THE CONSTRUCTION LOAN: WHO REALLY PAYS FOR THE PROJECT? WHAT HAPPENS WHEN THE LOAN IS IN TROUBLE

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THE CONSTRUCTION PROCESS - BASICS FOR THE LENDER.

I. Introduction.

Too often, the construction lender treats the construction loan as it would treat any other commercial loan, without anyone with significant background in the vagaries of the construction industry, ready to "pull the plug" should the loan become "out of balance." No construction loan should be undertaken by a lender without a clear understanding of the industry, the participants, the legal effect of loan and non-loan related documents, and the customs usually encountered in construction relationships.

The initial point to start is with the non-loan documents. For the reasons set forth below, every lender should review and approve the format of the construction contracts and subcontracts, since, in the event of a default by the owner or the general contractor, it may wish to utilize the same contractor (in the event of owner default) and subcontractors (in the event of a general contractor default) to complete the project. This avoids delays resulting from having to re-bid the entire project or have the contract renegotiated to the lender's detriment. The lender must ask itself, at a minimum, the following questions:

1. If changes in concept or plan occur, is it to be consulted to determine the adequacy of the loan balance for completion of the project?
2. In the event of construction delays (which appear to be endemic in the construction process), are there sufficient funds to pay for cost overruns customarily associated with delays?

3. To what extent should the lender participate in the construction process beyond the customary role of a secured creditor?

The construction contract is most critical since it establishes not only the duties and responsibilities of each party, but their goals too; i.e., the need of the general contractor or construction manager to make a reasonable profit on the project, the need of the owner to rely upon the project being completed on time and within budget, and assurance to the lender that the project will be completed in a good and workmanlike manner. The multitude of contracts available range from the American Institute of Architects (AIA) forms, the Associated General Contractors (AGC), American Subcontractors Associations (ASA), Engineers Joint Contracts Documents Committee (EJCDC) as well as the newest group with its own contract forms, Associated Owners and Developers. Each has its own constituency to protect. Failure to have a lending officer or legal counsel familiar with the forms and their inherent biases will ultimately result in chaos to the lender if the project is in trouble or there is a default.

Once the contract between the owner and general contractor is executed, the general contractor then contracts with many different subcontractors who will do much of the day-to-day construction. Each subcontractor will in turn contract with its own material suppliers.

Lenders should be aware that, too often, general contractors are carried away by an "adversarial" relationship between themselves and subcontractors and insert "murder clauses" in their contracts. These clauses contain language, so onerous in obligation and so open to potential conflict, that they invite litigation by their very terms: unrealistic scheduling, which cannot
reasonably be performed on a timely basis, is imposed by the owner on the general contractor, who then imposes the time limit upon each subcontractor; procedures for change orders are so complicated and difficult to implement that, rather than seek the change order, the subcontractor is tempted to cut corners on the base contract; lack of provisions for equitable adjustments which take into account the truly unforeseen condition or event and prevent a fair adjustment to the contract price; and, finally, liquidated damages or period clauses imposed on the contractor for its failure to achieve the impossible.

Among the most frequently used contracts are those published by and available from the American Institute of Architects (AIA). The most current forms are those dated 1997 and all prior editions should be discarded since the forms are a totally integrated set of documents which must be used as such. Although there are many sets of documents, they are interlinked to permit their use in an orderly and cohesive manner. For example, the A101 (Lump Sum Contract, A111 (Cost-Plus with Guaranteed Maximum Price) A141 (Cost-Plus with No GMP), A121 (Construction Manager at Risk with a GMP) and A131 (CM At Risk, No GMP) all require the use of the AIA General Conditions to make a complete contract. Even AIA A401, which is the Contractor-Subcontractor Agreement, interacts with the A201 through paragraph 1.2 of the A401 and subparagraph 5.3.1 of the A201. The net result of these two documents is that subcontractors owe the General Contractor the same responsibilities that the GC owes to the Owner—very handy if it becomes necessary for the Owner (or lender) to terminate the GC and take over the subcontracts directly. No discussion of these agreements would be complete without reference to the General Conditions (AIA Form A201) which contain the detailed provisions regarding the multitude of concerns occurring during the construction process. An area of concern to lenders deals with contractor defaults and the lenders ability to continue the project by providing at 5.4.1
for the conditional assignment of all subcontracts to the owner. Thus the project may proceed despite a general contractor default using the existing subcontractors and their subcontracts. However, it should be noted that 2.2.1 requires an owner, upon the contractor's request, to furnish satisfactory evidence that there are sufficient funds available to complete construction and to furnish sufficient information to the contractor to permit it to perfect its claim for mechanics' liens.

Lenders should carefully review Article 7 dealing with change orders since it creates two formats: The customary written change order signed by owner, architect and contractor (but not the lender), 7.2.1, and the Construction Change Directive signed by the owner and architect, but not the contractor, 7.3.6. Lenders should consider modifying these provisions to provide that all change orders must also be approved by it in writing to assure the lender that changes will not cause the loan to go out of balance (whatever that means).

