Practical Guidance

Construction Loan Transactions (FL)

A Practical Guidance® Practice Note by Elena Otero, Holland & Knight LLP

Elena Otero
Holland & Knight LLP

This practice note explores the key components of construction loans in Florida. This note discusses the purpose and structure of Florida construction loans, details key terms used in construction loan transactions, and provides an overview of construction loan documentation. It also offers general best practices for lawyers representing lenders or borrowers in such loans.

For more on construction loan agreements, see Construction Loan Agreements. For a form of construction loan agreement that you may modify for use in Florida, see Construction Loan Agreements. For more on construction loan term sheets and commitments, see Construction Loan Term Sheets and Loan Commitments. For more on draw requests, see Draw Request and Disbursement Process in a Construction Loan. For more on due diligence in construction loan transactions, see Due Diligence in Construction Lending. For more on closing a construction loan transaction, see Construction Loan Process and the Closing.

Introduction and Basics

Construction loans are used by borrowers to finance improvements to existing properties or ground up construction of vacant land. These loans are usually short-term in nature, with maturity of the construction component being tied to the projected timeline for the construction of the project, and sometimes have a permanent term conversion component whereby, once the lien-free construction of the project is successfully completed, the construction loan becomes a permanent term loan. This conversion to permanent financing depends largely on the type of project being built. For example, a conversion to permanent financing would be common in the ground up construction of an apartment building or remodeling of a retail development but would likely not be available to a borrower/developer who is constructing a condominium project and selling the condominium units. Essentially, it is usually available, to the extent offered by the lender on the deal, only in projects where the borrower/developer is intending to hold the collateral and stabilize the project rather than build and sell the project.

Generally, construction loans are advanced monthly or bi-monthly based on draw requests made by the borrower and certified by the lender's construction consultant. These draw requests are based on the budget for the project provided by the borrower and approved by the lender, usually prior to closing of the construction loan. Supporting documentation for draw requests include paid receipts, invoices, lien releases, statement of accounts, and other documents as requested by the lender or its construction consultant. Advances are made to the borrower only for the approved costs in the draw request. Retainage is usually withheld from each draw request and released in accordance with the terms of the loan documents and construction contract.

Depending on the magnitude of the project, these loans usually mature anywhere from one to three years and lenders are very sensitive to ensuring that the project is both on time and on budget. Delays to the timeline can be costly to borrowers and give cause for concern to lenders. As in most contractual relationships and financing transactions, communication between the parties is key to construction loans and timely notice of unexpected delays or budget changes to the lender is a best practice for construction loan borrowers.

Key Terms

The following is an overview of key terms used in construction loan transactions in Florida:

