

# Construction Loans

## *Avoiding the Pitfalls in Managing Distressed Loans*

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Construction loans represent a unique mortgage financing product in that the proceeds of such a loan are not fully funded to a borrower at origination, but rather are funded periodically upon requisition by the borrower. The central provisions of construction loan documentation concern the conditions the borrower must satisfy prior to a lender advancing money and the timeframes in which such advances must be made. While lender's counsel should make every effort to draft construction loan documents that provide the lender with maximum flexibility and discretionary power concerning the lender's obligations to make loan advances, many currently distressed construction loans were entered into under market conditions that afforded borrowers increased negotiating power that constrained such lender discretion. Because lenders seeking to limit further exposure may wish to reject or delay a borrower requisition or, in some cases, exercise owner-like control over the property, lenders must be counseled to avoid unnecessary liability when taking such actions. In cases of delayed or rejected requisitions, the exercise of discretion contrary to explicit loan provisions may be deemed unconscionable or in bad faith, triggering lender liability or otherwise restricting the lender's ability to exercise certain remedies. Additionally, a lender taking control of a construction project such that the borrower is extremely limited or closed out of construction management may cause the mortgagee to be deemed "in possession" for liability purposes.

New York courts have consistently held that a construction lender may refuse to make additional advances to a defaulting borrower without exposing itself to potential liability or vitiating its rights or remedies against the



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borrower and property under the construction loan documents. Bright-line defaults such as constructing a project in a manner that fails to conform to those plans and specifications approved by the lender, or by incurring cost overruns that throw the construction budget out of balance, often result in summary judgment for lenders in foreclosure proceedings. However, precedent indicates that borrowers may be successful in defending foreclosure actions if the borrower can demonstrate that the default stems from the lender's bad faith or oppressive conduct, making the borrower's compliance with the terms of the loan documents impracticable. In particular, a borrower's counterclaim may allege that the construction lender's improper refusal to promptly advance the requisitioned funds caused liquidity shortfalls that made it impossible for the borrower to complete the construction of the project in a timely manner and perform its obligations under the loan documents. The success of such a counterclaim by the borrower typically hinges on the terms of the applicable underlying construction loan documents.

Borrowers generally expect construction loan documentation to address the timeliness and manner in which loan requisitions shall be funded since the borrower relies upon prompt funding to satisfy its payment obligations to contractors. Notwithstanding the importance of such prompt payments to the borrower, lenders may successfully negotiate

broad discretionary powers that jeopardize the reliability of the lender's funding obligation and thereby the borrower's ability to complete construction and repay the loan. The lender's exercise of such broad authority is not in and of itself bad faith, and may not necessarily result in lender liability. In one case, a borrower and lender entered into a series of agreements in which the relevant loan documents provided that loan advances were to be made by the lender in its "sole discretion" based upon certifications submitted by an architect, engineer or other persons approved by the lender.<sup>1</sup> The lender commenced a foreclosure action when the borrower defaulted by failing to repay the principal balance of the loan and accrued interest at maturity. The borrower alleged the default was caused directly by the lender's refusal to provide timely loan advances which ultimately created serious cash flow problems that made it impossible to construct and sell the condominium units constructed at the property. In granting summary judgment in favor of the lender, the court concluded that the lender's broad discretionary power under the loan documents with respect to loan advances coupled with the defaulting borrower's failure to present evidence demonstrating the lender exercised its discretion in an oppressive or unconscionable manner resulted in the foreclosure being enforceable.

Even in instances in which the loan documents provide for such broad discretionary power, a lender may still be held liable for its failure to advance loan funds if the borrower demonstrates that the lender acted in bad faith. While many of the relevant cases involve credit facilities unrelated to construction loans, New York precedent suggests that the same principle may be applied to a construction lender's refusal to advance funds requisitioned by a borrower. In one such case, a borrower and lender entered into an agreement containing a provision whereby the lender was to provide discretionary lending "up to" an agreed upon amount. After making a number of advances, the lender abruptly refused to grant an additional requisition despite its awareness of the borrower's need

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for timely funding to satisfy certain debts, leaving the borrower with no alternative but to file for bankruptcy. When litigation ensued, the borrower alleged bad faith on the part of the lender due to the lender's sudden refusal to advance funds without furnishing advance notice to the borrower. The court held that a lender acting in good faith would have notified the borrower of the lender's unwillingness to advance future funds prior to rejecting its requisition, thereby affording the borrower adequate time to seek alternate financing to satisfy its outstanding debts. The court found the lender liable for the estimated value of the borrower's business prior to its filing for bankruptcy since the lender's seemingly arbitrary change in funding practice was deemed unconscionable. It should be noted that it is unlikely that a building loan agreement drafted in the market that preceded our current one would afford such broad discretionary powers concerning the lender's funding obligations. However, prudent counsel to the lender should err on the side of caution by advising its client that prior to the lender altering its pattern of discretion with respect to loan advances, the borrower should be given ample notice of the lender's changed standards.