To avoid front-end loading by general contractors, under 9.3.1 all requisitions from subcontractors and material suppliers must be part of a cost-plus contractor's request for payment. Front-loading is also controlled by the way payments are calculated, that is, even in a cost-plus contract, payments are based on the percentage of completion of the Work.

As to hazardous materials, it is now the duty of the owner to provide a hazard-free environment if polychloride biphenyl's (PCB) or asbestos is found on the premises (see 10.3.1). This permits the contractor to stop work until a hazard-free working environment is created.

II. The Construction Contract -- Selected Problem Areas For Lenders

The Contract Documents.

The base contract will always refer to, and incorporate into the base contract between Owner and Contractor, the plans, specifications, bid documents, shop drawings, addenda prior to
and during the actual construction, as well as all modifications to the contract. The latter should be of critical concern to the lender. Further, all contract documents should be signed and identified by the parties, and lenders should have a fully executed set in their file, initialed and dated by the parties or their duly authorized agents, prior to the commencement of construction.

**The scope of the work.**

The parties, including the lender, must have a clear understanding of the scope of work required by the contract. Vague and indefinite terms defining the scope of work are an invitation to litigation. Particularly troublesome are fast track projects (and some Design-Build projects) where the work begins prior to the completion of a full set of plans and specifications. Such projects require very careful monitoring by the lender's architect. This is especially true in Design-Build, where you may never see a completed set of drawings and specifications.

**Plans and specifications.**

If AIA contracts from the A201 family (as well as the Construction Manager at risk family) are used, the drawings (plans) and specifications are (or will become), by definition, a part of the contract documents which constitute the contract between the parties.

If a contract refers to plans and specifications and expressly makes them a part of the contract, the plans are deemed to be incorporated by reference as though they were physically attached to the contract itself. You might do well to ask yourself whether you have actually seen these documents when you incorporate them into “your” construction contract.

**Time of commencement and completion.**

Commencement and completion dates are critical, not only to the owner, but to the lender, too. Final completion is the event which indicates that the interim lender has fulfilled its
obligation and turns over the risk of re-payment of the loan to the end lender, who has purchased a completed project.

Construction contracts should always contain precise commencement and completion dates. In the absence of a written contract or in the absence of express time deadlines in a written contract, the courts will impose an obligation to perform the contract within a reasonable time.

When a construction project is not completed within the period called for in the contract, a frequent question is whether or not the phrase "time is of the essence" affects the time for performance of the contract, thus preparing the way for a claim for delay damages by the injured party, whether it be owner or contractor. The general rule appears to be that, time is not ordinarily of the essence in a building contract, unless the contract explicitly so states, or unless the circumstances and conduct of the parties indicate that such was the intent of the parties at the time the contract was executed. Note that subparagraph 8.2.1 of the A201 states that all time limits stated in the Contract Documents are of the essence.

The contract sum.

The contract sum sets forth the owners financial obligation and should be expressly agreed upon unless the contract is a Cost Plus or Time and Materials or Unit Price contract. In the event of the latter, the lender should approach the project with concern as it may ultimately pay more for the completed project than originally estimated. The risks can be controlled, if not eliminated, by requiring the establishment of a Guaranteed Maximum Price. Since the lender relies upon the contract sums to determine the extent of the risk it is prepared to assume, the amounts should be realistic and based upon bona-fide bids to assure their accuracy.
If a construction contract does not contain a definite price agreed upon by the parties prior to the construction, the lender faces the risk that a court may infer that the price for the materials is the reasonable cash market value, and the price for the labor is that which similar contractors customarily receive for similar work.

Payments under the contract.

The contract should explicitly provide for a payment schedule approved by the lender. This enables the owner to determine the extent of construction financing required and permits the lender to schedule its commitments to assure the contractor and owner that payments will be made on a timely basis to the general contractor, allowing it to make payments to its employees and subcontractors. It is, however, customary for the lender to provide for the lender’s architect to certify that the contractor’s work has been completed in accordance with the contract documents, and the owner is thus obligated to pay the contractor to that time, based upon the percentage of work completed to that date.

Complex projects often presenting a daunting question: how in heaven’s name could anyone say that a skyscraper office/retail/residential tower is x% complete? The answer lies in breaking the job down into smaller pieces, sometimes on a trade-by-trade basis, sometimes in more loving detail. In theory if not always in practice, it is more feasible to say that some particular aspect of the job has reached a particular level of completion. The percentage of completion of the subparts of the project can then be aggregated to arrive at an overall statement of the percentage of completion of the project. This is the purpose of the Schedule of Values, which is not a contract document. It is a submittal (see Par 3.12 of the A201 for submittals in general), but that does not diminish its importance. Neither should you think that the problems that surround a schedule of values can be helped by making it into a contract document. There is
no magic bullet for progress payments and “completion” of the Work. It requires careful
attention by a skilled team of professionals. Just keep in mind that counsel will usually not be
called in to review these problems until it is too late to do much more than pick up the pieces.