- **Advances.** See the overview of draws below. The terms advances and draws are used interchangeably.
- **Budget.** A budget in a construction loan transaction is the detailed line item budget of all construction costs, including direct and indirect costs (which are also at times called hard and soft costs) and land costs, and showing the total costs for each line item and the amount of each line item to be funded from the loan and/or borrower's equity requirement. Direct or hard costs are the direct construction costs incurred by borrower in connection with the project and indirect costs will be all other costs. Lenders will always want to control revisions to the approved budget and will usually have provisions in the loan documents that limit increases to any line items or the overall budget to keep the loan and project in balance as underwritten.
- **Carry guaranty.** A carry guaranty is a guaranty in which a guarantor agrees to "carry" the expenses of the property and cover various obligations of the borrower, such as utilities, taxes, insurance premiums, interest due, late fees, and other fees under the loan, operating expenses, maintenance expenses, management fees, marketing fees, and other costs and expenses.
- **Completion guaranty.** A completion guaranty is a guaranty in which a guarantor agrees that they will achieve lien-free completion of the project, including payment of all costs associated therewith, and also perform and satisfy all other covenants and agreements of the borrower per the loan documents.
- **Construction documents.** Construction documents are composed of the construction contract with the general contractor; all construction, architectural, and other design professional contracts and subcontracts; all change orders; all governmental approvals; the plans and specifications; and all other drawings, budgets, bonds, and agreements relating to the construction of the project.
- **Conversion to permanent financing.** Some construction loans will have a built-in option whereby the borrower can convert their construction financing (which is short-term financing that will mature upon completion of the project) to permanent financing. Such loans will have loan agreements that outline the conversion requirements, the method by which a borrower can elect such conversion, a conversion date, and the terms (such as the interest rate, maturity date, term) of the permanent financing if the loan is converted.
- **Draws (also called advances).** Draws refer to each funding of a construction loan to a borrower by lender subject to the terms and conditions of the loan agreement. The loan agreement will generally state how many draws will be made monthly (usually one to two times per month) and that the draws will only be for costs actually incurred for work in place as certified by the lender's inspector, and will require lien waivers, releases, and other such proof of payment as well as a title endorsement to the lender's title policy, among other items, for each draw to be made.
- **Draw request (also called advance requests).** A draw request is a request by a borrower to receive an advance under a construction loan. Such requests are usually on AIA Forms G702 and G703 or another form approved by the lender. Lenders will usually require that each draw request include certain representations by the borrower. As an example, a construction loan agreement may state that:
    - Each draw request will constitute a representation by the borrower that the work done and the materials supplied to the date of the request are in accordance with the plans and specifications
    - The work and materials for which payment is requested have been physically incorporated into the project
    - The value is as stated
    - The work and materials conform with all applicable rules and regulations of the public authorities having jurisdiction
    - Payment for the items described in such request has been made or will be made with the proceeds of the advance for which the draw request was submitted
    - The draw request is consistent with the budget
    - The proceeds of the previous advance have been actually paid by the borrower in accordance with the approved draw request for such previous advance – and–
    - No event of default or event which, with the giving of notice or the passage of time, or both, would constitute an event of default has occurred and is continuing

For more on draw requests, see Draw Request and Disbursement Process in a Construction Loan. For forms of draw request, see Draw Request and AIA® Document G702™ — 1992 (Application and Certificate for Payment, Sample Form).

- **Equity requirement.** Construction loans have what is called an equity requirement component which means that a borrower will be required to invest an amount equal into the construction of the project. This amount will be accounted for in the budget and will be a percentage of the project costs. Most lenders will require that the equity remain invested in the project for the term of the loan and will restrict borrower from reimbursing themselves, whether directly or indirectly, for their equity investment. Most loans require that the equity be spent before any advances are permitted, but in some cases, lenders and borrowers may agree to certain tranches of equity and loan advances as they see fit for their particular loan and project.
- **Force majeure.** Force majeure references delay due to acts of God, governmental restrictions or closures, stays, judgments, orders, decrees, enemy actions, epidemics, pandemics, civil commotion, fire, casualty, strikes, work stoppage, shortages of labor or materials, or similar causes beyond the reasonable control of borrower. Most borrowers will want to add these such provisions to construction loans to give themselves flexibility as to items that may occur that are out of their control and which could affect relevant deadlines. In turn, most lenders will want to limit this applicability to ensure that the project stays on track and will require timely notice of the alleged force majeure event to ensure these items are really outside of the borrower's control.
- **Loan balance/balancing.** Construction loans usually contain provisions requiring the loan to be in balance at all times. These provisions permit lenders to determine that the proceeds of the loan remaining to be advanced for any line item within the budget are sufficient to pay the amount of such line item remaining to be paid. Further, these provisions state that if any deficiency cannot be cured by a reallocation of budgeted amounts, the borrower is liable for any such deficiency. Some loans may call for a reserve account for such amounts to be funded at the time the lender deems the loan out of balance. Additionally, a loan being out of balance will likely be an event of default.
- **Payment and performance bond.** Payment and performance bonds are two separate bonds that are companions to each other and cover certain obligations under the construction contract. The performance bond secures the contractor's performance obligations under the construction contract. The payment bond protects against nonpayment in favor of certain subcontractors, materialmen, and other laborers on the project. These bonds are typically required to be in the form of AIA Document A312 without modification or revision, other than as acceptable to the lender. Lenders usually require that the surety be reasonably satisfactory to lender, be licensed or authorized to do business in the state where the property is located, and name lender as a dual obligee pursuant to a dual obligee rider to the bond. It should be noted that these bonds are underwritten on the creditworthiness of the general contractor. In some construction loans, borrowers will ask to bond only certain major subcontractors (to be defined by value of contract or specialty or otherwise as agreed to by the borrower and lender) in lieu of bonding the general contractor's construction contract. This ask is sometimes tied to the associated expense of these bonds, having an affiliated general contractor on the project, or having a general contractor who is not able to be bonded.
- **Plans and specifications.** The final plans and specifications include all maps, sketches, diagrams, surveys, drawings, and lists of materials for the construction of the project, prepared by the architect for the project, as acceptable to the lender. The plans and specifications will be approved by lender and any changes to them will also require lender's consent. The plans and specifications are an item that the lender's inspector will review.
- **Lender's inspector (also called lender's construction consultant).** Construction loans have an inspection component whereby a lender has the right to retain, at borrower's expense, an inspector to act as a lender's consultant in connection with the loan and the construction of the project. The inspector will review and advise lender with respect to the construction documents, and other matters related to the design, construction, operation and use of the project. The inspector will monitor the progress of construction, and review advance and change order requests.
- **Notice of commencement.** A notice of commencement is a document recorded in the public records prior to commencement of construction on a project. The notice of commencement should comply with Fla. Stat. § 713.23 and include:
  - The legal description of the property
  - A general description of the project
  - The name and address of the owner
  - Their interest in the property

