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Construction Loan Guarantees

*Mitchell S. Kaplan**

This article will discuss several different types of guarantees that may be required by lenders in order to minimize payment and performance risks associated with construction loans.

Commercial mortgage loans secured by existing income producing properties are often made on a non-recourse basis to the borrower (and its principals), other than with respect to customary limited recourse carve-outs. These permanent or mini-permanent loans generally have the benefit of real property collateral producing sufficient cash flow to service the lender's debt and cover operating expenses for the property. Construction loans, however, present a different risk profile for the mortgage lender due to, among other things, no cash flow being generated from the property during the course of construction, the possibility of the project not being completed within budget (or at all) and the increased risk of liens for labor and materials being filed against the property. In addition, even after construction is completed there is often a period of time prior to stabilization when there is insufficient cash flow to pay debt service on the loan and operating expenses for the property. Construction lenders require various mitigants to these and other construction related risks, such as requiring guaranteed maximum price contracts, payment and performance bonds and guarantees from creditworthy parties.

This article will discuss several different types of guarantees that may be required by lenders in order to minimize payment and performance risks associated with construction loans. Depending upon the underwriting for the particular project, a construction lender may require one or more of the guarantees discussed below. This article will not address the limited recourse carve out guarantees or environmental indemnities that are generally required for all construction loans since those guarantees/indemnitees are required for most commercial mortgage loans, and therefore, are not unique to construction loans.

COMPLETION GUARANTEE

Construction lenders will typically require a creditworthy party to deliver a completion guarantee. The completion guarantee will provide, in pertinent

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part, that the guarantor will guarantee the prompt and complete performance by the borrower of all of the terms of the loan agreement with respect to the design, construction and completion of the improvements that are the subject of the loan. The guarantor will be responsible for lien-free completion and all cost overruns and for all other costs that do not fall into the category of construction related expenses, such as interest charges under the loan, insurance premiums and real estate taxes. In certain instances, the portion of the completion guarantee that covers soft costs such as interest charges, insurance premiums and real estate taxes may only be in place until completion of the project or stabilization of the completed project. "Completion" under the guarantee is usually broadly defined to include punch list items.

To the extent a portion of the loan is budgeted for tenant improvement work for space leases, then the costs for such tenant improvements will likely be covered by the completion guarantee. This guarantee (or a separate guarantee) may also cover the obligation under the loan agreement that the borrower keep the loan "in balance." In other words, the guarantor may be required to deposit funds with the lender if the lender determines that the loan proceeds remaining to be advanced at any given time are insufficient to complete the project and pay for the operation and maintenance costs of the property and interest on the loan.

The construction lender may pursue its rights and remedies under the completion guarantee upon the occurrence of various events, including, among others, (i) the borrower's failure to commence or complete construction within the time periods set forth in the loan agreement, (ii) construction ceasing for an extended period of time resulting in a default under the loan agreement or (iii) the occurrence of any other event of default under the loan agreement. The completion guarantee will also require the guarantor to fully release and discharge all liens relating to the design or construction of the improvements.

The terms of the guarantee will likely provide that the lender will agree to advance funds to the guarantor under the terms of the loan agreement to enable the guarantor to complete the project. However, the agreement by the lender to so advance funds to the guarantor will be conditioned on (x) the guarantor's having cured all defaults under the loan agreement, with the possible exception of defaults that are personal to borrower and are unable to be cured by a third party, and excluding defaults relating solely to the borrower's failure to complete the project which will be cured by guarantor's performance under the completion guarantee and (y) the guarantor complying with the terms governing disbursements under the loan agreement. The guarantee will generally terminate upon the lien-free completion of the project and all statutory periods for filing liens having expired, and the conditions necessary to satisfy completion and receipt of the final loan advance under the loan agreement having been satisfied.

In as much as the guarantor will likely be an affiliate of the borrower, if the borrower fails to timely complete the project, the guarantor may be unable or unwilling to step up and perform under the completion guarantee (in addition to the lender's likely having lost faith in the ability of the borrower-related parties to complete the project). Furthermore, even if the lender desired the guarantor to complete the project under the terms of the guaranty, the lender may have difficulty obtaining specific performance as a result of the lender having the ability to instead sue for damages under the completion guarantee.

If the guarantor fails to perform under the completion guarantee, then the lender may perform on behalf of the guarantor and demand payment to the lender of all losses in connection with the guarantor's failure to perform or the lender's performing or causing to be performed the guarantor's obligations. The guarantee may provide that the lender's losses are the lender's out-of-pocket costs and expenses necessary to complete the project (including interest charges, real estate taxes and other operating expenses) in excess of the undisbursed loan proceeds remaining under the budget—that is, cost overruns and other excess expenses necessary to complete the project. The foregoing concept may be incorporated into a liquidated damages clause in the completion guarantee which would provide that the guarantor will be liable for (i) all costs incurred or which would have been incurred in connection with the lien free completion of the project, including, among other things, all operating costs which would be incurred during the time period necessary to achieve completion, in excess of (ii) the undisbursed portion of the loan at the time of the borrower's default.

