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Greenbacks for Building Green: Does a Lender for Sustainable Construction Projects Need to Make Adjustments to Its Current Practices?

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GREENBACKS FOR BUILDING GREEN:
DOES A LENDER FOR SUSTAINABLE CONSTRUCTION PROJECTS NEED TO MAKE ADJUSTMENTS TO ITS CURRENT PRACTICES?

BY
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In the development of real property, the availability of money to secure construction resources is an important factor for success. The construction loan plays a central role in providing funds to erect a building on real property, but a lender faces numerous exposures that might result in a loss. In evaluating a project to determine its viability and to uncover any exposure it might present, a lender will conduct an extensive underwriting review process. It will then use mitigation techniques through the construction loan agreement and disbursement requirements to reduce the perceived risks to an acceptable business level, for those developments deemed worthy. With the recent transition into more sustainable construction practices, many lenders will fail to recognize that the construction of a green building differs from that of a traditional one. The meaningful distinctions between these different methods merit an evaluation of their own to properly assess and manage the risk associated with a construction loan for a green building. Accordingly, this article seeks to address the unique issues associated with a construction loan for a green building and provide solutions that can mitigate the exposures presented to acceptable levels.

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I. INTRODUCTION

As construction returns to pre-recession levels, lenders will inevitably begin receiving more applications for loans to provide for erecting new buildings. Few real estate developers maintain sufficient funds to secure the resources necessary for construction on their own, so they turn to the lending community to provide interim financing until the completed building receives a permanent loan or mortgage.¹

In deciding whether to fund the loan, a lender will conduct an extensive evaluation of the project to determine its viability and to uncover any exposure it might face that would result in a loss.² To make a loan possible, the lender will also determine whether mitigation techniques through contractual provisions in the construction loan agreement and disbursement requirements will reduce the perceived risks to acceptable levels.³

In receiving these applications, many lenders will start to see more projects that seek a certified green building because government policies across the country and at all levels now try to encourage private developers to construct certified green structures.⁴ However, many lenders fail to recognize that the construction of a green building differs from that of a traditional one.⁵ This difference means a lender needs to evaluate its underwriting process to gain better insight as to whether the financial models and pro-forma statements present an accurate picture of its exposure to loss. For those loans deemed worthy of approval, a lender must also consider its mitigation techniques and conditions for disbursement to better address the risks that a green building presents.

Considering that many lenders will receive applications for construction loans on a green building and will not generally distinguish such projects from traditional ones, the question remains whether adjustments need to occur in the underwriting process and accompanying documents to properly manage and mitigate the risk exposure to acceptable business levels. This Article seeks to address these issues.

Part II of this Article examines construction loans as applied to traditional building methods. It begins by considering the various loss exposures a lender faces as well as the required processes and documents an applicant will attempt to negotiate in order to obtain the construction

⁵ See infra Part IV.
loan. With regard to loss exposure, Part IIA explores the risks that confront the mortgage arising from the different theories of title and liens that originate with contractors and material suppliers, as well as liens available against the loan itself. It also evaluates outside activities that can impose liability upon the lender and explains the environmental risks that originate from the dumping of hazardous waste on the land and government repayment programs. Part IIB explains the underwriting process that a lender follows to assess the viability and risk of a traditional construction project, as well as the package of documents and pertinent provisions used to execute the loan.

Part III considers the unique characteristics, attributes, and risks a green building construction project poses a lender. The first subpart examines green building-specific issues that affect the underwriting process: zoning and restrictive covenants, difficulties associated with the valuation process, and continually evolving business standards. The second subpart sifts through exposures that originate out of cure and default, responsible parties, and disbursement program risks.

Finally, Part IV responds to the unique risks a green building construction project poses a lender by offering solutions that can mitigate risk exposure to acceptable levels. In making this proposal, the subparts divide the recommendations between those that affect the underwriting process and those that involve the construction loan documents. The proposals for the underwriting process suggest that lenders capture pertinent information at the time of the loan application. It then describes methods to better acquire, evaluate, and analyze the financial models and pro-forma statements. Similarly, the recommendations concerning the loan documents offer risk mitigation provisions that address issues prior to and after a lender disburses a green building construction loan.

II. CONSTRUCTION LOANS

The availability of money to secure construction resources is an important factor for successfully developing private buildings. The construction loan plays a central role in providing funds to make improvements: it fills a financial gap that occurs between the owner’s ability to secure permanent financing upon the land with the planned improvements and the land in its current condition. Consequently, a construction loan increases the property’s value and better serves owners by eliminating the owners’ need to secure all of the financial resources necessary to complete construction at the start of the project.

6 JUSTIN SWEET & MARC M. SCHNEIER, LEGAL ASPECTS OF ARCHITECTURE, ENGINEERING AND THE CONSTRUCTION PROCESS § 8.05 (9th ed. 2009).

7 Depending on whether a project emerges from the public or private sector will play a major role in the method used to finance the building. See SWEET & SCHNEIER, supra note 6 at § 8.05. Typically in a publicly financed project, the legislature or administrative agency appropriates funds that pay for the building’s costs over the construction timeframe. Id. Sometimes the funding comes from a sole source, but it may also originate from a combination
Meanwhile, some financial institutions view construction loans as high-risk loans that offer a correspondingly superior reward in return.\textsuperscript{8} Because most loans focus on ensuring repayment through initial and alternative sources, the construction lender’s concentration is twofold: as the primary assurance, it considers whether the borrower has received commitments that guarantee permanent financing as a means to satisfy the debt obligation; as the backup option, it considers the potential income production of the completed development.\textsuperscript{9} Accordingly, some financial institutions believe the loss exposures outweigh the financial rewards; other bankers see construction lending in the opposite light so long as careful steps are taken during the process to minimize risk.\textsuperscript{10}

In conclusion, a construction loan supplies short-term credit to a landowner that does not have all of the funding for its development at the onset. At the same time, it provides the prudent lender an opportunity to attain superior rates of return for assuming such managed risks.

\textit{A. Loss Exposures}

In comparison with lending financed by a completed building, construction lending lacks traditional security for repayment.\textsuperscript{11} Construction lenders might find themselves undersecured because construction loans depend on future events to create value.\textsuperscript{12} These challenges range from the loss of superior claim rights from mortgage theories and liens to the possible liability for construction defects based upon a lender’s involvement during construction. These issues require a discussion prior to considering the new implications created by a green building.

\textit{1. Encumbrances on Real Property}

Since each state government maintains responsibility to develop and operate a recording system for land ownership, courts regularly face the task of recognizing and enforcing ownership and encumbrances on real property within their jurisdiction.\textsuperscript{13} In resolving these real property disputes, courts turn to the established recording system of a given jurisdiction to


\textsuperscript{9} See Livingston, supra note 3, at 794.

\textsuperscript{10} See Lasdon, supra note 8, at 606; Livingston, supra note 3, at 792.

\textsuperscript{11} GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 12.1, at 1013 (5th ed. 2007).

\textsuperscript{12} Id.

determine the priority order for an encumbrance on a specific parcel of land.\textsuperscript{14}

Depending on the jurisdiction, the recording act will provide guidance as to the priority order for multiple encumbrances and will likely yield different results using the same factual scenario.\textsuperscript{15} The different acts offer a compelling incentive to record encumbrances because they assist the courts in establishing priority positions, while taking no direct action against a party that affirmatively or inadvertently fails to follow the statutes.\textsuperscript{16} As a result, a party’s claim against a given parcel of land may be diminished if it fails to properly and timely record the encumbrance.\textsuperscript{17} The unique and potentially numerous encumbrances emanating from a land development project may create unexpected loss exposures for lenders participating in a construction loan.

a. Theories of Title

Depending on the mortgage law of a given jurisdiction, the titling and ownership of real property along with the ability to encumber it will vary within the context of a construction project. The main approaches in use today include the Title and Lien Theories of Mortgage Law along with an intermediate method.\textsuperscript{18} In jurisdictions following English common law under a Title Theory, the lender does not gain possession, but holds the legal “title” to the real property until the debt is satisfied or foreclosed.\textsuperscript{19} Whereas in a Lien Theory jurisdiction, the owner of the land maintains title, while the lender preserves a security interest in the real property and will gain the

\textsuperscript{14} Id.
\textsuperscript{15} Ray E. Sweat, \textit{Race, Race-Notice and Notice Statutes: The American Recording System}, \textit{PROB. & PROP.}, May/June 1989, at 27, 28. Amongst the state systems, about half of the statutes utilize a “notice” approach where a bonafide purchaser for value receives protection regardless of the recording of the encumbrance. \textit{See} \textit{CUNNINGHAM ET AL.}, \textit{supra} note 13, § 11.9, at 825–26. This approach makes the recording of an encumbrance irrelevant so long as there was value provided for the exchange. \textit{Id.} Approximately the other half of states turn to a “notice-race” system that embraces the bonafide purchaser requirement; but they also include a recording requirement. \textit{Id.} This approach means that the first to record and receive value for his or her encumbrance will receive priority over all others. \textit{Id.} Finally, the pure “race” statutes in some states award priority based on the order in which the encumbrances are recorded. \textit{Id.}
\textsuperscript{16} \textit{See} \textit{CUNNINGHAM ET AL.}, \textit{supra} note 13, § 11.9, at 825–26.
\textsuperscript{17} \textit{Id.} § 11.9, at 826.
\textsuperscript{18} \textit{See} \textit{NELSON & WHITMAN}, \textit{supra} note 11, § 1.5.
right to possession after a valid foreclosure occurs. Finally, a few states attempt to find middle ground through an Intermediate Theory where the real property title remains with the owner and the lender gains possession only after a default occurs.

With these different methods in place, the lender and property owner's status on the title and standing for obtaining a security interest in the real estate becomes an issue. In the jurisdictions that use a Title Theory, the lender automatically gains legal "title" and a security interest upon the real property at the time of the conveyance. This system makes it difficult for a

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lender to lose its priority status in foreclosing on the property in the event that the owner fails to repay the construction loan.

By contrast, the Lien and Intermediate Theory jurisdictions provide that an owner retains “title” to the real property while essentially turning the lender’s interest into that of a lienholder. By taking this approach, a careless lender could inadvertently lose its priority position and potentially suffer a loss should other encumbrances like a mechanic’s lien against the real property arise and gain superior rights.

Many of the participants in the real estate community and those involved in lending money recognize this situation, which means that lenders properly record these documents without delay. However, a lender may also face the possibility of losing its priority position in the jurisdictions that draw distinctions between obligatory and optional advances. In an obligatory advance, the covenants of the loan agreement may require the disbursement of funds at a later date, whereas an optional advance occurs at the discretion of the lender. Since the loan agreement does not compel the optional advance, some jurisdictions set the priority date based on the disbursement of funds. This approach may cause the mortgage to be subordinate to other lien claims.