- o The fee simple titleholder of the property, if not the owner
- o The name and address of the contractor
- o The name and address of the surety on the payment bond and attach a copy of the bond –and–
- o The name and address of the lender

Fla. Stat. § 713.23 further requires that:

a lender must, prior to the disbursement of any construction funds to the contractor, record the notice of commencement in the clerk's office . . . ; however, the lender is not required to post a certified copy of the notice at the construction site. The posting of the notice at the construction site remains the owner's obligation. The failure of a lender to record the notice of commencement as required by this subsection renders the lender liable to the owner for all damages sustained by the owner as a result of the failure. Whenever a lender is required to record a notice of commencement, the lender shall designate the lender, in addition to others, to receive copies of notices to owner.

- **Reallocation.** Reallocation is the act of moving amounts from one line item in the budget to another, usually as to line items savings and requiring the consent of the lender in most construction loans.
- **Reserves.** Reserves are amounts required by a lender to be held in specific accounts, sometimes to be restricted accounts, as additional collateral and to account for possible project overruns, such as contingency reserves to allow for loan balancing issues or cost overruns and stabilization reserves that are held to ensure that loan payments are made during the period in which the borrower is working on leasing out the project to stabilize same.
- **Retainage.** Retainage is amounts held back by the borrower from the general contractor and subcontractors on each draw. It can be a percentage of the costs of construction or a specific amount actually to be held back from each draw. Retainage is usually 10% of construction costs, but there are times where other amounts are negotiated or there is a system in place where retainage starts at a certain percentage but drops off as construction progress is made and completion is approached. The retainage is held by the lender until the final advance on the entire project is made, but in some instances is released as each discipline's final advance on the project comes due.
- **Stabilization.** Stabilization is achieved when the construction of the project has been completed and the project has been leased by third-party tenants to a certain agreed-upon threshold, is generating positive net income, or is able to meet a certain debt service coverage ratio. The metric will be lender- and project-specific but a key component is that the lien-free construction of the project is complete, and tenants are beginning to occupy the project.

Construction Loan Documents

A Florida construction loan will have many of the same loan documents that can be found in a mortgage loan, but it will include certain construction loan-specific documents. As with most loans, the majority of the terms and provisions will be found in the loan agreement. However, a construction loan will also have construction-specific guaranties, such as the carry guaranty and completion guaranty. For a form of loan agreement that can be modified for use in Florida, see Construction Loan Agreement. For forms of guaranties, see Guaranty Agreement (Construction Obligations) and Guaranty Agreement (Repayment Obligations) (Construction Loan).

Additionally, as part of the construction loan documents, a certificate and consent of each of the general contractor, architect, and engineers will be required. These certificates and consents, among confirming various project items, are issued by each of the general contractor, architect, and various project engineers to confirm that these parties will adhere by certain construction loan agreement provisions (e.g., such as restrictions on change orders, their contracts, or the plans and specifications of the project), will govern the priority of the contracts in relation to the loan, and will outline the procedure for continuing construction of the project between lender and the relevant party after an event of default by borrower under the construction loan. For forms of certificates and consents, see Certificate of Architect, General Contractor's Certificate, and Consent of General Contractor.

