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Construction and Development Financing v1 & v2

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Law • Practice • Forms

November 2015 Edition

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THIRD EDITION

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2015–2016 Authors' Highlights

New features and recent developments in this November 2015 Edition of *Construction and Development Financing* include:

New § 2:51 Underwriting, administrative, and legal considerations—The pervasive effect of governmental regulations—Public opposition to new projects—Disparate Impact under the Fair Housing Act

New § 4:159 The hotel/motel construction loan—Hotel condominiums

New § 4:160 The hotel/motel construction loan—Hotel condominiums—Luxury markets

New § 4:161 The hotel/motel construction loan—Hotel condominiums—Loan underwriting

New § 4:162 The hotel/motel construction loan—Hotel Condominiums—Pre-sale requirements

New § 4:163 The hotel/motel construction loan—Hotel condominiums—Regulatory issues

New § 4:164 The hotel/motel construction loan—Hotel condominiums—Securities laws

New § 7:10 Real estate development without mortgage financing—Tax benefits from conservation easements—Regulatory approvals as consideration

New § 7:44 Lease transactions involving the improvement of landlord's property—Build-to-suit lease—In general

New § 7:45 Lease transactions involving the improvement of landlord's property—Build-to-suit lease—Lease term

New § 7:46 Lease transactions involving the improvement of landlord's property—Build-to-suit lease—Sample commencement date clause

New § 7:47 Lease transactions involving the improvement of landlord's property—Build-to-suit lease—Sample substantial completion clause

New § 7:48 Lease transactions involving the improvement of landlord's property—Build-to-suit lease—Construction Agreement

New § 7:49 Lease transactions involving the improvement of landlord's property—Build-to-suit lease—Rent provisions

Preface

The process of financing real estate land development-from raw acreage to finished building-presents the borrower/developer and its financier with great risk. The legal and business procedures of land development and construction finance are the most complex aspects of real estate finance, and perhaps of commercial finance in general. This revised edition examines and explains the financing of the entire range of the land development and construction process, from raw land to finished building, with separate treatment of each type of financing loan: the land loan, development loan, construction loan, and permanent loan.

The lawyer for the construction lender and developer is confronted with many legal problems throughout the development process that counsel for a lender making a loan on the security of a finished building is not faced with. Land development is carried on by many diverse participants whose interests and rights vary, and each is compensated separately and in accordance with different guidelines. The seller of raw land, the engineer, the architect, the surveyor, the general and subcontractors, the leasing agents, and the salespeople all have legal rights established by contract and in many instances conferred by law. The attorney for developer and lender must be aware of the rights and duties of each party and see that these are recognized in the legal instruments that form the structure of the development process. Land development and finance is uniquely an area where business and legal problems go hand in hand. The borrower and its counsel must be familiar with the development process and concepts of real estate credit.

As the decade of the 1990 begins, the construction lending process is undergoing some of its most significant changes in many years. Among the causes of these changes are the demise of the savings and loan industry as a result of years of unsound loan practice, the tremendous influx of capital to pension funds and the desire to invest a portion of these funds in real estate, and the rise in importance of commercial banks, which see real estate loans, both construction and permanent, as the way to replace lost markets in corporate lending (as a result of the much greater use by corporations of commercial paper) and in lending to underdeveloped countries.

An additional factor affecting the construction finance industry is the move toward more conservative underwriting resulting from excessive building in the 1980's that led to extremely high vacancy rates and a large number of loan defaults. For the foreseeable future, developers can anticipate permanent and construction loan commitments that involve (1) lower loan-to-value ratios; (2) imposition of some or all resource (personel) liability; and (3) substantial preleasing requirements.

Perhaps the most significant fact relating to construction finance as this edition goes to press is the sharp increase in the market share of construction loan originations made by commercial banks, now by far the leading source of construction loans in all major lending categories. Commercial banks now account for about 93 percent of all construction financing on commercial projects, about 80 percent on multifamily projects, and 82 percent of all land development loans. About one half of all loans made on commercial projects are now held by the 300 largest banks.

Which institutions gave up the market share now held by commercial banks? The most obvious decline in originations is by thrift institutions which, in all three categories of construction loans, more than doubled their shares between 1980 and 1984 (following the Depository Institutions Act of 1982, which gave thrifts much broader lending powers). In the last few years the market shares of the thrifts declined to a point below the 1980 levels.