CARRY GUARANTEE

Construction lenders often require a carry guarantee from a principal of the borrower. This instrument may cover payments to the lender of all regular interest, default interest and late charges accruing on the loan, periodic principal payments (but excluding the balloon payment at maturity) and costs and expenses incurred in the course of maintenance and operation of the property. This guarantee may have some redundancy (for at least the period of time prior to completion or later termination event under the completion guarantee) with certain carry costs aspects of the completion guarantee. Lenders may agree to the termination of the carry guarantee upon a foreclosure or the tender of a deed-in-lieu of foreclosure, or in certain limited instances, upon the property achieving stabilization, which would include meeting certain debt service coverage ratio ("DSCR") tests or other agreed upon financial thresholds.

The potential release of the guarantor upon a foreclosure or deed-in-lieu may incentivize the borrower/guarantor to cooperate with the lender in handing the keys over to the lender in the event of a failed or stalled project to enable the lender to minimize its losses by bringing in a different developer/sponsor to complete the project or lease up the property.

In those transactions where there is an early release mechanism for the carry guarantee based upon the property achieving stabilization, the guarantor would no longer bear the risk of the property falling on difficult times after stabilization (whether due to macro-economic conditions or otherwise) prior to the loan being repaid in full (such as during any loan extension periods).

In instances where the lender is willing to permit a termination of the guarantee upon the tender of a deed-in-lieu of foreclosure, the lender would not be required to accept the deed but the mere tender of the deed would release the guarantor (on a going forward basis) subject, however, to numerous conditions being satisfied, including, among others, the following: clean title, clean environmental report, payment by the guarantor or the borrower of all realty transfer taxes, title insurance charges, environmental report costs, legal fees, and other costs and expenses incurred by the lender, delivery of all tenant security deposits and prepaid rents and indemnifications for any claims by tenants relating to such deposits/prepaid rents, a general release in favor of the lender, payment of all sums that have accrued and are due and payable under the guarantee as of the tender date and payment of a tender fee to the lender.

PAYMENT GUARANTEE

In some circumstances, construction lenders may require a payment guarantee for the loan. The guaranteed obligations under this particular guarantee may cover all principal, interest and any and all other indebtedness and liabilities of borrower in connection with the loan. Depending upon the facts and circumstances of the project and the borrower sponsor, the lender may agree to limit the payment obligations of the guarantor to a maximum percentage or dollar amount of the outstanding principal of the loan, plus accrued and unpaid interest, and any expenses in enforcing the guarantee. In other circumstances, a full payment guarantee may be required at the closing of the loan but the guarantee may have certain "burn off" provisions which would provide for a reduction (or elimination) of the guaranteed amount upon the project being completed, the property achieving certain financial thresholds, such as achieving an agreed upon DSCR for a prescribed period of time, and there then being no existing event of default.

In those limited situations where the lender is willing to make loan advances on a fast track basis (i.e., prior to approval by the lender of final plans and specifications for the improvements and prior to issuance of all building permits), the lender may require the guarantee to cover all loan advances prior to approval of final plans and issuance of all permits, but once those conditions are satisfied, the principal payment obligations of the guarantor may be limited in dollar amount. Partial payment guarantees will most likely recite that they are guaranteeing the last dollars of the loan, and therefore, the guaranteed amount shall not be reduced by partial prepayments, reserves, condemnation or casualty proceeds, or proceeds from foreclosure sales.

OTHER GUARANTEES

Based upon the location of the property and the deal specifics, there may be other guarantees required by the construction lender, such as guarantees covering payments from the borrower to third parties. For instance, if the improvements to be constructed will rely on parking located on an adjacent parcel not owned by the borrower that is the subject of a parking agreement between the borrower and the adjacent property owner, the lender may require a payment and performance guarantee with respect to that parking agreement (in addition to some type of recognition agreement with the adjacent property owner). In addition, for condo developments in certain jurisdictions, such as Florida, where the developer may have the right to utilize condo unit deposits for construction costs, the lender may require a deposit guarantee to cover any insufficiency of unit deposits which were budgeted for construction costs but were not received from contract vendees by an agreed upon date.

FINANCIAL COVENANTS OF GUARANTORS

Construction lenders will likely require that its guarantors comply with liquidity and/or cash balance covenants and net worth covenants. The cost to build the project, the proposed loan amount and the financial condition of the guarantor at the time of loan origination will be relevant to the lender's determination of the financial covenants imposed on the guarantor. The required minimum liquidity or cash balance must reflect the unencumbered amounts of such assets and may be satisfied by the guarantor's delivery of an acceptable letter of credit in favor of the lender. In addition, in certain instances where the guarantor is an institution as opposed to an individual, the lender may allow funds available from certain qualified, unconditional, unencumbered capital commitments to count toward the liquidity and net worth requirements of the guarantor.

CONCLUSION

Construction lenders face certain risks not generally associated with term loans secured by performing income producing properties. These risk are partially mitigated by the delivery of credit enhancements in the form of guarantees from creditworthy parties. Each construction loan transaction is unique and may require one or more guarantees to cover certain obligations of the borrower, and these additional guarantees are intended to provide comfort to the lender that the project will be completed on time, in a lien-free manner, and its loan will be timely repaid.