In addition, many lenders are seriously considering as an alternative method of disbursing
progress payments the concept of direct disbursement to subcontractors to assure payment and
avoid the filing of mechanics' lien claims. The Appendix contains a publication of the American
Subcontractors Association explaining the process in greater detail. {Where???}

In the absence of a specific contractual clause, it is generally held that the contractor is
entitled to final payment when the construction project is substantially completed.

AIA Document A201, General Conditions, defines substantial completion as existing
when the construction is sufficiently complete, so that owner can occupy or utilize the work or
designated portion thereof for the use for which it is intended. Thus, “if the owner benefits from
its use of the project, it should be responsible for payment” is an often-heard formula. However,
subparagraph 9.9.1 of the A201 hints that there is much more to this topic than a simple rule of
thumb. Partial occupancy of Work can be addressed up front in the contract, as it often is in
complex, multiphase projects. Or it can be addressed as a way of working through performance
problems, as when an Owner accepts late completion provided that certain critical parts of the
Work are delivered on time. In still other cases, the “occupancy” is not the same as beneficial
end-use, but is instead having another contractor do something with the Work, such as installing
an expensive floor covering. If there is something wrong with the slab, you had better have a
way of allocating the risk and cost to someone, otherwise the Developer will foot the bill, and it
may queer the equity/loan balancing that was the basis on which the loan was underwritten.
The final payment, as well as the retained percentages, are not due until all conditions of the contract are met; i.e. substantial completion, and submission by the contractor to the architect or owner and the lender an affidavit, under oath, that all payroll and materials and equipment invoices have been paid, as well as all receipts, releases, and mechanics' lien waivers of all subcontractors and material suppliers on the project and, of course, completion of any remedial or punch list work required. No lender should ever close out the final amount due under the contract to the contractor until these documents have been provided. Failure to require such documents can result in the loss of defenses to the mechanics' lien claims of subcontractors, who may claim that they have not been paid by the general contractor.

A common practice in the construction industry is "retention," whereby the owner and lender will withhold a fixed percentage of each progress payment, usually ten percent, pending satisfactory completion of the entire project by the contractor. Once substantial completion is achieved, retention takes on a different color: the purpose of retention is then to ensure the owner and lender that the contractor will correct any deficiencies discovered prior to or within a specific period following completion of construction, i.e. remedial work and punchlist work.

Other wrinkles surrounding retention include the growing tendency to reduce retainage when the percentage of completion reaches a certain level—typically fifty per cent. It is becoming more and more common to agree that retention will be held on the first half of the work but thereafter, so long as the Work is on schedule, no further retention is held.

Keep in mind, too, that retention can be very different depending on exactly which AIA(or other) documents comprise the contract for construction. While an A101 contract calls for retention to be released at substantial completion of the entire Work, the A121/131 forms call for retention to be released based on whatever terms are written into the subcontracts—and they
typically call for releasing retainage when the Work of the trade is substantially complete. Thus a foundation contractor will expect to be closed out when his work is done instead of waiting for the entire project to be completed. This can produce surprises when defects in the foundation are not discovered until the steel erector begins looking for the fasteners that were supposed to have been embedded in the foundation, and either cannot find them, or finds that they are in the wrong place, damaged, or otherwise unusable. The same scenario has been repeated with infinite variety and freshness. There’s no substitute for staying awake.

III. BASIC PRINCIPLES OF SURETYSHIP

A Surety Bond is a three-party agreement by and among the surety, the obligee and the principal. In a simple construction setting, the obligee is usually the owner to whom the obligation runs. The bond principal is generally the contractor with responsibility for completing the project. The surety is an insurance company who executes and issues the bond at the request of the principal.

The five types of construction bonds furnished by surety are a bid bond; performance bond; labor and material payment bond; completion bond; and lien bond. All bonds serve as collateral for some other, primary obligation, the performance of which (by the principal obligor on the bond, typically the contractor) will exonerate the bond.

These bonds differ according to their conditions. Thus a bid bond (typically for ten percent of the amount bid) stands as security for the contractor’s obligation, in the event that it is the successful bidder, to deliver an executed contract and related payment and performance bonds. It is part of counsel’s obligation to ensure that the delivery of payment and performance bonds—if required as part of the deal—is also made part of the covenants underlying the bid bond. If
such is not expressly required, then the Owner will not have access to the bid bond if the Contractor does not deliver proper bonds.