The lien theory of a given jurisdiction, along with language that fails to compel subsequent disbursements, could allow a careless construction lender to have its security interest subordinated to other encumbrances that gain priority.

b. Mechanic’s Liens

While not a part of English common law, the roots of the mechanic’s lien as a tool to foster a commitment by contractors and tradesman to provide labor and materials for a construction project began in the State of Maryland in 1791, when it ceded the territory known as Columbia to the United States government for the development of the city of Washington.

23 See Nelson & Whitman, supra note 11, §§ 4.2, at 139, 4.3, at 143.
24 See Bruner & O’Conner, Constr. Law § 8:146.
25 See Cunningham et al., supra note 13, § 11.9, at 826.
26 See Bruner & O’Conner, Constr. Law § 8:146.
27 Id.
28 Id. One of the first cases to establish an order of precedent between two loans secured by a parcel of real property occurred in Gordon v. Graham where the first lender made optional advances after the second mortgage occurred. Gordon v. Graham, (1716) 22 Eng. Rep. 502; 7 Vin. Abr. 52, pl. 3. The Gordon courtreasoned, “it was the Folly of the second Mortgagee, with Notice, to take such Security.” Id. Today, a majority of states follow the “Obligatory Advance Rule” that conveys priority to the construction lender over subsequent liens or encumbrances when the loan documents compel periodic disbursements. See Bruner & O’Conner, Constr. Law § 8:102. Should the controlling documents fail to obligate the lender to distribute the remaining portions of the loan, the subsequent releases become subordinated to any liens or encumbrances perfected ahead of the disbursements since the courts will interpret them as optional. Id.
29 Acts of Gen. Ass. of Md., c. 45, passed Dec. 19, 1791. In this legislation, the General Assembly of Maryland followed the recommendation of a commission that included Thomas Jefferson and James Madison that wished to accelerate and improve the construction of the city.
This innovative approach to protecting contractors and tradesman who furnished services and materials to construct buildings and other structures eventually inspired the passage of mechanic’s lien laws in every state, which are now part of today’s American legal framework. Each state’s legislature and local governments uniquely drafted and interpreted their distinct approach within their court systems. As a result, the lien statutes across the country provide a patchwork of pitfalls and authority. Following the basic premise that the encumbrance will provide a means for allowing contractors and suppliers due payment based on their services or materials to improve a real property parcel through the land’s newly inherited value, the mechanic’s lien will usually require the unpaid party to perfect its claim through a judicial action similar to that of a mortgage foreclosure. During the process, the court assigns a lien date, which indirectly establishes a claimant’s priority against other claims, mortgages, and encumbrances.

As long as the lender records the mortgage prior to the commencement of the building project, the construction loan will generally retain its priority over a mechanic’s lien. This generality may vary between some

by providing a lien for master builders on houses erected and land occupied. SAMUEL L. PHILLIPS, A TREATISE ON THE LAW OF MECHANIC’S LIENS ON REAL AND PERSONAL PROPERTY § 7 (2nd Ed. 1883). Pennsylvania became the second state after Maryland when it enacted its own legislation in 1803. Laws of Penn., Act of Apr. 1, 1803.


31 See NELSON & WHITMAN, supra note 11, § 12.4, at 1051–52. The commentators point out that the lien statutes are extremely varied due to legislative amendments and any further requirements set forth by local governments. Id. at 1052.

32 Id. at 1053, 1056. In general, a lien claimant will need to file a notice of the claim within the statutory time period after completing its work on the real property. Id. at 1056. This filing usually entails some type of notice and recording of the claim followed by a period of time that allows for the property owner to make the payment prior to a court hearing. Id. While each state maintains differences, many of the statutes require the “owner” to consent to the improvements to make the real property subject to a mechanic’s lien. Id. at 1059. Depending on the definition of an “owner,” a leaseholder or life tenant may not maintain the power to give consent under the statute. Id. As a result, some courts imply this transfer of power by acquiescence or knowledge of the construction, which has resulted in corresponding legislation that allows an owner to file a notice or disclaimer of responsibility. Id. at 1060.

33 Id. at 1057. The establishment of priority under a mechanic’s lien differs greatly between the states. Id. About half of the states use the commencement of construction as the method of establishing priority; others turn to the time at which the claimant began furnishing services or materials on the project followed by the date of the general or liens’ contract or the recordation of notice. 3 BRUNER & O’CONNER, CONST. LAW § 8:146.

34 See 53 AM. JUR. 2D, Mechanics’ Liens § 273 (2006). For example, New York requires a lender to record a mortgage to attain superior rights over a mechanic’s lien. N.Y. LIEN LAW §§ 13, 22 (McKinney 2012). Should a lender fail to comply with this requirement by falling short of its obligation to provide all of the necessary notices, the mortgage will become subordinate to a subsequent mechanic’s lien on the real property. Nanuet Nat’l Bank v. Eckerson Terrace, Inc., 391 N.E.2d 983, 986 (N.Y. 1979); see also N.Y. LIEN LAW § 13(1) (McKinney 2012).

In contrast, a federal court in Minnesota held that a lender may invoke the applicable statute for priority even though it failed to record the mortgage before the commencement of construction by giving actual notice to potential claimants. Resolution Trust Corp. v. Lawyers Titles Ins. Corp., 796 F. Supp. 1233, 1243 (D. Minn. 1992). The court recognized that a lender
jurisdictions because the definition of commencement may include different interpretations such as: the date of the construction contract, the point in time when a contractor or supplier actually began to provide labor or materials, or some other event like a preliminary lien notification requirement. 35

However, a lender may also relinquish its superior rights through recording mistakes, waiving its priority position, or accepting a deed in lieu of foreclosure. 36 Should a lender record the mortgage in the wrong jurisdiction or fail to include all of the appropriate notices, subordination may occur. 37 For example, a New York court found that a lender failed to comply with the public notice requirements within its jurisdiction and did not include mandated information in its recording. 38 The court pointed out could provide actual notice of its mortgage by placing a sign on the real property to trigger the applicable state statute for determining priority status. Id. Moreover, the perfection of a claim may preempt mortgages and other mechanic’s liens for superior rights, since many states recognize the time at which the project commenced as the event that establishes priority. See Nelson & Whitman, supra note 11, § 12.4, at 1057. In practice, priority is a point of contention because courts disagree on the exact point in time that a project commenced. Id. To avoid any type of confusion in the event a claimant files a lien and to preserve a mortgage’s priority status, Professors Nelson and Whitman point out that the prudent lender needs to establish that construction did not begin through photographs of the real property. Id. at 1058.

Statutes in some jurisdictions specifically prefer a mechanic’s lien to prior claims, mortgages, or encumbrances associated with a particular piece of real property where the construction leads to a new and unrelated structure that may be removed without harming the land. 53 Am. Jur. 2d Mechanics’ Liens § 269 (2012). Upon interpreting these statutes, the courts that evaluated these pieces of legislation found that the mechanic’s liens maintained superior rights on the constructed buildings; while the mortgage still retained its priority claim on the land. See Dunham Lumber Co. v. Gresz, 2 N.W.2d 175, 178 (N.D. 1942); Drake Lumber Co. v. Paget Mortg. Co., 274 P.2d 804, 813–15 (Or. 1954). These courts bifurcated the structure from the real property to allow both the mechanic’s lien and mortgage to retain their respective priority status while coexisting under the apparent conflict in the statute. See Dunham Lumber Co., 2 N.W.2d at 178; Drake Lumber Co., 274 P.2d at 812–13.

35 See 3 Bruner & O’Connor, Constr. Law § 8:146. The courts in these states upheld the priority status of a mechanic’s lien over a lender’s recorded mortgage because the construction contract predated the loan. Id. Despite that the furnishing of labor and materials occurred after the recording of the mortgage, the courts used the earlier date of the construction contract with the property owner to give the lien priority over a lender’s claim. See Adamson v. First Fed. Sav. & Loan Ass’n of Andalusia, 519 So. 2d 1036, 1038–39 (Fla. App. 1988); Nat’l Lumber Co. v. Advance Dev. Corp., 732 S.W.2d 840, 848 (Ark. 1987); R.B. Thompson, Jr. Lumber Co. v. Windsor Dev. Corp., 383 N.W.2d 357, 365 (Minn. Ct. App. 1980); Matter of Phillips House Assoc., Inc., 64 B.R. 912, 922–23 (Bankr. W.D. Mo. 1986).

In other jurisdictions, the courts set the priority date based on when a contractor began to furnish labor or materials. See Nelson & Whitman, supra note 11, § 12.4, at 1058. Professors Nelson and Whitman explain that this approach creates difficulties as well, since a mortgage could straddle the priority status of lien claimants by creating prior and subsequent claims. Id. This result could run contrary to a statute that calls for parity amongst the mechanic’s lien claimants and lead to further litigation. See id.


37 Id. at 1056.

38 Nanuet Nat’l Bank v. Eckerson Terrace, Inc., 391 N.E.2d 983, 985–86 (N.Y. 1979) (holding that under notice requirements, a lender’s mortgage will be subordinated to subsequently
the pivotal role of a lender in a construction project and the lack of recourse options for a contractor. It then subordinated the mortgage to a subsequent mechanic’s lien on the real property.  

Likewise, a lender may waive its superior status when it participates in the construction project on the real property it accepted as collateral.  

Depending on the lender’s involvement with respect to the construction of improvements on real property, a court will make its determination based on a particular set of facts rather than following a clear-cut rule derived from equitable principles. Missouri courts have allowed lender-induced improvements upon real property to meet the criteria for a waiver but have recently struggled with whether active participation needs to supplement any knowledge on the part of those making the construction loan in order to qualify as well.  

Finally, a deed in lieu of foreclosure may not extinguish the claims made against real property under a mechanic’s lien and could ultimately gain priority over a mortgage. If a lender chooses to accept a deed in lieu of foreclosure, a mechanic’s lien remains attached to the real property. The mortgage then becomes subordinate because the holder of the note accepts title in exchange for extinguishing the debt. A Louisiana court explained this precedent as appropriate because the lien holder did not have the opportunity to bid on the property in a foreclosure sale, so the lender accepted the real property subject to the mechanic’s lien.  

A mechanic’s lien poses a real and serious threat to a construction lender because the lender may lose priority over an inferior claim through the numerous possibilities inherent in the risks of improving a particular parcel of real property.  

