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ALM

A Lending Primer

On Document Review and Loan Administration

The recovering economy has seen a significant increase in construction lending activities. In order to assist lenders and their counsel in the review of construction documents and the administration of construction loans, we offer this primer.

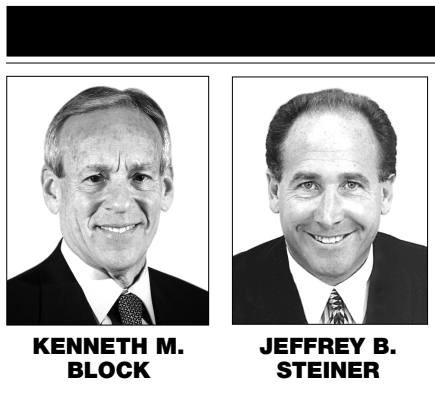
Design and Construction Documents

The most commonly used design contracts on construction projects are issued by the American Institute of Architects and include the Standard Form of Agreement between Owner and Architect (AIA Document B141) and the Abbreviated Standard Form of Agreement Between Owner and Architect (AIA Document B151). Even though these forms generally are accepted by the industry, care should be taken to determine whether the forms properly reflect the agreement between the borrower and its architect and are sufficient to protect the rights of the lender.¹

Certain critical issues should be reviewed by the lender prior to its approval of the design contract, such as:

- Whether the scope of services provided by the architect is adequate in light of the size of the project and the manner in which it will be constructed.
- Whether the architect will provide contract administration services during the course of the project necessary in order to bring about completion.
- Whether the architect who designed the project will supervise construction and be able to ensure that the approved plans are followed.
- Whether the architect is assuming full responsibility and liability should its plans and specifications be deficient.²

Kenneth M. Block and **Jeffrey B. Steiner** are members of Brown Raysman Millstein Felder & Steiner in New York. **Natalie Newman**, a summer associate, assisted in the preparation of this article.



KENNETH M. BLOCK

JEFFREY B. STEINER

Given the importance of the role of the architect on the project, the lender should recommend that the contract contains a provision allowing the architect to terminate the contract only in the event of persistent defaults by the borrower, following notice to the borrower and the lender after a reasonable grace period. The lender may also wish to determine whether it is fully protected in such areas as the right to use the architect's drawings and specifications in the event they are needed for expansions of the project or to correct any deficiencies.

The design contract should also include provisions requiring the architect to furnish copies of its construction draw approvals directly to the lender; granting the lender the right to terminate the design contract upon the borrower's default; allowing for the assignment of the design contract to the lender upon the borrower's default or for the assignment to a third party should the lender wish to dispose of the project. In view of the lender's participation in the review of the design contract, it also may be helpful to include a provision whereby the architect acknowledges that the lender is not in privity with the architect and that no claim can be filed by the architect against the lender in the event the borrower does not pay the architect's fees.

The lender's review of the construction contract should follow along the same theory as the review of the design contract; that is, is the bor-

rower and the lender protected by the agreement with the contractor? Inasmuch as the lender is providing the funds for the construction of the project, the lender must ensure that the amount advanced through the borrower to the contractor is reasonably consistent with the value of the work in place at the time each progress payment is made. It is therefore important to ensure that funds are advanced strictly in accordance with the progress of completion of the project. The lender should review the cost allocations for each item of work and satisfy itself that the amounts allocated are consistent with usual practice. In other words, the lender should ensure that the construction costs are not "front loaded" so that funds are disbursed in a disproportionate amount to the stage of construction.³

Another area of particular concern to the lender are change orders and claims for extras. The lender should ensure that there are specific procedures for implementing change orders or other needed amendments to the contract and that they be strictly adhered to during the performance of the work. Changes generating costs in excess of a certain dollar amount without prior written approval of the lender should be prohibited. In order to ensure that this prohibition is followed, another provision may be included stating that the lender will not be bound by any contract amendment or change order not approved by the lender.

The lender should also anticipate a possible default by the contractor and ensure that there are clear, specific and appropriate provisions to protect the borrower if such default occurs, including the right to terminate the contract and assume possession without delay. In the event of a borrower default, the lender should be given notice of the default and an opportunity to cure prior to the exercise of termination rights by the contractor.

The lender should also provide that if the borrower defaults under the construction loan, the lender may assume the borrower's obligations (but not be required to) under the construction contract. The usual documentation employed to