A performance bond secures the contractor’s obligation to perform the Work in keeping with the Contract Documents. It should address the right of the Owner to prescribe changes in the documents, since without a reserved right to do so, any change in the documents will exonerate the surety under the rule of *strictissimi juris*. A payment bond secures the contractor’s obligation to pay the costs of the work to subcontractors and material suppliers.

Both payment and performance bonds are subject to being defeated if the Owner defaults in making payments to the contractor. To enhance the lender’s comfort level, in some cases, a Completion Bond is required. A completion bond stands as collateral security for the lien-free completion of the Work, and Owner default is not an excuse but is instead one of the events that triggers the surety’s obligation to pay. Payment and performance bonds are generally obtained for 100% of the lump sum or Guaranteed Maximum Price, if applicable.

Lien bonds are also frequently encountered. Most mechanic’s lien statutes have a mechanism whereby a surety bond can be substituted for the real property that is attached by the filing of a mechanic’s lien claim. The amount of the bond is typically the amount of the lien plus a cushion of ten per cent or so, the amount generally being set by the court, by agreement of the parties, or, in some cases, by a statutory formula.

The obligee obtains these bonds to provide assurance throughout the construction process that its contract will be entered into and completed in accordance with the plans and specifications and that all persons furnishing materials and/or labor will be paid. Because of the nature of its obligation, the surety is generally a silent party to the construction process and hopefully not called upon to act. If the bond principal fails to perform its obligation, the surety's
responsible for the bonds are triggered. If the surety is required to respond by way of performance or payment, it has a common law right to seek reimbursement from its principal for all expenditures. Moreover, in exchange for furnishing the bonds the surety obtains a premium as well as an Indemnity Agreement. The Indemnity Agreement is always executed by the bond principal (corporate indemnitor) and usually by several individuals associated with the corporation as well as their wives (individual indemnitors). The agreement gives the surety an additional contractual cause of action against one or more corporate or individual indemnitors. The liability of such individual indemnitors affords further insurance for the surety, inasmuch as these people are liable up to and including the extent of their personal assets.

The penal amount of the bond usually corresponds with the original contract price. The amount of the bond, almost without exception, represents the maximum extent of the surety's liability to the obligee.

Performance bonds used in conjunction with public projects are required by statute. Federally financed construction projects require performance bonds pursuant to the Miller Act. State and local improvements also require performance bonds. These statutes govern the terms of a performance bond furnished on a public job. Certain language is included within the bond form in accordance with the statute regardless of whether it appears on the face of the instrument. On a private construction project, the obligee is free to dictate the terms of the bond in order to satisfy its particular needs. In reality, the language contained in statutory and private bonds is generally very similar.

When a default has been declared by an owner, the surety generally has little or no information regarding the nature of the default or status of the construction project. It must conduct an immediate investigation and obtain as much information as possible from all
concerned parties. It is at this stage of the surety's involvement that it is asked to make the most important decisions. These decisions will dictate the surety's future course of conduct and ultimate exposure under the bond. Ironically, the surety has the least amount of information available at this stage of the decision making process. Therefore, there is no substitute for experience on behalf of the claims representative and practitioner.

Assuming the obligee's declaration of default is proper, several options become available to the surety in terms of fulfilling its obligations under the performance bond. The goal of the surety is to determine the cost of curing the default with an eye towards fixing its liability and minimizing its exposure.

A surety's liability to the owner under the performance bond is usually equal to the difference between the cost of completion less the remaining contract balances and retainerage. However, as a general rule the performance bond surety is liable to the obligee for damages for delay to the same extent as is its principal under the bonded contract. Under this general rule, courts have allowed an obligee to collect for liquidated damages, delay damages, architects, engineers and attorneys' fees, loss rentals, loss of use, and interest.

IV. EARLY WARNING SIGNALS OF A TROUBLED CONTRACTOR

Much has been written and said about the defaulting mortgagee, but little is said about the mortgagor whose default is caused by the defaulting contractor. For example, how can the lender protect itself where the contractor causes the default of the owner/mortgagor due to delays in completion, or failure to orderly schedule project construction causing subcontractors to be unable to order the specially fabricated material, or where the contractor fails to pay its subcontractors on a timely basis causing them to fail to meet their financial obligations? It is easier to deal with the default caused by the loan being "out of balance," since it is usually a
matter of mathematical calculation. [Although it is also clear that the manner of such calculation is generally a matter of dispute. In general, “out of balance” means that the Owner/Developer’s “equity injection” will not be enough to complete the Project or otherwise that financial ratios required by the loan documentation will not be satisfied.] But what signals are present which the alert lender can spot during the course of construction long before the contractors default throws the entire project into disarray, confusion and possible termination?

Some of the causes can be cost overruns caused by unrealistic bids by the contractor, reliance of the contractor on unrealistic bids by subcontractors, or the inability of contractors to properly bid due to vague plans prepared because the project is a fast track project where bids are based upon certain assumptions which may prove to be in error when more detailed plans are eventually prepared. It is not only the developer who may be guilty of wrongfully diverting mortgage funds, but also the general contractor who is so thinly capitalized that it is using funds payable on your project to cover payments on other projects where payments may be delayed.