\textit{c. Liens on Construction Loans}  

Given that savvy lenders take numerous steps to avoid situations that will cause their loan to be subordinated and that an unpaid subcontractor or supplier may never recoup its outlay on a construction project, several arising mechanic’s liens if the lender knowingly files a building loan contract which materially misrepresents the net sum available to the borrower for improvements).  

\textsuperscript{39} Id. at 986.  

\textsuperscript{40} See 3 BRUNER & O’CONNER, CONSTR. LAW § 8:146.  

\textsuperscript{41} Kranz v. Centropolis Crusher, Inc., 630 S.W.2d 140, 147 (Mo. Ct. App. 1982).  

\textsuperscript{42} See In re Exec Tech Partners v. Resolution Trust Corp., 107 F.3d 677, 680 (8th Cir. 1997); Trout’s Invs., Inc. v. Davis, 482 S.W.2d 510, 517 (Mo. Ct. App. 1972).  

\textsuperscript{43} Compare In re Gateway Ctr. Bldg. Investors, Ltd., 95 B.R. 647, 654 (Bankr. E.D. Mo. 1989); Cinco Enters., Inc. v. Lake St. Louis Estates Co., 557 S.W.2d 9, 10 (Mo. Ct. App. 1977) with Genesis Eng’g Co. v. Hueser, 829 S.W.2d 579, 580 (Mo. Ct. App. 1992); Kranz, 630 S.W.2d at 148–49.  

\textsuperscript{44} Bayou Contractors, Inc. v. Brown, 693 So. 2d 1249, 1254 (La. Ct. App. 1997).  

\textsuperscript{45} Id.  

\textsuperscript{46} Id.  

\textsuperscript{47} Generally, a mechanic’s lien offers lower tiered subcontractors and material suppliers inadequate security against nonpayment because a mortgage typically maintains priority and
states now provide legislative remedies through stop notice or trapping statutes, or judicial remedies such as equitable liens.\textsuperscript{48} These legislative and judicial remedies provide a subcontractor or supplier with the opportunity to enforce a claim for nonpayment against those disbursing funds.\textsuperscript{49} Stop notice or trapping statutes and equitable liens apply to the undistributed portion of a construction loan and offer a distinctly unique remedy from a mechanic’s lien, which places an encumbrance on a piece of real property.\textsuperscript{50}

\textit{i. Stop Notice or Trapping Statutes}

To utilize the stop notice or trapping statute type of remedy, a claimant must meet specific requirements.\textsuperscript{51} The process usually begins after the claimant completes the assigned work and submits an invoice for payment pursuant to the stop notice requirements.\textsuperscript{52} After surpassing a given state’s statutory requirements for an overdue invoice and serving any necessary preliminary lien notifications, the claimant may generally serve the stop notice upon a responsible party.\textsuperscript{53} Each state maintains a different procedure the cost of recovery frequently exceeds the amount owed. See Charles E. Goulden et al., Comment, \textit{California Mechanic’s Liens}, 51 CALIF. L. REV. 331, 356 n.197 (1963).


\textsuperscript{49} MARIANNE M. JENNINGS, REAL ESTATE LAW 131 (9th ed. Cengage 2011). A stop notice places a lien on the unpaid contract funds whereas a trapping statute provides a means for the subcontractor or supplier to receive direct payments from either the owner, lender, or government when the main contractor fails to do so. See SWEET & SCHEEGER, supra note 6, at §§ 23.06B, 23.06C. However, these approaches may unwittingly create a situation where an owner pays the prime contractor and then must make a second disbursement in order to remove the lien. Id.

\textsuperscript{50} See 3 BRUNER & O’CONNER, CONST. LAW § 8:144.


\textsuperscript{52} See, e.g., WASH. REV. CODE ANN. § 60.04.221(1) (West 2004).

\textsuperscript{53} Id. Depending on the state, some jurisdictions allow for the lender to receive notice while others include the owner as well. See, e.g., ARIZ. REV. STAT. ANN. § 33-1051 (2007). Other common restrictions may prevent the claimant from pursuing a stop notice when a payment bond exists on a construction project. See, e.g., COLO. REV. STAT. §38-22-102(d)(2) (2012); N.J. STAT. ANN. § 2A:44A-12 (West 2000); WIS. STAT. ANN. § 779.36 (West 2001).
for executing, perfecting, and enforcing a stop notice or trapping statute.\footnote{Compare Wash. Rev. Code Ann. § 60.04.221 (West 2004), with Cal. Civ. Code §§ 8508–60 (West 2012). For example, a lender in Washington State that receives a stop notice as the responsible party must select one of three courses of action. First, a lender may continue to allow further disbursements against the construction loan but must withhold sufficient funds that equal the stop notice from the next and subsequent draws. Wash. Rev. Code § 60.04.221(5) (West 2004). Second, the lender may elect to ignore the stop notice claim and continue to disburse funds without any withholding. In this situation, the statute specifically creates priority for the stop notice by stating “the mortgage, deed of trust, or other encumbrance securing the lender shall be subordinated to the lien of the potential lien claimant to the extent of the interim construction loan proceeds or to the property owner’s funds.” § 60.04.221(7). Lastly, the lender may choose to stop disbursing the funds associated with the construction loan and begin a foreclosure action, which will subordinate the stop notice claim and require the filing of a mechanic’s lien with no special priority to recoup any nonpayment for services or materials supplied. Richard Paroutaud, Mechanics’ Liens: The “Stop Notice” Comes to Washington, 49 Wash. L. Rev. 685, 696 (1974).}

Because this type of remedy is effective in insuring payments for services or materials rendered, many parties choose to litigate these statutes and tend to find the courts unfriendly to lenders’ and owners’ objections.\footnote{See Paroutaud, supra note 54, at 696.} Some of the courts in California—in an effort to protect the public policy behind the statute—closely enforced the statutory deadlines but freely interpreted other components of the legislation to support a claimant’s assertion.\footnote{See Lewis J. Soffer, Policy Considerations Trump Statutory Construction, Giving Stop Notice Claimants A Big Advantage Over Construction Lenders, 20 Miller & Starr Real Est. Newsalert 85, 86 (2009) (addressing the reasoning behind a policy preference for protecting laborers and materialmen over conformity with principles of statutory construction).} Another court in California and one in Washington discredited

\footnote{See e.g., Corbett v. Chambers, 41 P. 873, 875 (Cal. 1895) (noting the plaintiff “is not required to ascertain at his peril the name of the true owner…. as it sufficient if he gives the name of the reputed owner”); Hendrickson v. Bertelson, 35 P.2d 318, 319 (Cal. 1934) (noting the mechanic’s lien is remedial in character and should be liberally construed to promote justice); Rossman Mill & Lumber Co. v. Fullerton Sav. & Loan Ass’n., 34 Cal. Rptr. 644, 647 (Cal. Dist. Ct. App. 1963) (stating that the statute is meant to protect mechanics and materialmen and must be construed to effect its objects and promote justice); Familian Corp. v. Imperial Bank, 262 Cal. Rptr. 101, 102 (Cal. Ct. App. 1989) (stating there is strong public policy to afford protection to laborers and materialmen). In fact, one California court explained that a lender protects itself}
the assertion that a stop notice and mechanic’s lien were mutually exclusive remedies.\(^{58}\)

Also, in response to this type of legislation and the related support from the courts, many construction lenders tried to structure their loans to avoid the stop notice remedy.\(^{59}\) The California courts faced these issues frequently and disallowed the subordination of a stop notice to a construction loan through a private agreement.\(^{60}\) It also disallowed situations where the lender received a stop notice and then applied the unexpended funds to reduce the borrower’s debt, to complete the project,\(^{61}\) or to retain priority status by placing undisbursed monies into a general fund or an escrow account for pro rata distribution at a later date.\(^{62}\) In Alaska and Arizona, the courts distinguished their applicable cases from this precedent based on their jurisdictions’ statutory differences with the California statutes and refused to subordinate the construction loan.\(^{63}\) Consequently, a prudent lender must consider whether or not a jurisdiction maintains an applicable stop notice or trapping statute and determine the likelihood that a court would uphold an agreement to maintain priority in the event a claimant pursued recovery for its losses.

against default by securing top priority for its deed of trust and can also compel the borrower to secure a payment bond. Miller v. Mountain View Sav. & Loan Ass’n, 48 Cal. Rptr. 278, 288–89 (Cal. Dist. Ct. App. 1965). In addition, a lender maintains other disbursement controls through joint checks, progress inspections, and other techniques. Id. at 89. As a result, the court reasoned that a claimant furnishes labor and materials that contribute to an increase in the property's value, which enhances the lender's security. Therefore, the stop notice remedy offers an appropriate solution that furthers proper compensation as well as the public policy that seeks to use lenders as a means to monitor the construction industry. See generally id.


\(^{59}\) See, e.g., A-1 Door & Materials Co. v. Fresno Guar. Sav. & Loan Ass’n, 394 P.2d 829, 833 (Cal. 1964) (noting the lender’s argument that there was nothing to garnish because the stop notice remedy was unavailable as a result of the owner defaulting); Rossman Mill & Lumber Co., 34 Cal. Rptr. at 646–47 (noting that when a lender and a borrower set up a building fund and control disbursements according to their private agreement to protect the lender, they preclude the stop notice remedy); Miller, 278 Cal. Rptr. at 286 (noting private agreements between a lender and borrower cannot preclude the stop notice remedy); Idaco Lumber Co. v. Nw. Sav. & Loan Ass’n, 71 Cal. Rptr. 422, 426 (Cal. Ct. App. 1968) (describing a lender’s attempt to preclude the stop notice remedy by transferring the loan balance into its general fund); Calhoun v. Huntington Park First Sav. & Loan Ass’n, 9 Cal. Rptr. 479, 484–85 (Cal. Ct. App. 1966) (concluding that the holder of construction funds may not invalidate the effect of a stop notice by transferring those funds to other creditors or using them to advance its own interest).

\(^{60}\) See Rossman Mill & Lumber Co., 34 Cal. Rptr. at 646–47

\(^{61}\) See A-1 Door & Materials Co., 394 P.2d at 832; Miller, 278 Cal.Rptr. at 286.

\(^{62}\) See Familian Corp., 262 Cal. Rptr. at 103; Idaco Lumber Co., 71 Cal. Rptr. at 426; Calhoun, 9 Cal. Rptr. at 484.

