

INDUSTRY FOCUS: COMMERCIAL REAL ESTATE

Developers can help head off lender-contractor disputes

Expert Opinion

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Project owners and developers often spend many hours negotiating with contractors. Owners some times make the mistake, however, of failing to ascertain the contractual and documentation requirements of the project's lender as a condition for making the construction loan.

Below is a look at some typical lender requirements, as well as the sometimes competing concerns of the parties regarding those requirements.

The owner and its lawyer should review the loan documents and construction contract, each in terms of the other, with the goal of making the provisions of both consistent. That will go a long way toward eliminating a situation where the owner is caught in the middle between its obligations to the lender and the contractor's obligations to the owner.

For example, the loan agreement's definition for "substantial completion" of the project — which may trigger payment of retained amounts and other rights and responsibilities between the owner and lender — should match the definition of substantial completion in the construction contract.

As much as possible, the owner should ensure it is not obligated to pay retainage to the contractor until the lender is obligated to pay that retainage to the owner. Also, the timing of (and supporting documentation for) payments should be consistent between the loan documents and the construction contract so payments flow smoothly from lender to owner to contractor.

Probably the most important lender requirement that should be included in negotiations with the contractor is the documentation the lender wants from the contractor before closing the construction loan or commencing construction.

Foremost among that documentation is the consent-to-assignment form, in which the contractor agrees to the owner's assignment of the construction contract to the lender as security and to the lender's right to have the contractor finish the project if the owner defaults under the loan documents.

The interests of the lender and the contractor after the owner defaults may be at odds.

The lender, for instance, wants flexibility on whether to have the contractor continue the project after the default. The lender also wants to pay no more to the contractor than it would have paid to the owner.

The contractor has different concerns: that the consent-to-assignment not affect its right to stop work under the contract for nonpayment or other reasons; also that it will obtain all amounts due under the contract if the project continues.

In an example of the differing interests, the lender may insist that consent-to-assignment include a provision giving it 60 days after the owner's default to decide whether to continue construction and that the contractor work during that decision period. The contractor likely will view this as undermining its right to stop work earlier if the owner has not made timely payments.

Another example: The lender may want the consent-to-assignment to obligate it to pay the contractor amounts due under the construction contract only from the date the lender decides to require the contractor to continue the work. The contractor — interested in being paid all amounts due both before and after the lender steps into the owner's shoes — will rarely agree to such a provision.

Those sorts of issues may prolong negotiations, project commencement and loan funding. The owner and its lawyer, therefore, are well served to facilitate a compromise satisfactory to both lender and contractor.

One common solution is to make the deadlines the same for lender takeover and contractor work stoppage after a default.

Compromises on payment issues often are achieved by requiring the lender to pay all amounts due the contractor, whether before or after the lender takes over the project, if the amount in question has not already been funded to the owner.

The contractor still would bear the risk if the owner absconded with those payments, but that risk can be minimized by careful monitoring or by a direct-pay mechanism in which the lender pays loan draws for construction costs directly to the contractor.

To avoid bogging down the construction in disagreements between the lender and contractor, prudent owners should act proactively and take the following steps:

- Ascertain the lender's requirements as early as possible, preferably before the construction contract is executed.

- Include the lender's requirements and form consents in the proposed contracts put out to bid or for negotiation, so provisions can be negotiated when the owner's leverage is highest.

- If the precise requirements are not known when the construction contract is executed, include a provision requiring the contractor to provide all information and documentation reasonably requested by the lender and to agree to contract changes the lender requires. To protect the contractor, provide that if the lender's requirements increase the cost to the contractor, the contract price may be equitably adjusted.

- Avoid using lenders and contractors that have shown an unwillingness on past projects to compromise or that have insisted on unreasonable positions. Once bitten, twice shy.

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