In addition to a sudden change in the lender's exercise of discretion, a lender may be deemed to have acted in bad faith when its refusal to advance funds is interpreted as arbitrary or misleading.<sup>2</sup> When a lender refused to advance requisitioned funds under a credit facility, litigation ensued in which the borrower defended against the lender's motion for summary judgment by asserting the lender acted in bad faith.<sup>3</sup> In denying the lender's motion, the court noted numerous allegations of the borrower that a trier of fact may interpret as the lender acting in bad faith, namely (i) the lender leading the borrower to believe that advances under the credit facility would eventually be available, and (ii) notwithstanding the lender's awareness of the exigency of the borrower's situation, the lender never notifying the borrower that it planned to withhold funds indefinitely.<sup>4</sup> Assuming a court's willingness to apply the foregoing principle to construction lending, should a construction lender elect to reject a borrower's requisition, prudent counsel should draft the notice of rejection so as to give no impression that the requested funding will eventually be available. Furthermore, the notice should unequivocally state that the requisition is being rejected and that the discretion exercised by the lender is final and not subject to change.

Even when the acts or omissions of the borrower amount to a default under the loan documents, the borrower may be relieved of its default if it can demonstrate that the lender unexpectedly and abruptly demanded compliance with provisions of the loan documents that are inconsistent with the parties' course of

dealing. In one case, the borrower and lender entered into a commercial lending transaction in which the borrower was required to make monthly interest payments to the lender.<sup>5</sup> Following the inception of the loan, rather than enforce the aforementioned provision, the lender paid the required monthly interest to itself out of an interest reserve account. After years of continuously receiving payment in this manner, and despite the existence of sufficient funds in the interest reserve account to make such a payment, the lender abruptly and unilaterally stopped this practice, declared a default and instituted foreclosure proceedings. The lender alleged that failing to enforce a term in the past does not waive its right to insist that the borrower later comply with the term as written in the loan documents. The court held that implicit in a loan agreement is an implied covenant of fair dealing and good faith, and suggested that the lender was in violation of such a covenant by unilaterally altering what had become the expectation of the parties with respect to interest payments. Despite the existence of a particular default, by repeatedly advancing funds to a borrower or funding interest from an interest reserve, the lender may jeopardize its ability to rely on that default as being adequate justification to refuse future requisitions. Under such circumstances, counsel should effectively safeguard its client from potential liability by ensuring there are adequate grounds to refrain from advancing funds independent of any defaults that the lender repeatedly failed to declare.<sup>6</sup>

While a construction lender's refusal to advance requisitioned funds may operate as an effective protective measure to minimize the financial burden incurred by an anticipated default, lenders may also wish to preserve an unstable construction loan through more active participation and closer monitoring of the construction process. By increasing its involvement in activities customarily supervised by the borrower, a lender may risk its actions amount to the type of dominion and control typical of a "mortgagee in possession." Such a classification exposes a lender to potential liability from which it would otherwise be immune in its capacity as a mortgagee.

In order to assist its client in avoiding the potential pitfalls of assuming mortgagee in possession status, lender's counsel should ensure that its client refrains from exercising dominion and control over the construction project or the property in general. While the standard courts employ in making a determination that a lender is a "mortgagee in possession" is fact intensive and highly case specific, lender's counsel should be cognizant of certain guidelines that courts have set to avoid the consequences of excessive involvement and management of a construction project or property. Lenders should avoid, for example,

employing an agent to occupy the distressed property or market the property at the lender's instruction. In addition, other cases suggest that a lender may be deemed a mortgagee in possession by merely possessing keys to the property and having repair work done after the property has been abandoned.<sup>7</sup>

These examples of overreaching lender involvement should be distinguished from prudent construction lending practices whereby lenders monitor ongoing construction efforts through the employment of third-party engineers and consultants that regularly monitor a project's progress and provide reports to the lender so that the lender may effectively protect its collateral. Affirmative steps taken by a lender to retain its classification as a mortgagee would include: (i) properly documenting the active participation of the borrower concerning the management and daily operational affairs of the facility; (ii) requesting that the borrower join lender representatives in executing an agreement that sets forth the respective accounting, maintenance, insurance and tax responsibilities; and (iii) engaging a receiver for the property during the enforcement of any foreclosure proceedings to avoid the strict accounting responsibilities of a party in possession.

When representing a lender in connection with a distressed construction loan, lender's counsel should advise its client not only of its rights to reject a loan requisition or take control of the construction project, but also how to proceed in exercising such rights so as to avoid potential liability. A close examination of the provisions of the loan documents governing the degree of discretion afforded the lender with respect to its funding obligations, together with a firm understanding of the case law surrounding construction lending, will enable lender's counsel to be in a position to effectively represent its client's interests.



1. *Thrift Ass'ns. Serv. Corp. v. Legend of Irvington Joint Venture*, 152 AD2d 666, 668 (2d Dept. 1989).

2. *Maharaja Travel Inc. v. Bank of India*, 1997 WL 154044 (S.D.N.Y. 1997).

3. *Id.*

4. *Id.*

5. *River Bank America v. Daniel Equities Corp.*, 213 AD2d 929 (3rd Dept. 1995).

6. This article does not address the enforceability of a loan document provision that preserves a lender's right to later enforce existing loan defaults.

7. *Morris v. Azzi*, 866 F.Supp., 149,150 (D.N.J. 1994).