In addition to stop notice and trapping statutes, some jurisdictions entertain liens based on equitable principles as another remedy for recovery. In these situations, the claimant may attempt to encumber some portion of the undisbursed funds using common law doctrine; however, no consensus exists for a particular rule of law as applied to a lawsuit pursuing payment from a construction loan. In general, these cases tend to focus on the use of equitable doctrines where the defendant was unjustly enriched by his actions and needs to provide restitution. A claimant may also assert that it should receive third-party beneficiary status under the construction loan agreement.

Under a theory of unjust enrichment, the claimant will try to show that the statutory remedies did not provide an adequate resolution and that the lender received a benefit without paying for it. Some courts that apply this approach begin their evaluation with an inquiry as to the completion status of the project before allowing a lien on the construction loan.

64 Depending on the jurisdiction, some courts will view mechanic’s lien and stop notice statutes as exclusive remedies, while other courts allow equitable remedies in addition to those adopted by the state. Compare Donnybrook Bldg. Supply Co., 736 P.2d at 1153–54, with Town Concrete Pipe of Wash., Inc. v. Redford, 717 P.2d 1384, 1387 (Wash. Ct. App. 1986).


67 See Reitz, supra note 65, at 449–50. Professor Reitz points out that one of the most difficult concepts for a court addressing this type of approach concerns the amount and proof of enrichment by a lender. Id. Some courts do not find unjust enrichment and explicitly bar recovery in situations where a lender releases funds to a responsible party based on the progress of the work completed, but ultimately discover that the claimant did not get paid. See, e.g., Myers-Macomber Eng’rs v. M.L.W. Constr. Corp., 414 A.2d 357 (Pa. Super. Ct. 1979).


69 See Anglo-American Sav. & Loan Assoc., 13 App. D.C at 600 (finding that where a lender retains part of a loan without justification, equity imposes a constructive trust on the retained amount); Pac. Ready Cut Homes, Inc., 14 P.2d at 511 (finding that it would be unjust to allow the builder and the lender to withhold parts of the fund on which the lien claimants relied);
grounds in equity for a lien on the construction loan until the project is complete. 70

Many other courts begin their evaluation of a case by determining if the owner or lender of the project made any assurances to the claimant, regardless of the completion status. 71 Some courts require an owner to induce the claimant, either by direct representation or by a reasonable expectation arising from the owner's actions. 72 Other jurisdictions look for a lender's false statement that encouraged further work or materials. 73 In both instances, the courts essentially provide relief for those situations where a foreclosure occurred and the owner or lender received an improvement on the real property without paying for it. 74

Following the third-party beneficiary claim approach, courts will determine whether the parties involved with the construction and the loan intended for the claimant to have benefits from the financing agreement. 75 In some jurisdictions that follow the third-party beneficiary rules pursuant to common law, the courts analyze the totality of the transaction and recognize that an owner borrows funds from a lender with the intention to pay or

Fred S. Conrad Constr. Co., 215 So. 2d at 47 (reversing dismissal of counterclaims against lender that defended against lender's foreclosure complaint on the ground that it had permitted work to continue after default without notifying the contractor of default); Morgen-Oswood & Assoc., Inc., 323 So. 2d at 685 (finding that because building was completed according to plans, the lender had the security it bargained for, and that it was unjustly enriched when it failed to issue final payments); Blosam Contractors, Inc., 353 So. 2d at 1227–28 (holding that the lender owned condominiums outright after default, but subject to an equitable lien resulting from the lender's withholding of funds).


71 See NELSON & WHITMAN, supra note 11, § 12.6.


73 See Pioneer Plumbing, supra note 63, at 122.

74 See NELSON & WHITMAN, supra note 11, § 12.6, at 1079–80.

75 See id. at 1080. Professor Reitz explains that this approach appears analogous to approaches taken in other legal areas such as partnerships or joint ventures. See Reitz, supra note 65, at 457. In those areas, each partner accepts liability for the contractual obligations of each associate in the partnership or joint venture entity. Id. Enlarging this analogy to encompass limited partnerships and evaluating the lender in the role of a limited partner, a claimant will assert that the borrower fulfills the role as an authorized representative to establish contractual privity within the context of the broader construction project but not within each particular agreement. Id.
benefit the contractor, the subcontractors, and materials suppliers.\footnote{See Pac. Ready Cut Homes, Inc. v. Title Ins. & Trust Co., 14 P.2d 510, 511 (Cal. 1932); McHain v. Santa Clara Sav. & Loan Ass’n, 51 Cal. Rptr. 2d 78, 83 (Cal. Ct. App. 1996); Miller v. Mountain View Sav. & Loan Ass’n, 48 Cal. Rptr. 2d 278, 290 (Cal. Ct. App. 1995); Gee v. Eberle, 420 A.2d 1050, 1063 (Pa. Super. Ct. 1980); Spring Constr. Co., Inc. v. Harris, 562 F.2d 933, 937 (4th Cir. 1977); Trans-Bay Eng’rs & Builders, Inc. v. Hills, 551 F.2d 370, 382–83 (D.C. Cir. 1977); Am. Fidelity Fire Ins. Co. v. Construcciones Welr, Inc., 407 F. Supp. 164, 183 (D. V.I. 1975); Travelers Indem. Co. v. First Nat’l State Bank of N.J., 328 F. Supp. 208, 211 (D. N.J. 1971).} Other jurisdictions shift the inquiry to determine whether the construction lender or borrower induced the lien claimants to continue working or supplying materials through deceptive statements or actions.\footnote{See Chase Manhattan Bank v. S/D Enters., Inc. 353 So. 2d 131, 133 (Fla. Dist. Ct. App. 1977); Half’s Miscellaneous Ironworks, Inc. v. All S. Inv. Co., 283 So. 2d 372, 374 (Fla. Dist. Ct. App. 1973); Fed. Deposit Ins. Corp. v. Key Biscayne Dev. Ass’n, 858 F.2d 670, 674 (11th Cir. 1988); In re Commercial Invs., Ltd., 92 B.R. 488, 492 (Bankr. D. N.M. 1988); But see In re 200 Woodbury Realty Trust, 99 B.R. 184, 187 (Bankr. D. N.H. 1989); Edd Helms Elec. Contracting, Inc. v. Barnett Bank, 531 So. 2d 238, 239 (Fla. Dist. Ct. App. 1988). In the event that a claimant makes a false statement to the lender, a court may bar recovery on the basis of ”unclean hands.” Mursor Builders, Inc. v. Crown Mountain Apartment Assocs., 467 F. Supp. 1316, 1334 (D. V.I. 1978).} Moreover, a borrower’s default or breach of the covenants on the construction loan may provide another obstacle to an equitable lien using the third-party beneficiary approach. In some courts, the ability to place an equitable lien will lapse because a lender’s obligation to release additional loan funds terminated due to a default or a breach of the covenants contained in the lending agreement by the borrower. The termination of the lender’s obligation also ceased any third-party beneficiary rights.\footnote{Van-Tex Inc. v. Pierce, 703 F.2d 891, 900 (5th Cir. 1983); Trans-Bay Eng’rs & Builders, Inc., 551 F.2d at 379–80; Pioneer Plumbing Supply Co., 428 F.2d at 121. Two courts considered the time at which the claimant performed the work in relation to the borrower’s default to claim that the lien “vested.” See Trans-Bay Eng’rs & Builders, 551 F.2d at 380; Travelers Indem. Co., 328 F. Supp. at 217. Professors Nelson and Whitman take issue with these courts’ approach because it “makes no sense in terms of the lender’s fundamental obligations under the construction loan agreement.” See NELSON & WHITMAN, supra note 11, § 12.6. at 1081. They point to another court that decided that a lender’s activities to persuade subcontractors and suppliers to continue their work even though default already occurred chose to waive its superior status with regard to the lien claimants. See id. § 12.6 n.38.} As such, an equitable lien using the third-party beneficiary theory as precedent faces profound issues in the event of a default or breach of a covenant on a construction loan.

A lender involved with a construction loan must evaluate the risks posed by the stop notice and trapping statutes as well as equitable liens imposed by a court. Because these remedies attach to the undisbursed portions of a construction loan or to the land itself, a lender’s security interest may become subordinated to a claimant and create additional loss exposure. Hence, a lender needs to remain informed that the disbursements on a construction loan translate into payments for those parties furnishing labor or materials on a project or risk an unforeseen loss.

2. Lender Liability for Activities Beyond the Loan

Aside from encumbrances, a lender whose actions go beyond those associated with the construction loan could face additional liabilities from other parties. Sometimes an injured party will assert that a lender participated in the construction project or advanced some type of fraudulent scheme that went beyond the loan activities. As such, a sympathetic court may hold the lender legally responsible for its involvement in the construction project.

In the cases where the courts find that a lender participated in the construction project, the claims often arise out of construction defect situations. The different plaintiff assertions for these types of cases focus on whether the lender became too involved with the development, did not uphold its promised actions, or became the responsible party when it

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80 See, e.g., Connor v. Great W. Sav. & Loan Ass’n, 447 P.2d 609, 616 (Cal. 1968).
81 See Connor, 447 P.2d at 616 (finding a construction lender liable when it became an “active participant in a home construction enterprise”); Central Bank v. Baldwin, 94 Nev. 581 (Nev. 1978) (holding that a lender will only be liable when “the loss or damage is the result of some other action or activity of the lender [other than the loan transaction]”) (quoting a Nevada statute). The holdings from the courts for these cases tend to deny attaching liability to a lender because a plaintiff usually fails to prove the level of extensive involvement required under the law/equitable principles. However, a California Supreme Court decision kicked off a minority position that found a lender maintained too close a relationship with the developer, which meant that it could have prevented some of the defective construction. Connor, 447 P.2d at 616–18. See also Wright v. United States, 428 F. Supp. 782, 789 (D. Mont. 1977) (stating “the Conn[or] decision is an exception to the rule of tort liability by a lender, rather than the generally accepted rule”). Finding the California decision persuasive, the Nevada Supreme Court also chose to follow this approach in a case it heard subsequently. See Central Bank v. Baldwin, 583 P.2d 1087, 1089 (Nev. 1978) (resting its holding in part on language found in a Nevada statute that was enacted five years after Connor).
82 These situations tend to involve broken promises made by a lender to an owner or another party. See NELSON & WHITMAN, supra note 11, § 12.11, at 1151–52. An early case acknowledging this approach started at the Alabama Supreme Court where it found the California Supreme Court’s decision in Connor persuasive enough to order a new trial, allowing the jury to decide whether a lender would be liable for construction defects for its statement to a contractor that the lender would disallow disbursements if its inspector found the work was done improperly. Rudolph v. First S. Sav. & Loan Ass’n., 414 So. 2d 64, 71 ( Ala. 1982) (holding that a lender will be found liable only when it “voluntarily undertakes to perform [an] inspection on behalf of and for the benefit of the borrower”). Following its early decision in Central Bank, the Nevada Supreme Court found a lender responsible for failing to stop further disbursements on the construction loan when the borrower alleged defective work by the contractors. Davis v. Nev. Nat’l Bank, 737 P.2d 503, 505 ( Nev. 1987) (stating that a lender’s liability arises “not from the loan transaction” but from a “breach of a nonconsensual duty of care”). Moreover, the Kansas Supreme Court found the Nevada Supreme Court’s reasoning persuasive but distinguished its case based on the lack of a promise by the lender. Daniels v. Army Nat’l Bank, 822 P.2d 39, 43 ( Kan. 1991) (holding that “a person who is not under any disability or disadvantage may not . . . unilaterally impose a fiduciary relationship on another without a conscious assumption of such duties by the one sought to be held liable as a fiduciary”). However, a Tennessee Court of Appeals decided to take a middle ground. The court found a lender liable for incomplete items of work but not construction defects, where the lender promised to disburse funds based on an inspector’s progress report despite knowing of the shoddily completed examination. Lomax v. Headley Homes, No. 02A01-9607-CH-00163, 1997 WL 269432, at *3–4 (Tenn. Ct. App. May 22, 1997) (quoting authority for the assertion that “absent a
assumed control of and completed the project. In contrast, one federal court in Illinois evaluated a lender’s actions to determine if it actively participated in or advanced a fraudulent scheme and, finding that its undertakings went well beyond normal lending practices, allowed liability to attach.