Some contractors tend to front-end-load their draw requests by drawing down funds in excess of labor performed or material furnished and basing their overhead and profit percentage on the phantom work or materials, thus taking out more than they have earned. Too often, lenders fail to realize that not only can their borrowers go into bankruptcy, but so too can the contractor and subcontractors who wait for payments that fail to materialize on a timely basis.

V. AN OVERVIEW OF MECHANICS' LIENS FOR LENDERS

One of the most effective means a subcontractor has to protect itself from non-payment is to file a mechanics' lien upon the property on which it has performed work. This mechanics' lien is a claim or charge on the real property for the payment of a debt incurred by the contractor to the subcontractor for work performed by the subcontractor. In the event the subcontractor is not
paid, the debt can be satisfied by distributing the proceeds from the sale of the secured property through judicial proceedings, provided other requirements are satisfied. Crucial to the health of the project and the lender is the effect of paying a general contractor who then does not properly pay the subcontractors. In most cases, payment to a general contractor prior to the subcontractor(s) giving notice that they have not been paid does not expose the developer or lender to paying twice for the same work. However, local practices are highly variable. There is no substitute for familiarity with the vagaries of local practice. Good working relationships with title insurers are invaluable at times like these.

The mechanics' lien is purely statutory in nature, and was unknown at common law. Since it is only by virtue of legislative authority that a subcontractor may acquire and enforce a mechanics' lien on property, it is critical to comply with the statutory requirements of the local act. Deviation means failure.

Enforcement of the mechanics' lien is based upon certain equitable principles. A court must weigh (1) the benefit accruing to the property by reason of the subcontractor's work; (2) the detriment to the subcontractor performing the work; (3) the concomitant increase in the property's value resulting from the foregoing; and (4) the equitable principle that one should not benefit from the labor of another without paying for that benefit. The statutory right which secures payment for the subcontractor's performance by a mechanics' lien upon the owner's land or the improvement thereon does so without the requirement of privity of contract. Generally, a contractual relationship is required to permit one party to sue another for breach of contract. In the construction setting, however, there is no direct contract between the owner and the subcontractor. Mechanics' lien statutes obviate the need for privity of contract, and permit a subcontractor to enforce its rights against an owner's property.
Today, each state has its own particular mechanics' lien statute. Each state's statute has its own method for protecting subcontractors by giving them a secure and immovable interest in property to protect their right to payment. The prudent practitioner must always analyze the statutory framework of his or her own jurisdiction, to assure perfection of the lien rights as provided by each state's Act.

VI. ANALYZING THE CONSTRUCTION LOAN IN DEFAULT

The first point to explore is what is the stage of construction (whether it is the borrower or contractor in default)? In other words, what is the stage of completion? Is it partial? That is, is it in a state that prospective users have to be informed that the project is so far from completion that they must seek an alternative site? Is it substantially complete -- that is, with some accelerated work will the project be available with moderate, though not fatal, delays?

The second area of concern is whether work is continuing or whether subcontractors already stung by delayed payments have engaged in slowdowns, marshalling their employees to other projects but not quite reaching the point where they will terminate their contracts.

At the same time the lender is determining the activity at the job site, it should be making a title search to determine if any mechanics' liens have been recorded against the property. In this instance, a working knowledge of the local mechanics' lien act is critical. Each state has its own mechanics' lien act and from that act the lender will be able to determine priorities, effectiveness of compliance with perfection requirements and, equally important, whether there are sufficient funds available both to complete the project and pay lien claimants who may be necessary for the completion of the project.

The lenders architect should be consulted at this stage as to the conformity of the work in place to plans and specifications, as well as the status of change orders relating to proper
changes, extras based upon changes not contemplated, disputed extras where the architect and the contractor (if the extra is claimed by a subcontractor) claim that the work is with the scope of work as defined by the contract documents, plans and specifications.

The lender will have to take this preliminary information and determine the cost to complete the project, which would include the cost of remedial work as well as work which is to be completed, and if there are any funds available for unpaid subcontractors who have liened the project.

It is also at this stage that the lender looks to potential third party assistance. For example, with regard to mechanics' lien claims, lenders will usually have requested interim certifications of their mortgage priority over lien claims and, therefore, any mechanics' lien claim should immediately be tendered to the title company for defense. *This is the time to deal with the early underwriting decision as to whether or not the project should have been bonded in the first place.* "Stanley, at this point it's too late to do much more than rejoice because bonds were required or weep because they were not; maybe we just need to say that this is when the chickens come home to roost and leave it at that!" Developers do not like to pay for the bond premium since it is a soft cost that does not add to the value of the project. However, if the decision had been made at the time of underwriting the loan to have the general contractor bond the project and major subcontractors bond their portion of the project, this is the time to serve notices on the bonding companies that the project is in trouble. One note of caution deals with the reliability of the bonding company and the lenders due diligence at the time of the commitment. Was the bonding company authorized and licensed to do business in the jurisdiction at the time the bond was issued and at the time of the default? Beware of the Grand Cayman Island Surety, Fidelity and Reliable Company which only has a post office box and no
local office. Further, be extremely cautious where the bonding company is a subsidiary of the general contractor and is not financially viable in its own right.