There will also be assignments of permits, contracts, developer rights, any development agreement, and any such other items that would permit the lender to step into the shoes of the borrower in the event that the lender, most times after an event of default, has decided to proceed with the construction of the project. For a form of assignment, see Assignment of Contracts, Licenses, and Permits (Construction Loan). For more on development agreements, see Construction Loan Agreements — The Developer and the Development Agreement in a Construction Loan. For a form of assignment of development agreement, see Collateral Assignment of Development Agreement.

Construction Loan Diligence

Similar to the loan documentation, the baseline loan diligence in a Florida construction loan transaction will be the same as would be conducted in a mortgage loan transaction. As a caveat to the lender's title policy that will be issued after closing of the construction loan, the lender will want construction loan advance endorsements at the time of each draw. A construction services agreement between the lender, borrower, and title company is usually also entered into at closing as part of the title diligence on the loan.

Construction diligence will include receiving and reviewing, in part by counsel and in part by the lender and lender's inspector:

- The general contractor's construction contract
- Architect contracts
- Engineer contracts
- The development agreement
- Subcontractor contracts
- Plans and specifications
- Permits
- All land use and zoning approvals and entitlements for the project –and–
- All other diligence required by the lender or its inspector for them to review the project and the budget

In addition to the land use and zoning approvals and entitlements, a lender may also require a zoning opinion confirming to the lender, among other items, that the project is or will be properly permitted and is feasible pursuant to applicable zoning laws.

In addition, prior to closing and during the loan diligence stage, the lender's inspector will be retained and conduct a plan and cost review prior to closing that will confirm to the lender various items that impact the project, including the feasibility of the project in light of the plans and specifications and the budget, the risk of cost overruns, the reputation of the contractor and reliability based on prior experience, potential disruptions that could impact project completion, and reliability of the budget and other estimates. The plan and cost review is a critical component of a construction loan and is used by lenders to mitigate their risk in construction loans. While the lender's counsel does not generally review the plan and cost review report, it is important to understand the overall concept and importance of this report.

For further guidance on performing diligence in a construction loan transaction, see Due Diligence in Construction Lending.

Lender Considerations

As a lawyer representing a lender in a construction loan, it is important not only to understand the concepts discussed in this practice note, but also to have sensitivity to the following items that are important to the lender's perspective:

- The project should be well-defined in the loan documents, you should have a clear legal description, title and survey should be aligned, and you should have a building footprint overlaid on your survey to ensure no issues. You will also want to know how far from approval of the project and permitting the project is and whether that works with the maturity date and timeline for the project if the loan is closing prior to permits being issued.
- The notice of commencement should comply with Florida Statute and you will want to control recording of same. Ideally, the closing agent will record the notice of commencement after the mortgage on the closing date. You will want to prepare the notice of commencement; ensure the project, borrower, and lender information is correct; and complete and attach any payment and performance bonds as required.
- Lenders will want to limit changes to the general contractor, architect, and engineering contracts; the budget; the plans and specifications; and all project timelines. It is important to have provisions in the construction loan agreement that flesh out what changes require lender consent and which, if any, do not and for those limitations and restrictions to be included in the certificate and consent signed by the relevant construction parties so that all are aligned on the construction loan restrictions and where lender consent is required.
- The material adverse effect provisions in the loan agreement should include, depending on lender preference, items such as ability of the borrower to construct the project, ability to attain completion by the maturity date (or any earlier date), and ability to comply with the construction covenants in the loan agreement.
- The lender may want the right to step into the borrower's shoes and construct the project prior to an event of default or at any time after one, whether directly or by enforcing the completion guaranty. Some lenders prefer broad rights to take over construction if they feel that completion is not likely, even if an event of default has not yet occurred.