Accordingly, these cases provide modest guidance and limitations on what activities will cause additional liabilities to attach when a lender crosses the line and on the willingness of a court to take such an action. A lender must identify these types of risks and proceed with caution when it makes assurances to parties involved in the construction project or participates in activities outside of its normal lending scope.

a. Environmental Issues

Given that a construction project by its very nature introduces foreign materials to a given piece of real property, environmental concerns through the improper disposal of hazardous waste pose serious risks to a lender. These risks can in turn cause an unexpected loss on a loan. A lender may face these risks directly in one of two ways: first, a court may attach liability as a responsible party; second, the government may place a lien on the property that subordinates a mortgage or deed of trust. For these reasons, a participant in a construction loan must assess the impact of these risks within a land development project it considers funding.

i. Hazardous Waste

In response to the growing troubles connected with the improper disposal of hazardous and toxic waste, Congress passed the Comprehensive...
Environmental Response, Compensation, and Liability Act of 1980 (CERCLA),\(^86\) the Superfund Amendments and Reauthorization Act of 1986 (SARA),\(^87\) and the Small Business Liability Relief and Brownfields Revitalization Act (Brownfields Act) in 2002.\(^88\) These collective legislative efforts impose strict liability, jointly and severally, on owners, past owners, and operators of facilities for the costs involved in a Superfund cleanup.\(^89\) One of the main reasons Congress took this approach was to identify those parties that benefited from the production and disposal of hazardous materials on the property and require that they pay for its remediation costs.\(^90\)

For example, those participating in loans on real property became targets for recovery when a U.S. Court of Appeals for the Eleventh Circuit attached liability to lenders that attempt to influence the borrower's hazardous waste disposal.\(^91\) Following this same reasoning, a court in another jurisdiction extended lender liability, placing lenders that took title at a foreclosure sale in the same position as any other buyer.\(^92\)

In response, Congress created the “security interest exemption” to create a safe harbor for lenders.\(^93\) Under this exemption, the government cannot hold a lender that maintains a mortgage or lien on a property as collateral for the underlying promise to repay the loan responsible for the environmental cleanup costs.\(^94\) However, a lender may lose this exemption should it foreclose on the contaminated property or somehow become involved in the operation of the business by its influence or outright takeover.\(^95\)

The initial hazardous waste legislation that allowed the government to recover its expenses created broad exposure to losses for lenders. With some enhancements, the current laws require some type of actual ownership or participation in the management of the real property in question.\(^96\) A lender must now take a more extensive look at its options when deciding whether to further involve itself with an existing borrower that brings environmental risks.

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\(^{90}\) See Claude et al. supra note 2, at 484.

\(^{91}\) United States v. Fleet Factors Corp., 901 F.2d 1550, 1559 (11th Cir. 1990).


\(^{94}\) See Claude et al. supra note 2, at 485.

\(^{95}\) 42 U.S.C. § 9601(20)(a)(ii)(I) (2006). Should a lender avail itself to a claim through either a foreclosure or by influencing the business operations through other undertakings, several statutory defenses become available. Id. § 9607(b). These defenses include assertions that the lender does not fit within the meaning of a responsible party, the contamination occurred solely due to an act of God, an act of war, or the act or omission of a third party having no relationship with the lender, or the innocent purchaser or landowner defense applies. Id.

\(^{96}\) See supra notes 93-95 and accompanying text.
ii. Environmental Liens

Providing another tool to make sure the federal government receives reimbursement for its cleanup costs, the SARA legislation allows the federal government to lien the real property for which a person is liable under § 107(a) of CERCLA. Expanding these powers, the Brownfields Act further refined the “windfall lien” in favor of the Environmental Protection Agency (EPA) for those situations where a bona fide prospective purchaser takes title to property that received the benefit of public cleanup funds. The EPA calculates the lien amount by considering the difference in fair market value attributable to the remediation efforts and includes those costs from the moment the agency spends money on the cleanup until the disposition of the property or when another source pays for the response costs.

While neither the SARA legislation nor the Brownfields Act specify a priority for the lien with regard to other encumbrances, several states’ statutes address the issue. In these jurisdictions, a state’s hazardous waste lien can subordinate other deeds, mortgages, and encumbrances. Nonetheless, the federal statute still requires perfection of the windfall lien and only allows for priority status once recorded.

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98 Id. § 9607(r)(2). For the EPA to pursue a “windfall lien,” the agency must prove that it carried out a response action, it failed to recoup its costs to respond, and that the cleanup activity increased the fair market value of the property over a prior assessment based on its condition at the time. Id. § 9607(r)(3)(A)–(B). To provide initial guidance on the use of the lien authority, the EPA issued several policy statements that explain the process and requirements for giving notice, filing, and perfecting this type of lien. Memorandum from Thomas L. Adams Jr., Assistant Admin’r., U.S. Envtl. Prot. Agency, to Reg’l Admin’rs, Reg’l Counselors, and Dirs., Waste Mgmt. Divs., U.S. Envtl. Prot. Agency 2–10 (Sept. 22, 1987), available at http://www.epa.gov/compliance/resources/policies/cleanup/superfund/fed-sflien-mem.pdf.
101 This provision guarantees the recordation of the lien by stating: “If the State has not by law designated one office for the receipt of such notices of liens, the notice shall be filed in the office of the clerk of the United States district court for the district in which the real property is located.” 42 U.S.C. § 9607(1)(3) (2006).
Interestingly, the EPA may incur cleanup costs at one point in time but proceed to perfect and record the lien at a later date.\textsuperscript{103} Because the statutes specify that the lien “will arise” at the moment when the EPA spends money to clean up the pollution, the potential for a “secret lien” presents itself.\textsuperscript{104} In response to the potential hesitancy of lenders to accept this type of risk, as well as to encourage greater participation in brownfield redevelopment, the EPA maintains a policy to address issues raised by interested parties.\textsuperscript{105} At the request of an interested party, the EPA may issue a letter that explains the agency’s intentions with regard to pursuing a windfall lien on a particular piece of real property.\textsuperscript{106}

Consequently, a construction lender needs to evaluate each project for any loss exposure it may have from an environmental perspective before funding a development until the repayment of the loan. Some of this assessment must occur at the beginning or the lender may unwittingly lose priority on its security interest to the government. Other aspects need to occur continually to avoid later litigation.

Thus, a construction loan poses some significant loss exposures to a lender from a variety of sources. The main methods for enforcing a claim include subordinating a construction loan to other liens or litigating based on a lender’s involvement that went beyond the normal activities associated with loans. Because of these loss exposures, a lender choosing to participate in a construction loan must take various precautions to avoid or manage such risks.

\textbf{B. Acquisition and Attributes}

Customarily completed prior to commencing construction, the construction lending process and agreement consist of many unique attributes that distinguish it from other kinds of real estate loans. This difference means that the underwriting process and corresponding loan documents will progress over several phases to minimize risk and ensure a smooth transition to permanent financing upon completion of the construction project.\textsuperscript{107} After completing the underwriting process, the

\begin{footnotesize}

\textsuperscript{104} See Interim Windfall Lien Policy, supra note 103.

\textsuperscript{105} See Interim Windfall Lien Policy, supra note 103; Windfall Lien Admin. Procedures, supra note 103.

\textsuperscript{106} See Interim Windfall Lien Policy, supra note 103; Windfall Lien Admin. Procedures, supra note 103.

\textsuperscript{107} See CLAURETTE & SIRMANS, supra note 2, at 271. Several commentators explain that the threat of an incomplete project poses a significant risk to a construction lender, so the total
\end{footnotesize}
lender will draft construction loan documents for a given project, which should provide temporary and permanent financing for the most viable construction endeavors while setting restrictions to ensure order and minimize risks for all those involved.108

1. Preliminary Underwriting Process

In response to the large number of projects seeking a construction loan, many lenders screen the project for economic viability first.109 In its submission package, the applicant needs to supply preliminary plans, specifications, an itemized cost analysis for the project, a feasibility study, pro-forma financial forecasts for the completed project, as well as cash flow estimates and financial statements for the borrower and guarantor.110

In sifting through the application, the underwriter will need to gain confidence that the completed project will generate enough revenue to cover the permanent financing obligations and supply a sufficient return on the investment to its owners.111 To accomplish this goal, the lender begins by determining if the requested funds and those already allocated by the borrower will adequately cover all of the costs to complete the project.112 Should this cursory review satisfy the underwriter, the lender then orders a site inspection.113

During this phase, the lender will inspect the construction site and conduct its own analysis of the project, then evaluate the reasonableness of the applicant’s income projections and operating expenses.114 With this information in hand, the lender will develop its own pro forma financial statements for the project and establish its own capitalization rate that will allow it to attach an initial estimate of value.115 Based on this calculation, the lender will decide if the project merits closer scrutiny in the final underwriting process, or if it should decline the loan application.116 Hence, this initial screening allows the lender to proceed with those projects that

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109 See SWEET & SCHNEIER, supra note 6, § 8.05.
110 See Livingston, supra note 3, at 795.
111 Id. (explaining that at the time of the article, the generally accepted minimum for the debt service ratio occurred at 1.25 dollars of income for each dollar of loan).
112 Id.
113 Id.
114 The lender’s analysis will consider the location of the project and the comparables used in the feasibility study submitted by the applicant. The underwriter will gather its own information and data through leasing agents, property managers, realtors, appraisers, and other lenders such as mortgage bankers. With this information in hand, the lender will develop a model to forecast and validate the income projections in comparison and in conjunction with the market to ensure that the location for the project offers economic stability or improvement going forward. Id. at 795–96.
115 Id. at 796.
116 Id.
meet its criteria for a construction loan and that demonstrate a strong viability.