Mortgage companies are a second type of lender that lost significant market share in commercial construction financing. Many of these firms were bought by commercial banks, which is one cause of the shift in market share from the mortgage companies to the banks. In the case of multifamily housing, the sharpest decline in market share is by state and local housing finance companies which, from a peak of just under 18 percent in 1986 fell to only 3.5 percent in 1989 as a result of restricts on tax-exempt financing imposed by Congress.

At the present time, virtually no lenders other than commercial banks play a significant role in the construction loan market. Given the banks current exposure in long-term mortgage markets, the ability of commercial banks to continue to provide this level of construction financing becomes more difficult until nonbank institutional lenders resume their traditional functions of providing permanent takeout commitments.

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Jo Ann Drew type and retyped many pages of manuscript with her usual patience and good nature.

ALVIN L. ARNOLD

Manhasset, New York
August 1990

Summary of Contents

Volume 1

Volume 2

Appendices

Table of Contents

CHAPTER 1. THE LAND LOAN

I. ACQUISITION AND WAREHOUSING OF LAND BY DEVELOPERS

II. INSTITUTIONAL LAND FINANCING

CHAPTER 2. THE LAND DEVELOPMENT LOAN

I. ORIGIN, STATUTORY BASIS, AND FUNCTION OF SUBDIVISION CONTROL ORDINANCES

CHAPTER 3. THE CONSTRUCTION LOAN: APPLICATION, UNDERWRITING APPROVAL, AND COMMITMENT

I. THE CONSTRUCTION LOAN

II. INTERVENING LIENS AND RIGHTS OF THIRD PARTIES

III. REVIEW OF THE PROJECT

IV. BOND FINANCING BY STATE AND LOCAL FINANCING AGENCIES

V. REMEDIES FOR THE BORROWER

CHAPTER 4. THE CONSTRUCTION LOAN

I. THE CONSTRUCTION LOAN MORTGAGE

II. MODEL HOMES

III. METHODS OF FINANCING

IV. CONSTRUCTION CONTRACTS AND ARCHITECT'S AGREEMENTS

V. ENSURING THE PRIORITY OF THE CONSTRUCTION MORTGAGE LIEN

VI. BUSINESS REASONS

VII. STRUCTURING THE PARTICIPATION

VIII. LEAD-LENDER AUTHORITY AND RESPONSIBILITY

IX. CONSTRUCTION LOAN ADMINISTRATION

X. RESPONSIBILITY FOR CONSTRUCTION LOAN ADMINISTRATION

XI. LIABILITY OF CONSTRUCTION LENDER TO THIRD PARTIES

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Table of Contents

CHAPTER 5. THE CONSTRUCTION LOAN "TAKEOUT" OR PERMANENT LOAN

I. TYPES OF TAKEOUTS

CHAPTER 6. CONSTRUCTION LOAN DEFAULTS, ENFORCEMENT, AND WORKOUTS

I. METHODS OF FORECLOSURE

II. ADVANTAGES FOR THE LENDER

III. DISADVANTAGES FOR THE LENDER

IV. THE TRANSACTION

V. LEGAL PROBLEMS OF LOAN MODIFICATIONS AND WORKOUTS WITH THE EXISTING BORROWER

CHAPTER 7. OTHER CONSTRUCTION-FINANCING TRANSACTIONS

CHAPTER 8. ENVIRONMENTAL RISKS IN CONSTRUCTION FINANCING

I. LENDER LIABILITY UNDER CERCLA

CHAPTER 9. UNIFORM LAWS, PUBLIC POLICY, AND TAX ISSUES AFFECTING THE CONSTRUCTION LENDER

APPENDICES

Chapter 5

The Construction Loan "Takeout" or Permanent Loan

I. TYPES OF TAKEOUTS

Research References

Treatises and Practice Aids

Bruner and O'Connor on Construction Law, Ch 8

Law Reviews and Other Periodicals

"Financing: Construction Lender Need Not Reveal Financial Data to Takeout Lender," 30 Real Estate Law Report 5 (Nov. 2000)

§ 5:1 Definition and function of the takeout

The "takeout" is the loan or other financial arrangement for