremental increase in property, sales, or other taxes generated by a real estate project to support additional project financing, in lieu of paying such amounts to local governments.

Trust—A legal arrangement by which property is held by one person or entity for the benefit of others.

Trust Deed—In substance, another name for a deed of trust of mortgage.

Underwriter—A person or company that arranges the sale of debt or equity securities.

Value Engineering—This involves a contractor analyzing plans and specification, identifying any areas that could be changed, including materials used, methods of construction, and still have the ability to perform its intended function as well, or better than was originally designed, at a lower cost. The cost savings is usually shared by the owner and the contractor.