2. Final Underwriting Process

When commencing the final underwriting process, the construction lender will initially complete an extended analysis of the total cost budget for the project to better understand and possibly manage exposures that may arise from an endeavor that falls short of completion. In this effort, the lender will evaluate the budget in search of omissions that could have a material effect on the estimate. It will also evaluate some of the more significant elements to the financial plan such as: costs for construction not already under agreement or excluded from the contract, payment of interest during the project, and any other development expenses. After satisfying any doubts regarding the project’s economic viability, the lender will turn to addressing the permanent financing.

Commonly called a “take-out” commitment, this requirement calls for the project to obtain and maintain a commitment for permanent financing from another lender upon completion of construction. Normally, the borrower and the two lenders execute a triparty agreement that calls for the purchase and sale of the promissory note used to finance the construction of the building when completed. This agreement usually contains covenants that require the use of a single set of documents for the entire transaction. Moreover, a long-term lender will also limit its obligation to purchase the promissory note to those buildings that comply with the agreed upon plans and specifications at the time the contract gets executed. Because of this agreement, the underwriting process for the construction loan contains issues that can be classified into two categories: those relating to

117 See SWEET & SCHNEIER, supra note 6, § 8.05.
118 In reviewing the payment of interest on the construction loan, a lender will evaluate this situation very carefully to ensure a proper amount for this contingency is included in the budget. Depending on a particular project’s circumstances and the firmness in the construction budget, the amount of contingency a lender may require will vary from the traditional 5% guideline. Similarly, the underwriter will verify that borrower can pay and will pay the other development expenses like legal fees that may originate from the project’s owner and both the construction and permanent lenders. See Livingston, supra note 3, at 796-97.
119 Id. at 797.
120 See NELSON & WHITMAN, supra note 11, § 12.3 at 1035; Livingston, supra note 3, at 797 (explaining that this requirement works to limit the exposure of a construction lender to only those risks that emanate from performance and encumbrances while preventing the permanent financer from undertaking another underwriting evaluation when the project completes, as well as facilitating a smooth transition into the long term loan).
121 Paul V. Franke, A Primer on Construction, Permanent, and Bridge Lending in Financing the Affordable Housing Deal, 7 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 279, 284 (1998) (suggesting that a borrower reasonably satisfy all conditions for the permanent loan commitment prior to the approval and closing of the construction loan).
122 Id.
123 Id.
construction and completion, and those concerning suitable documentation for the permanent lender.\textsuperscript{124}

\textit{a. Construction and Completion Issues}

When considering the issues associated with the construction and completion of the project, a lender must address many topics in its documentation.\textsuperscript{125} For many of these topics—like confirming that the soil report's recommendations were incorporated, the environmental impact study gained approval, the appropriate permits were drawn, and that the owner assigned his interest in his agreements with the architect and general contractor—the construction lender looks to protect its interests in the event of default, in which case it will need to complete the construction for a later sale to avoid a substantial loss on the loan.\textsuperscript{126} In other areas, such as cost overruns and outside financing situations, the construction lender looks to safeguard its priority position for repayment prior to any other creditors claims.\textsuperscript{127}

Moreover, the disbursement policies and inspection procedures require special attention given the risks previously discussed with regard to preemption from collateral parties.\textsuperscript{128} At the center of this decision, the lender and borrower need to agree on an approach that balances on the one hand, the need for a process that generates cash flow to satisfy the invoices generated by contractors, subcontractors, and material suppliers with on the other hand, a system of safeguards to prevent fraudulent actions, liens, and the developer's failure to complete the project.

Normally, the construction loan calls for payments to be released to the developer through installments when the completed work reaches specific milestones and employs one of several methods for the disbursements.\textsuperscript{129} In

\begin{footnotes}
\footnote{124}{See Livingston, \textit{supra} note 3, at 798.}
\footnote{125}{\textit{Id.} at 798–800.}
\footnote{126}{See \textit{supra} Part II.B.1.}
\footnote{127}{See Livingston, \textit{supra} note 3, at 798–800.}
\footnote{128}{See \textit{supra} Part II.A.1.}
\footnote{129}{See Livingston, \textit{supra} note 3, at 799–800. The two most common methods include progress payments and the voucher system. See Nelson & Whitman, \textit{supra} note 11, § 12.1, at 1020. Under the progress payment method, the parties use various percentages or stages of completion as milestones for disbursement. Under the voucher system, the lender may release funds only when invoiced for completed work on the project. \textit{Id.} Professors Nelson and Whitman also explain that in the jurisdictions with a stop notice or trapping statute, the lenders tend to favor tighter oversight of the voucher system, so they may avoid inappropriate diversions of the disbursements that do not satisfy progress claims made by subcontractors and material suppliers. \textit{Id.} § 12.6, at 1076. Commonly, a holdback or retainage of 5 to 10% serves as a risk mitigation tool to provide money for settling a claim against an owner and contractor without requiring a lawsuit and assists with gaining final lien releases. See Livingston, \textit{supra} note 3, at 799; Sweet & Schneier, \textit{supra} note 6, at § 19.04. In one case that contained a 15% rate, the holdback gained approval because all of the parties involved in the loan agreement and submitting pay applications followed a practice that calculated the rate as such even though the loan documents stated a lower number. Schuler v. Cnty. First Nat'l Bank, 999 P.2d 1303, 1305–06 (Wyo. 2000). Accordingly, a prudent lender will create a draw schedule in such a manner that...}
\end{footnotes}
addition, the lender will most likely require periodic inspections of the project to reconcile its disbursements and to provide tangible oversight that should discourage inappropriate or fraudulent actions with the funds by those receiving them.  

b. Permanent Lender Documentation Issues

Of significant importance to the underwriting process is a good working relationship between the two lenders. To help facilitate the transaction, the previously mentioned tri-party agreement needs to include a provision that calls for the use of joint documents in the lending process. This arrangement assists both lenders in facilitating the assignment and sale of the note at the appropriate time while preventing any of the loan conditions from materially changing during the course of the project.

For the construction lender, this agreement provides upfront guidance as to what types of documentation and other conditions the permanent financer will require when it is called to perform. Knowing this information at the beginning will allow the borrower and construction lender to obtain approvals from the permanent financer during all phases of the project and allow the parties the flexibility to work out any difficulties before they become a point of contention.

Furthermore, this approach provides some certainty that the construction lender's role will conclude when the project finishes even though external conditions like interest rates may change from the time of the original commitment and make the permanent loan less desirable. Thus, the inclusion of this type of agreement will permit the permanent financer to purchase the note from the construction lender via an assignment. Consequently, a construction lender will issue a commitment letter to an applicant once the underwriting process deems the property as "an acceptable earning asset in its portfolio."

3. Loan Documents

Upon completion of the underwriting process and approval of the construction loan, the lender will require the borrower to execute several documents as part of a package agreement. These documents will include a construction loan agreement, a construction loan mortgage or deed of trust,
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and a promissory note. In sum, these documents will provide the underlying guidance and responsibilities for all of the parties involved in the construction project and its financing partners.

Serving as the central framework to the financial transaction, the loan agreement will provide the overarching guideline for the subsequent construction activities. This document will specify the terms of the loan and give details with respect to priorities for repayment and other representations and warranties, covenants, and restrictions. Amongst the many issues addressed, it will refer to and incorporate all of the construction plans and specifications for the project as well as include a mutually agreeable budget and completion date. The agreement will also outline and distinguish between which construction activities and their associated costs fall within the provisions of the loan and will identify the parties responsible for permitting at all levels of government and site infrastructure activities like streets and utilities.

Moreover, the loan agreement will describe the approach and responsibilities for the various financial activities like the disbursement of funds, obtaining bonds, and purchasing insurance in addition to the various inspections required by the lenders and other interested parties. The construction loan agreement will also set forth the conditions for declaring a default as well as any remedies available to the lender.

Since construction timeframes are usually short with a high risk to the lender in the event of nonpayment, a borrower is usually required to offer a security interest in the project as collateral in exchange for the loan. Given the risks mentioned earlier, the lender will usually arrange for its construction loan mortgage or deed of trust to obtain priority status over other encumbrances on the property receiving improvements.

As such, the construction lender will attempt to carefully negotiate its way through the various pitfalls with a meticulous and well thought out approach that considers all relevant exposures to risk. Therefore, the construction loan plays a central role in the creation of many buildings, but requires a lender to seriously evaluate and manage the risk associated with each project to acceptable business levels while competing in the financial marketplace to fill an important need by real estate developers.

139 See NELSON & WHITMAN, supra note 11, § 12.1, at 1018.
140 See Franke, supra note 121, at 280.
141 See id. at 280–84 (discussing various clauses in a typical loan agreement and their importance).
142 See NELSON & WHITMAN, supra note 11, § 12.1, at 1018.
143 Id.
144 Id.
145 Id.
146 See SWEET & SCHNEIER, supra note 6, § 8.05. Professor Reitz explains that one interesting aspect of this security interest is that "the foreclosure value of the security effectively rises as the work proceeds toward completion." Reitz, supra note 65, at 417–18.
147 See supra Part II.A.
148 See CLAUDETTE & SIRMANS, supra note 2, at 398.
III. LENDER EXPOSURE TO RISKS ON A GREEN BUILDING PROJECT

Given the complexities associated with a traditional construction project, the presence of green requirements or sustainable features create additional issues or risks that require their own treatment by the parties involved in building and financing these types of structures. In considering the added risk presented by a green building project to a construction loan, part of the exposure occurs prior to signing the loan documents, which means that it emanates out of the underwriting process. However, another portion of the risk also originates after the signing of the documents, which can occur due to inadequate language in the loan agreement or poor execution by the parties. As such, this section identifies some of the types of risks a lender involved with funding construction loans must take into account when evaluating a green building project.