It is not unusual for the surety to deny a portion of the claim by claiming that the delay was not the fault of the contractor but the developer, who was using its own forces to do a portion of the work such as site development; or the failure of the developer's architect to approve shop drawings on a timely basis, thus causing the delay; or misrepresenting site conditions to the contractors; or other similar defenses.

When a default occurs in a construction loan, the construction lender is under great pressure to act quickly and effectively. Two factors become critical: First, the necessity for completion of the improvement on the secured property to avoid the risk of losing access to the fundamental sources of loan repayment to the interim lender, such as a permanent lender, pre-construction commitment sales or pre-construction leases; secondly, a loan workout, as the term is used here, refers to the course by of action which the construction lender attempts to resolve a construction loan default without resorting to litigation.

While it usually is evident when an actual construction loan default occurs, there are also certain "red flags" or warning signals which should alert the construction lender well in advance of the possibility that a default is about to occur. For example, when construction fails to progress in accordance with the time schedule established by the construction contract, loan agreement or construction schedule established by the owner, architect and contractor; cost overruns occurring in certain categories, or where they are pervasive; when mechanics' liens are filed by subcontractors claiming they have not been paid despite loan disbursements to the general contractor; when contractors or subcontractors are routinely replaced on the project without any justification; or when the borrower fails to comply on a routine basis with lender's
requests for information and lender's draw procedures. All of the foregoing gives ample warning that a default is in the making.

The lender should immediately determine the precise status of the loan contract and the progress of construction, and analyze why a default has occurred or will occur. Oral modifications of the construction loan agreement should be avoided by officers or representatives of the lender as it could have an adverse impact upon the lender's right to demand strict compliance with the loan documents.

All parties who may have a stake in working out the construction loan should be clearly identified, and the lender's rights and obligations as against these parties should be determined. These parties include the title insurer; any bonding company or surety; the permanent or take out lender; contractors, material suppliers, architects; engineers; prospective or actual tenants; junior lien

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At the same time the lender is determining the activity at the job site, it should be making a title search to determine if any mechanics' liens have been recorded against the property. In this instance, a working knowledge of the local mechanics' lien act is critical. Each state has its own mechanics' lien act and from that act the lender will be able to determine priorities, effectiveness of compliance with perfection requirements and, equally important, whether there are sufficient funds available both to complete the project and pay lien claimants who may be necessary for the completion of the project.

The lender's architect should be consulted at this stage as to the conformity of the work in place to plans and specifications, as well as the status of change orders relating to proper changes, extras based upon changes not contemplated, disputed extras where the architect and the contractor (if the extra is claimed by a subcontractor) claim that the work is with the scope of work as defined by the contract documents, plans and specifications.

The lender will have to take this preliminary information and determine the cost to complete the project, which would include the cost of remedial work as well as work which is to be completed, and if there are any funds available for unpaid subcontractors who have liened the project.

It is also at this stage that the lender looks to potential third party assistance. For example, with regard to mechanics' lien claims, lenders will usually have requested interim certifications of their mortgage priority over lien claims and, therefore, any mechanics' lien claim should immediately be tendered to the title company for defense. This is the time to deal with the early underwriting decision as to whether or not the project should have been bonded in the first place. Developers do not like to pay for the bond premium since it is a soft cost that does not add to the value of the project. However, if the decision had been made at the time of
underwriting the loan to have the general contractor bond the project and major subcontractors bond their portion of the project, this is the time to serve notices on the bonding companies that the project is in trouble. One note of caution deals with the reliability of the bonding company and the lenders due diligence at the time of the commitment. Was the bonding company authorized and licensed to do business in the jurisdiction at the time the bond was issued and at the time of the default? Beware of the Grand Cayman Island Surety, Fidelity and Reliable Company which only has a post office box and no local office. Further, be extremely cautious where the bonding company is a subsidiary of the general contractor and is not financially viable in its own right.

It is not unusual for the surety to deny a portion of the claim by claiming that the delay was not the fault of the contractor but the developer, who was using its own forces to do a portion of the work such as site development; or the failure of the developer's architect to approve shop drawings on a timely basis, thus causing the delay; or misrepresenting site conditions to the contractors; or other similar defenses.

holders; prospective project purchasers; partners of the borrower (including limited partners); and other creditors of the borrower.

