Freeborn

Your Future Is Our Purpose

Construction Completion Guaranty: Worthwhile for a Guarantor to Negotiate

by Chad J. Richman

A FREEBORN & PETERS LLP CLIENT ALERT

ABOUT THIS CLIENT ALERT:

In a construction loan, the real property securing the loan does not achieve its underwritten value until construction is complete and the project is generating income. A principal concern for a construction lender is that the borrower will fail to complete construction of the project, leaving the lender to oversee a construction project with a partially-finished building. In order to minimize this risk, a lender may require a third-party completion guaranty-- which assures the lender of project completion in accordance with approved plans, on schedule, within budget, free of lien claims (i.e., fully paid), and in accordance with other provisions of the applicable loan documents. This client alert provides helpful information that a guarantor should consider while negotiating.

In a construction loan, the real property securing the loan does not achieve its underwritten value until construction is complete and the project is generating income. A principal concern for a construction lender is that the borrower will fail to complete construction of the project, leaving the lender to oversee a construction project with a partially-finished building. In order to minimize this risk, a lender may require a third-party completion guaranty-- which assures the lender of project completion in accordance with approved plans, on schedule, within budget, free of lien claims (i.e., fully paid), and in accordance with other provisions of the applicable loan documents.

Sometimes a construction completion guaranty includes “carry costs”, such as real estate taxes, insurance, interest, utility charges and other property-related expenses, on the theory that ownership costs are necessarily incurred in the course of completing the project.

A construction completion guaranty usually has several pages of provisions, but the remedies provision is by far the most important and usually gives the lender the option to: 1) require the guarantor to complete the project at its own expense, or 2) allow the lender to complete the project at the guarantor’s expense.

“Market” terms vary widely and depend on the size and scope of the deal as well as the credit and track record of the sponsor. Here are some points that may be worthwhile negotiating from the guarantor’s perspective, especially where the guarantor is not providing a simultaneous full payment guaranty:

The construction completion guaranty should terminate upon a foreclosure sale, a bankruptcy sale, a receivership sale, or any involuntary sale that divests the borrower group from ownership. This way, if the lender takes the property back they will risk losing their liquidated damages.

- Add a negotiated “liquidated” amount in lieu of the guarantor’s obligation, or lender’s right, to complete the project. This will limit the amount of the lender’s damages, which should never exceed the amount of the lender’s deficiency on the loan after application of other collateral. This could be as simple as an amount equal to costs to complete the project at the time of default determined by a construction consultant (acceptable to both parties or subject to arbitration) less the undisbursed balance of the loan. If no liquidated damages are specified courts have been reluctant to specifically enforce compelling the guarantor’s completion of the project and instead apply their own measure of damages which have been based on market values of the project “as completed” versus “as is” at various points of time pre- and post-default. This can be very theoretical and risky.

- It would be beneficial to get an additional offset (full or partial) to the liquidated amount for the increased market value of the property on the basis that the lender should not profit off of the guarantor performing completion (i.e., to the extent that the value of the property becomes more than the sum of its prior value plus the costs of construction). The timing of determination of increased market value can be during construction based on estimates, or at the end, or both.

- The guarantor should only be required to complete construction if the lender funds the full amount of the construction loan. Alternatively, if a “liquidated” damages provision is used (as suggested above), the guarantor should receive a credit for unfunded loan proceeds. In most construction loans, the lender will require the borrower’s equity to be fully invested in the deal before the lender will fund any loan proceeds. Therefore, barring any cost overruns, general contractor issues or other unforeseen issues, if the lender funds the full amount of the construction loan, the guarantor’s exposure on the construction completion guaranty is minimized. Note that lenders will typically only agree to fund the remaining balance of the construction loan after a default if the borrower or guarantor first contributes sufficient capital to bring the loan back into “balance” (i.e., the undisbursed balance of the loan equals or exceeds the remaining costs to complete the project).

- The construction completion guaranty should terminate upon a foreclosure sale, a bankruptcy sale, a receivership sale, or any involuntary sale that divests the borrower group from ownership. This way, if the lender takes the property back they will risk losing their liquidated damages. The general rule set forth in *Chase Manhattan Bank, N.A. v. Am. Nat’l Bank & Tr. Co.*, 93 F.3d 1064 (2d Cir. 1996) is that a completion guaranty should not survive a foreclosure where there is no circumstance whereby the lender would ever incur completion costs; but in *Turnberry Residential Ltd. Partner, L.P. v. Wilmington Tr. FSB*, 99 A.D.3d 176, 950 N.Y.S.2d 362 (App. Div. 2012) the court distinguished and ruled that the completion guarantor could not avoid liability for amounts unpaid to mechanics in a bankruptcy sale. The *Turnberry* ruling hinged on the language in the completion guaranty providing for the “survival” of obligations following a change in ownership.

Freeborn
Your Future Is Our Purpose

ABOUT THE AUTHOR

Chad J. Richman
Partner, Real Estate Practice Group

Chicago Office
(312) 360-6491

crichman@freeborn.com

Chad Richman's real estate practice includes acquisitions and dispositions, development, leasing, fund formation, venture structuring, and complex financing involving all types of real estate uses. Chad has an extensive business asset transactional practice with commercial finance expertise in an array of dealings.

- The guarantor should argue that the completion guaranty only covers "hard" construction cost overruns (i.e., construction risk) and not interest or other "carry cost" obligations (which, it should be argued, are the lender's financial risk included in its underwriting). If unsuccessful, as a backstop argument, the guarantor's "carry cost" obligations should be terminated as early as possible (preferably upon completion and not stabilization) and the guarantor should receive a credit against "carry cost" obligations in an amount equal to any income received by the lender from the project and applied to the loan.

- The lender should forbear from foreclosing and exercising other available remedies if the guarantor is performing under the completion guaranty.

- The guarantor should get the benefit of proceeds from any contractor bond proceeds and also the right to participate in those proceedings or negotiations.

- The completion guaranty should be substituted and replaced with a mezzanine lender completion guaranty if there is a change in control due to the mezzanine lender exercising remedies. In such a scenario, the senior lender and mezzanine lender will often times negotiate up-front funding and extension of completion date provisions directly.

ABOUT FREEBORN & PETERS LLP

Freeborn & Peters LLP is a full-service law firm, headquartered in Chicago, with international capabilities and offices in Springfield, Ill.; Richmond, Va.; and New York City. Freeborn is always looking ahead and seeking to find better ways to serve its clients. It takes a proactive approach to ensure its clients are more informed, prepared and able to achieve greater success – not just now, but also in the future. While the firm serves clients across a very broad range of sectors, it has also pioneered an interdisciplinary approach that serves the specific needs of targeted industries.

Freeborn is a firm that genuinely lives up to its core values of integrity, effectiveness, teamwork, caring and commitment, and embodies them through high standards of client service and responsive action. Its lawyers build close and lasting relationships with clients and are driven to help them achieve their legal and business objectives.

For more information visit: **www.freeborn.com.**

Disclaimer: This publication is made available for educational purposes only, as well as to provide general information about the law, not specific legal advice. It does not establish an attorney/client relationship between you and Freeborn & Peters LLP, and should not be used as a substitute for competent legal advice from a licensed professional in your state.

© 2017 Freeborn & Peters LLP. All rights reserved. Permission is granted to copy and forward all articles and text as long as proper attribution to Freeborn & Peters LLP is provided and this copyright statement is reproduced.