A. Pre-Closing Issues

Prior to the signing and executing of the construction loan package of documents, the lender conducts the underwriting process where it heavily researches, identifies, and tries to assess its risk of exposure in lending to a construction project. During this time, the underwriters devote a great deal of their attention to researching all of the details associated with the applicant’s project. Key aspects of this research effort to bear in mind are some of the unique issues associated with a green building like the applicability of zoning or restrictive covenants, the difficulties in creating viable and accurate financial models and pro-forma statements, and the impact of evolving certification standards.

1. Zoning and Restrictive Covenants

A beginning point for identifying the differences between a traditional and a sustainable construction project is the applicable zoning or restrictive covenants placed on the land scheduled for development. In different locales, the environmentally friendly or sustainability policies take different forms. Sometimes, the government gets involved and exercises its police power to overlay the real property with zoning restrictions to advance its environmental or sustainability agenda. In other situations, where a master developer owns a large parcel of land slated for development, the use of a restrictive covenant ensures that subsequent construction adheres to sustainable building practices. These types of restrictions may materially

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149 See generally Prum, Aalberts, & Del Percio, supra note 4.
150 Id. at 214.
151 Darren A. Prum & Robert J. Aalberts, Our Own Private Sustainable Community: Are Green Covenants, Conditions, and Restrictions a Viable Alternative to a More Environmentally Sustainable Future For Homeowners? 43 N.M. L. Rev. 157 (2013) (manuscript at 46) [hereinafter Prum & Aalberts]. Most recently, two different communities, one in Maine and one in Oregon, began to privately regulate development through restrictive covenants placed on the land. Id. (manuscript at 21–35).
affect the property value positively or negatively and require special consideration when trying to appraise the land by itself as well as with a constructed building.

2. Financial Models and Pro-Forma Statements

Similar considerations must also occur with the valuation process that an underwriter follows to develop a financial model that provides guidance in making the lending decision. The difficulties in setting a valuation amount start with the appraisers, where one practitioner explained that “there is currently a lack of comprehensive educational material and practical guidance on the integration of sustainability aspects into the educational programs for North American appraisers.” 152 Given this lack of consensus and approach amongst the appraisal community to calculate a fair and accurate value for sustainability features, a construction lender must understand that its financial model probably will contain significant margins of error with respect to a green building application.

Furthermore, the construction budget and valuation calculations included in the green building application will also consist of materials and techniques that may pose an equally difficult dilemma to resolve. In some cases, a suitable replacement for a particular material or contractor may prove difficult or significantly more expensive to replace should their loss occur, which will require a larger contingency fund than usual to account for these issues. 153 In other scenarios, application of burgeoning technologies to achieve high-performance sustainable design may impute risks to the project inherent in the use of unproven techniques or products. These technologies may require special treatment, especially if the project itself is serving as a test-bed for full-scale application of the technology. 154 This makes the task of calculating the pro-forma financial statements and construction budgets more difficult and less accurate while increasing the margin of error when attempting to capture and manage exposure to a project’s risk. 155

152 Grant W. Austin, Sustainability and Income-Producing Property Valuation: North American Status and Recommended Procedures, 4 J. SUSTAINABLE REAL EST. 78, 79 (2012).
153 See, e.g., WILLIAM E. KELLEY, JR., STANDARD FORM CONTRACTS TAKE DIFFERENT APPROACHES TO SUSTAINABLE AND GREEN PROJECT GOALS, http://www.dbiaglr.org/storage/Standard%20Form%20contracts%20Take%20Different%20Approaches%20to%20Sustainable%20and%20Green%20Project%20Goals.pdf (last visited July 21, 2013) (“Sustainable Project Goals Exhibit,” a standard form contract released by the Design-Build Institute of America, contains a contractual option requiring the Design-Builder to “cure any failure to achieve the desired sustainable goals through the addition, replacement or correction of materials, configurations, systems or equipment in order to obtain the targeted level of LEED certification or to satisfy the identified sustainable standards,” and providing that Design-Builder may meet this obligation by using an existing contingency fund); Jeff Slivka, Inexperience and Unproven Products: The Risks of Sustainable Construction, RISK MGMT., Nov. 2011, at 6, 6–8, available at http://cf.rims.org/Magazine/PrintTemplate.cfm?AID=4440 (detailing contractor and building material risks associated with green building).
154 See Slivka, supra note 153, at 6–8.
155 See, e.g., id.
The underwriter’s financial model also needs to account for tax and other incentives offered by the government. These incentives pose their own exposure risks because some jurisdictions allow for financial inducements that become available for limited periods of time, while others provide nonfinancial consideration that can translate into real money. The direct financial incentives for building green are easier to quantify in the financial model, but an underwriter needs to proceed with caution because some contain payout and other limitations that could reduce or eliminate the benefit. In contrast, the nonfinancial incentives can translate into cost savings that become more difficult to quantify and require some type of special treatment, which can potentially turn into a point of contention.

Likewise, the estimate for potential lease or rental income generated from a green building may be debatable. Many studies evaluate the reasons behind the premiums associated with certified green buildings. A comprehensive evaluation of these studies concluded that the buildings possessing green certifications obtained substantially higher rates for occupancy and leases as well as superior sales prices. Applicants attempt to justify pricing premiums on green buildings based on health and productivity savings by the buyer or tenant. These assertions are


157 See id. at 188-90 (listing limits enacted in several states); Prum, Aalberts, & Del Percio, supra note 4, at 212. For instance, one of the early tax credit programs occurred in the state of New York. See Prum 1, supra note 156, at 190-92. The initial program only allocated $25 million for qualified green buildings, but its success led the legislature to add an extra $25 million because seven projects received the entire allocation. Id. at 190. Likewise, the state of New Mexico began offering a tax credit in 2007. The New Mexico incentive allocated two annual aggregated limits of $5 million apiece for a commercial and a residential program through the 2013 fiscal year. Id. at 194-97. In Nevada, the original 2005 program and the 2007 update both offered property tax abatements that provide relief for no more than ten years. Moreover, the financial incentives can offer borrowers a very lucrative return if they construct a certified green building, as was seen in Nevada’s original program that caused dire fiscal predictions. See id. at 177, 180.

158 See Prum, Aalberts, & Del Percio, supra note 4, at 213-15 (discussing non-financial incentives and noting that these incentives can lead to cost savings for government and private parties alike).


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controversial and many attorneys already foresee litigation work from what could be deceitful claims. Consequently, the financial models and pro-forma statements used to evaluate an applicant seeking to construct a green building must navigate these thorny issues with due care to develop an accurate tool that assists in assessing the risk and exposure for the loan receiving consideration.

3. Green Building Standards

Finally, a lender must also consider the applicable green building standard for a given project during the underwriting process. Originally, the green building standards allowed an environmentally conscious owner to demonstrate sensitivity through voluntary certifications offered by third-party verification organizations like Austin Energy, the United States Green Building Council, or the Green Building Initiative. More recently, the International Code Council unveiled the IgCC for adoption by governments looking to add a sustainability component to its building codes and the State of California developed and implemented CALGreen as part of its statutes. As a result, the jurisdictional approach to sustainable building requirements will demand that an underwriter evaluate each applicant’s project and distinguish between governmental mandates and voluntary compliance situations.

Under those locations that mandate sustainable construction, the underwriter’s evaluations and assessments would not see a difference because the building code will receive environmentally friendly updates that would apply to all applicants and would be incorporated into the risk management model like other changes in the regulations or statutes. However, the underwriters must take a different position for those applicants that wish to voluntarily attain a third-party certification for its construction project.

In those situations, the underwriter must be familiar with the fact that many of the programs offer multiple levels of achievement and will need to

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161 See, e.g., Prum & Del Percio 1, supra note 1, at 248.
take into account the evolving nature of the standards. These varying levels of certification correspond with the building’s performance characteristics and may influence the values assigned in the financial models and pro-forma statements.\textsuperscript{166} Moreover, the evolving nature of the certification standards may also present a moving target for the endeavor with additional exposures for the lender. Any extended delay between the creation of the financial model or pro-forma statements and the registration of the project could force a different level of compliance for the same rating because the third-party’s program upgraded its standards in the intervening period of time with a corresponding increase to the construction budget.\textsuperscript{167}

Consequently, the financial models and pro-forma statements need to take into account some of the unique characteristics associated with a green building project and recognize that loans for such endeavors will require additional research and tough determinations in order to properly evaluate a lender’s exposure to the risks in an application.

\textbf{B. Post Closing Issues}

Beyond the pre-closing issues that mainly plague the financial models and pro-forma statements, a construction lender must evaluate the risk exposures that occur after signing the loan documents. Given the complexities associated with constructing a building, the added layer of sustainable features and a specified green outcome bring additional exposure to the application; a lender needs to recognize that a borrower may have issues with cure and default from its contractors and material suppliers, could include problematic language in the underlying construction contracts with responsible parties, and might potentially suffer difficulties with the disbursement schedule and process.

\textit{1. Cure and Default}

As with any construction project, cure and default situations loom large and whenever possible require preventive measures. A performance bond normally offers sufficient assurances because it contractually obligates a surety to complete the project while reducing the risk of nonperformance by a contractor.\textsuperscript{168} While the performance bond forms maintain some uniformity in their contractual language, the coverage for green features and certification remains varied.\textsuperscript{169}

A surety’s financial exposure with green building projects is greater than with traditional construction because a contractor agrees to deliver

\textsuperscript{166} See Fuerst & McAllister, supra note 159, at 4.
\textsuperscript{167} See generally Sweet & Schneier, supra note 6, at § 25 (discussing risk management, the shifting of losses, contribution, indemnity, and insurance).
\textsuperscript{168} Id. at § 25.04A.
precise results or build innovative designs linked to sustainable outcomes measured by third-party organizations.\footnote{170}{Peter S. Britell, Green Buildings: Law, Contract and Regulation § 10.08 (2010).} In an effort to manage its exposure, a surety will include language in its contracts that requires it only to deliver a completed structure despite the possibility of mistaken reliance by a borrower and lender that the performance bond will deliver a certified green building.\footnote{171}{See Prum & Medders, supra note 169, at 25, 38.} As a result, the construction lender needs to take further steps to eliminate its exposure to a large loss situation for a green building project that it chooses to fund even though the borrower serves as the first line of risk reduction.