Borrower Considerations

In turn, on a borrower representation in a construction loan, some items to note are as follows:

- Borrowers will generally push for flexibility in the construction loan agreement, which unsurprisingly is contrary to what the lenders would prefer. Most borrowers will want a monetary threshold of permitted change orders that do not require lender consent, the ability to adjust the plans and specifications (perhaps to allow for flexibility in future negotiations with potential tenants and owners), the ability to reallocate costs savings between line items in the budget, and the right to use force majeure or other such permitting delays to roll their completion deadline. Lenders usually are willing to agree to some thresholds of these items in amounts or as to items that they would not deem material. For example, small changes to the plans and specifications would likely be an item a lender would concede, but structural changes to the plans and specifications would likely not be conceded. Borrowers will also at times ask for flexibility with retainage requirements and may even ask that the equity requirement be staggered (i.e., it is put up in stages with lender funding from the loan in between those stages as certain equity amounts are put in by the borrower). As borrower counsel, it is important to discuss these items with the borrower and understand the general items that the borrower will need or want to have a successful project. For example, if the permits have not been issued and you are closing the construction loan before the relevant permits are issued, what permitting delays can be foreseen that you will want to work around in the completion timeline in the loan agreement? Thinking through the key components of a construction loan as noted in this practice note will help identify areas that you need to discuss with the borrower to ensure that you negotiate as much flexibility as possible.
- Borrowers will also want to make sure that they have a force majeure provision in the construction loan agreement and that it is broad, even at times covering items such as permitting delays. Post pandemic, some borrowers are negotiating governmental closures, unavailability of materials, and large increases in costs to materials (whether by deeming a monetary threshold or percentage) as force majeure to protect them from being in default due to items that are out of their control. As can be expected, lenders will want to limit what is included in this definition and borrowers will want to expand the provision. A fair compromise can be found by tying thresholds to certain items where feasible and negotiating time limits for certain events. If notice is required for a force majeure event to take effect, borrowers will want to ensure that they understand the notice requirements fully.
- As with most loans, borrowers will want notice and right to cure. This will be important in the context of defaults that are related to the project and its construction. Borrowers will always want the right to bond off liens and solve any contractor or subcontractor disputes without those disputes triggering a default as long as they are working towards resolution.
- As can be expected, borrowers will want to negotiate limitations on their lender taking over construction of the project. As borrower's counsel, you will want to try to negotiate notice, right to cure, and even perhaps a guarantor taking over prior to the lender being able to do so to give the borrower the ability to complete the project if it can do so. A guarantor completing the project if for some reason the borrower cannot is a good default provision for the borrower, and while not the ideal for either of borrower or lender, if it can be a cure that is successful, is a good avenue to be explored by the parties.

Conclusion

This practice note summarizes the key elements of a Florida construction loan. For lawyers that have experience with mortgage loans, a construction loan layers on that experience. In sum, a basic understanding of these concepts is the first step in representing a client in a construction loan transaction in Florida. At the forefront of that analysis is reviewing these concepts in light of the role of the representation (whether lender or borrower side) and, as discussed throughout this note, knowing how those key concepts and elements impact the client and what the client's goals and risk concerns are in such a representation.

Elena Otero, Partner, Holland & Knight LLP

Elena Otero is a transactional attorney in Holland & Knight's Miami office primarily practicing in the areas of real estate, finance, and banking law, with a focus on commercial real estate and commercial lending transactions. Ms. Otero counsels local, national, and international financial institutions and lenders in commercial lending transactions, including construction and permanent real estate financing, healthcare real estate finance, commercial and industrial loans, and asset-based lending. She also represents clients in the acquisition, development, leasing (including sale-leaseback, triple-net and build-to-suit lease transactions), disposition and financing of commercial and residential real estate.

Ms. Otero's experience advising developers includes representation in various types of projects such as land development, condominiums, mixed-use developments, joint venture investments, hotels, restaurants, retail, and office buildings. Additionally, that representation usually involves navigating contractual, zoning, and other developmental issues that arise as project development evolves. She also assists clients with management of real estate assets and a multitude of contractual agreements, including subleases, licenses, and assignment agreements.

Additionally, Ms. Otero works closely with the firm's estate and tax planning team to counsel wealthy individuals, their families and their businesses in their real estate investments, acquisitions, and dispositions. Ms. Otero also represents institutional and private lending clients with licensing, regulatory and compliance matters.