The lender should determine whether the project as originally projected is still viable and assess whether or not the borrower will be cooperative in attempting to work out the construction loan default and the lender should determine precisely who in the lender's organization will be responsible for dealing with the borrower and the project in default.

Several alternatives are available to the lender in the face of a construction loan default: whether or not to take non-judicial direct possession of the project from the borrower or to immediately initiate mortgage foreclosure proceedings.
The reasons for the construction loan default often will determine whether foreclosure should be initiated. If the reasons are related to the borrower's financial weakness, his inability to properly manage the project or the borrower's honesty, a foreclosure is appropriate. If problems have occurred which are beyond the control of the borrower, such as supply problems, sales problems or general economic conditions, a non-judicial workout rather than a judicial foreclosure may be the best course of action.

Completion of construction is always the paramount consideration since there rarely is a buyer willing or available to purchase a partially completed project for a price approaching the balance of the loan.

Initiation of foreclosure proceedings may void the permanent commitment to refinance the project and this alternative should be considered only after an analysis of the take-out commitment. Of course, an unsecured default and incomplete construction may very well vitiate the takeout commitment just as certainly. The exercise is patently one in risk management and benefit analysis. Further, contractors and subcontractors may be reluctant to continue in the event of a foreclosure and will no doubt immediately file their mechanics' lien claims. Foreclosure will also increase the likelihood of a borrower filing for protection under the Federal Bankruptcy Act and staying all judicial proceedings, which includes judicial foreclosures.

A consensual workout may be an agreement under which the lender and borrower cooperate to modify or restructure the construction loan, or in a non-adversarial manner complete a judicial foreclosure or where the borrower tenders a deed in lieu of foreclosure to the lender. All of the foregoing avoids the expense and delay of protracted litigation. The construction lender may determine that a modification of the construction loan, without a foreclosure, is an appropriate course of action where a prudent borrower has run into difficulties with the project
beyond his control, such as economic problems, technical problems or material or labor problems. However, this requires a determination by the lender that the construction project remains economically viable with the modified loan, and that the borrower can complete construction of the project expeditiously.

In utilizing the consensual takeover approach, care must be taken to avoid loss of priority of the lien of the construction loan mortgage. Junior lienholders may have to consent to material modifications of the construction loan, or the construction lender will risk loss of its priority as to them. If the lender agrees to make additional loan advances beyond the amount of the original loan principal, it may be that these optional advances only have priority from the date of the advance, and not from the date of the original construction loan.

Care should be taken since material modification of a loan agreement may exonerate guarantors and others secondarily liable upon the loan and whenever possible the consent of these parties to a modification should be obtained.

The lender and borrower may agree that the lender should take title to the defaulted construction project without foreclosure proceedings. This may occur where the borrower is unwilling or unable to complete construction, given the changed circumstances, and where the lender determines that its loss may be minimized by completing the project either by itself, or through an agent.

Due to the expense and time involved in a mortgage foreclosure, the mortgagee may reach an agreement with the mortgagor regarding the default and ultimate disposition of the property without the necessity of foreclosure proceedings. The Deed in Lieu of a Foreclosure is an agreement reached between mortgagor and mortgagee wherein the mortgagor agrees to convey the property directly to the mortgagee and the mortgagee agrees to terminate the debt
under the note and mortgage. The benefit to the mortgagee is that it will have title to the premises in fee simple without the fear of title impediments or redemption rights of the mortgagor. The benefit to the mortgagor is that it need not fear a deficiency judgment nor be subject to the payment of costs and attorneys' fees in the event of foreclosure proceedings.
APPENDIX

General Contractor's Letter

Last National Bank
Chicago, Ill.

Re: Premises: 70 W. Madison Street

Improvements: 50 Story Building

Borrower: Honest Owner

Loan No.: 123461973

Gentlemen:

We are the General Contractor for the Improvements. In consideration of your loan to the Borrower made to finance the construction of the Improvements, we agree that in the event of default by the Borrower under any of the loan documents, we shall, at your request, continue performance under our agreement with the Borrower on your behalf, provided that we shall be reimbursed in accordance with the terms of said agreement for all work, labor and materials rendered on your behalf.

We further agree that we shall not perform work pursuant to any Change Order which will result in a change in the contract price set forth in said, nor pursuant to any such agreement in excess of the Change Order Amount, nor pursuant to any such Change Order which, together with the aggregate of Change Orders theretofore executed between the Borrower and us, excluding those theretofore specifically approved by you, will result in an increase or decrease in such price in excess of the Aggregate Change Order Amount, unless in either case we shall have received your specific approval of such Change Order. In the event we fail to secure your
specific approval of such Change Order, we shall deem said agreement to be unmodified by such Change Order.

Very truly yours,
General Contractor

By: _______________________
    Authorized Agents/Officers
Assignment of Contractors' Contracts

THIS ASSIGNMENT ("Assignment") is made and entered into as of April 10, 2003, by the undersigned Last National Bank, not personally, but as Trustee under Trust Agreement dated April 1, 2003 and known as Trust No. 00-0000-00 (the "Trustee"), whose mailing address is 100 South LaSalle Street, Chicago, Illinois 60603, and Honest Owner, an Illinois Limited Partnership, which own(s) all of the beneficial interest under the Trust Agreement with the Trustee (the "Beneficiary" whether one or more), whose mailing address is 1111 North Avenue Valley, Oak Brook, Illinois 60521, to and for the benefit of Last Mortgage Company, a Delaware corporation and its successors or assigns (the "Lender"), whose mailing address is 500 North LaSalle Street, Chicago, Illinois 60603. Beneficiary and Trustee are collectively referred to herein as the "Assignor."

At the request of Assignor, Lender has agreed to lend or cause to be lent to Trustee the sum of Thirty Million and 00/100 Dollars ($30,000,000.00) (the "Loan"), to provide funds for constructing and/or remodeling on certain real estate situated in the City of Chicago, County of Cook, State of Illinois, a 50-story office building (the "Project"), to consist of vacant office space, lobbies and other amenities and to also construct an enclosed parking deck, together with related on-site and off-site improvements, all in accordance with final plans specification (the "Plans and Specifications") prepared by Helmet Wright/Wrong Architects, Inc., bearing Job Number XYZ-000 and heretofore submitted and approved by to Lender.

NOW THEREFORE, in consideration the mutual covenant herein contained and the good and valuable consideration of the parties hereto agrees as follows:
A. In order to induce Lender to make, as additional security for, the Loan and for all obligations of Assignor and each of them under all documents at any time given to lender to secure the Loan, Assignor hereby assigns to Lender, subject to the terms and conditions hereinafter set forth, all right, title and interest of Assignor and each of them in and to those certain contracts listed on Exhibit "A" attached hereto and made a part hereof (being hereinafter collectively referred to as the "Construction Contract") pursuant to which the General Contractors have agreed to act as General contractors for the construction and/or remodeling of the Project.

B. Lender agrees that unless and until an event of default occurs under the PROMISSORY NOTE of Trustees of even date herewith (the "Note") which evidences the Loan, or under the MORTGAGE, SECURITY AGREEMENT AND FINANCING STATEMENT of Trustee securing the Note or under the BUILDING LOAN AGREEMENT of even date herewith concerning the Loan or under any other document executed by Trustee or Beneficiary or by other and given to secure repayment of the Loan, Lender shall not exercise any rights of Assignor or any of them under the Construction Contract; provided, however, that from and after the time of such event of default, Lender shall become immediately entitled to exercise all of the rights of Assignor and each of them under the Construction Contract.

**THIS AGREEMENT** is executed by Trustee, not personally but as trustee as aforesaid in the exercise of the power and authority conferred upon and vested in it as such trustee (and the undersigned Trustee hereby warrants that it possesses full power and authority to execute this instrument), and it is expressly understood and agreed that nothing herein contained shall be construed as creating any liability on Trustee personally to perform any covenant either express
or implied herein contained, all such liability, if any, being expressly waived by every person nor
or hereafter claiming any right or security hereunder.

IN WITNESS WHEREOF, Assignor has executed this Assignment as of the day and
year first above written.

ASSIGNOR
Conditional Assignment of General Contractor

The undersigned herein after referred to as "General Contractor," represents that it is the general contractor of the Project described in the foregoing ASSIGNMENT OF GENERAL CONTRACTOR’S CONTRACT. In consideration of LAST MORTGAGE COMPANY herewith referred to as Lender agreeing to make the Loan as aforesaid the General Contractor hereby agrees that in the event of default by the Trustee, any Beneficiary, therewith any other party set forth under any of the documents evidencing and/or securing the Loan, the General Contractor shall, at the request of the Lender continue performance on behalf of Owner or Lender under the Construction Contract March 24, 2003, in accordance with the terms and conditions thereof.

General Contractor agrees that it shall not perform any work pursuant to any Change Order or otherwise which will result in any change in the Contract Sum or in a material deviation from the Plans and Specifications, unless in each case General Contractor has received specific approval from Lender of such change or deviation. General Contractor's Construction Contract for the Project shall (for the purpose of General Contractor's obligation aforesaid to continue performance thereunder and hereunder for the benefit of Lender by deemed not to have been modified by such change or deviation.

The officers executing this instrument on behalf of General Contractor hereby personally certify that General Contractor has full power and authority under all applicable laws, ordinances and regulations to perform all of its obligations under the Construction Contract in accordance with the terms thereof and to execute this Agreement.
Dated as of March 26, 2003.

General Contractor

Last National Bank, not personally, but as Trustee as aforesaid

Honest Owner an Illinois Partnership Limited

Accepted:
Last Mortgage Company