Moreover, many of the systems, materials, and products used in constructing a green building offer cutting edge solutions, which make the task of curing a defect or replacing a contractor more difficult.\footnote{172}{See generally Marsh, Green Building: Assessing the Risks 9 (2009).} This risk creates another exposure to loss because finding a suitable replacement could significantly alter the construction costs or possibly cause a project to lose its ability to achieve certification or a specific level within a program. While retainage is supposed to limit this type of exposure, it may not provide enough protection for sustainable construction techniques that also utilize high performance products. A lender should consider requiring a higher rate for the holdback on green building projects.\footnote{173}{Id. at 10, 15.}

2. Responsible Parties

In the unfortunate event that a green building project fails to attain a specific certification and a default occurs by the borrower, a lender will likely need to turn to the courts to offset some of its losses. Some of this secondary exposure likely originates from the holistic approach that dominates the green and high performance building process.\footnote{174}{See Darren A. Prum, Green Buildings, High Performance Buildings, and Sustainable Construction: Does it Really Matter What We Call Them?, 21 VILL. ENVTL. L.J. 1, 5 (2010). The National Institute of Building Sciences and other leading experts in the field note that green and high performance buildings should follow whole building design guidelines, which requires collaboration by all disciplines throughout the construction process. Id.} It could also arise because the parties did not tailor their underlying construction contracts for such a project.\footnote{175}{Id. at 257.} Some relief may be available if the underlying construction contract contains an applicable liquidated damages provision,\footnote{176}{Id. at 265.} but the lender could also consider pursuing direct or consequential damages.

Distinguishing between the two different types of damages in a green building claim presents a challenge for the courts because of the lack of case law on the subject and the short time of existence for this type of construction.\footnote{177}{Darren A. Prum & Stephen Del Percio, Green Building Contracts: Considering the Roles of Consequential Damages & Limitation of Liability Provisions, 23 LOY. CONSUMER L. REV. 113, 143–44 (2010) [hereinafter Prum & Del Percio 2].} Depending on the jurisdiction, either common law or the
Uniform Commercial Code may apply to the underlying construction contracts. Many of the existing form contracts contain language that grants a mutual waiver for consequential damages while others do not.\footnote{See id. at 116–43.}

In addition, a claim arising out of a torts action for negligence may face similar issues with respect to the lack of guidance from the courts.\footnote{Darren A. Prum, Green Building Liability: Considering the Applicable Standard of Care and Strategies for Establishing a Different Level by Agreement, 8 Hastings Bus. L.J. 33, 59 (2012) [hereinafter Prum 3].} Because a green building endeavor usually articulates and upholds a desire to attain a specific level of certification from a third-party organization, the project may try to include an outcome approach to a negligence claim in the underlying construction contracts, but many participants will find this type of language difficult to accept.\footnote{Id.} As a result, the underlying construction contract may call for a different standard of care than available at common law.

Accordingly, a lender that funds a construction loan for a green building may find itself with larger than expected exposures to loss for any remaining completion issues after a default because the underlying construction contracts did not properly address issues like liquidated, direct, or consequential damages as well as the applicable standard of care for a negligence claim.

3. Disbursement Issues

With respect to disbursement exposure, a lender needs to balance its interests in preventing fraud versus becoming too involved in the green building project. While many of the disbursement programs are designed to prevent fraud,\footnote{Id.} a lender needs to evaluate the chosen method for a green building. Should the lender require a percentage of completion approach, it runs the risk that disbursement of the loan funds will not coincide with the milestones; whereas a voucher system might unduly burden the borrower with unreasonable interest accumulation on the holdback funds.

In a green building project, the timing of costs and milestones incurred by the contractors and material suppliers may occur at different times than a traditional construction project so the lender may need to consider adjusting its accepted model to capture these distinctions. This may persuade the

\footnote{A notable exception to the common law standard of care allows for parties to contract for a level below that which a reasonable person would expect when the subject matter does not concern safety. Id. at 53. In considering the sustainable construction situation, a green building consultant offers a wide variety of services; but if none of them concern safety, then a standard below that of the reasonable person may apply. Id. at 62–63. This practice could make a negligence claim against such a party extremely difficult, if not impossible, to prevail. Id. Extending this reasoning, other parties involved in the construction of a green building could bifurcate their services that concern safety from those that do not to gain an extra layer of protection from a subsequent lawsuit in those areas covered under a provision with a lower standard of care. Id. at 61.}

\footnote{See NELSON & WHITMAN, supra note 11, § 12.1.}
parties to consider the voucher system as an alternative approach; but if a lender chooses to impose a higher than normal retainage on the project as a security measure, then a borrower might object to paying interest on funds that were not disbursed until completion. As such, a lender that funds a construction loan on a green building must completely evaluate the project as well as the positives and negatives of the two methods for disbursement to determine a mutually satisfactory system.

Furthermore, a lender may have a tendency to require too much oversight on a green building project, since it will most likely appear as a greater risk due to its novelty. In many aspects of the green building project, the specifications will call for high performance equipment and construction techniques or make tradeoffs between materials that offer environmentally friendly solutions and will fit within the risk tolerances of a construction lender. However, the green building consultant and owner may also include innovative designs to gain third-party certification, which may fall outside of a lender’s comfort zone. While the increased oversight may seem prudent in these instances, the lender needs to be careful to limit its activities to those associated with the loan or risk that a court finds its actions constitute participation.

Thus, a lender needs to evaluate each green building project on its own merits to determine the most appropriate disbursement method that reduces the possibility of fraud, releases funds in a timely manner, and supplies a degree of comfort that prevents the need for extra involvement in the construction activities. Hence, a lender faces a diverse and unique set of risks when participating and funding a green building construction project.

IV. MANAGING EXPOSURE ON A GREEN BUILDING CONSTRUCTION LOAN

Due to the diverse set of exposures a lender faces when making a construction loan, the decision to proceed or decline the application will require knowledge of the unique characteristics associated with a green building, a prudent evaluation of the project, and an understanding of the real estate market. This approach will translate into sensible decision making at all levels and permit the best green building projects an opportunity to succeed while giving many lenders the chance to show their sensitivity to the environment.

In setting its underwriting criteria, a lender needs to balance its acceptance of risky projects that pose large possibilities of default with rejecting excellent ones that will cause a loss of current and future business. Borrowers need to recognize that the unique characteristics of a green building will pose difficulties to construction lenders and the underwriting process. To deal with the additional exposure to risk, a lender may require higher interest rates or decline to finance a project. Those green building

183 See Prum & Del Percio 1, supra note 1, at 261.
184 See MARSH, supra note 172, at 16.
185 See supra Part II.A.2.
projects that fail will cause extra consternation to the process and requirements.

In response to this diverse exposure of a possible loss when making a construction loan for a green building, a lender may require and implement a number of mitigation measures to achieve an acceptable level of risk for its underwriting standards. These actions by a lender to proceed with funding a green building construction project may occur within the underwriting process or become incorporated into the loan agreements. With a lender incorporating these proposed adjustments, the added exposure posed by a green building construction loan becomes manageable.

A. Underwriting Process Driven Adjustments

Considering the previously discussed issues that originate out of the underwriting process, a lender can make reasonable adjustments to its procedures to better capture and comprehend a project that incorporates sustainable construction practices. A lender should start with creating a separate track for construction projects that plan to seek green certification. The lender’s application should require an applicant to distinguish between traditional construction and those projects that plan to seek green certification from a third-party organization. With this distinction acknowledged within the application, the underwriters can begin a process that properly evaluates the risk associated with a green building project in a different manner than in traditional construction.

1. Supplemental Application for Green Construction

In this separate process, the underwriters should develop a supplemental application that asks the pertinent questions related to a green building in addition to those already requested for traditional construction, which will help address the later quantification issues associated with determining the lender’s exposure on a project. These questions should request information pertaining to any third-party certification goals, any limitations or benefits that encumber the land, and any incentives or benefits the project will receive from the government.

More specifically, the supplemental application should begin by asking about which third-party organization will provide certification, the version pertaining to the project, and the expected level of distinction within the program. It should ask the applicant about any relevant advantages or

\[186\] See supra Part III.A.

\[187\] Several organizations provide recognizable systems that attempt to quantify and verify the sustainable features within a building. See Prum, Aalberts, & Del Percio, supra note 4, at 194–200. The Leadership in Energy and Environmental Design (LEED) program was created by the United States Green Building Council (USGBC) in 1998 and provides a collection of tracks for compliance depending on the construction type, as well as the four different levels of certification: certified, silver, gold, and platinum. See id. at 195; GREEN BLDG. CERTIFICATION INST., LEED CERTIFICATION POLICY MANUAL 5–6 (2012), available at https://www.leedonline.com/irj/go/km/docs/documents/usgbc/leed/config/terms/Legal_Documents_Download/ratin
disadvantages that affect the project's zoning with regard to the green features as well as whether any restrictive covenants placed on the land would affect construction.

Finally, the addendum needs to address governmental incentives that pertain to the project. The applicant will need to describe any incentives or benefits that the project expects to receive from the government and their impact on the project. With this information included in a supplemental set of questions, the underwriters could turn to evaluating and researching the data while completing the financial model and pro-forma statement.

2. Gathering and Analyzing Green Construction Data

During the evaluation phase, the underwriters can address data accuracy issues through specialized consultants and research. While the appraisal community continues to develop a cohesive and unified approach to quantifying sustainable features on a given piece of property, some professionals have more experience with green buildings than others. The underwriter needs to confer with professionals accustomed to determining a market value for green buildings rather than those without the specialization. This specialized consultation will help ensure that the financial models and pro-forma statements present the most accurate data available while assisting with the more problematic areas like capturing and quantifying the governmental assistance on a green building project.

Next, the underwriters need to work with an appropriate green building consultant who has familiarity with the project’s application process. Since the various programs attempt to quantify and express a building's sustainable features with different methodologies, the underwriter needs to utilize the expertise of an independent consultant that maintains credentials with the certifying organization specified in the application. This person should be able to assist in evaluating and quantifying the exposures to risk in a given project that originates from the sustainable features. The consultant should be able to explain the strategy for attaining certification and the likelihood for attaining it while recognizing and making suggestions on how to quantify the riskier aspects of the project like cutting edge technology.


Furthermore, the underwriter needs to use existing research to aid in determining market premiums and liabilities in this dynamic field. Many researchers around the world are evaluating the features associated with green buildings and are trying answer many of the same questions.\textsuperscript{189} From the income side of the financial statements, current research tries to explain key underwriting assumptions such as occupancy rates and premiums for leases and sales of these types of structures.\textsuperscript{188} Beyond the income side of the financial statement, other researchers look at the cost side through utility usage and other operating costs.\textsuperscript{188} This research could give an underwriter justifiable and current multipliers that could bolster and support assumptions that utilize market data collected for the location of the green building.

Hence, the addition of specialized consultants and the use of current research to a modified underwriting process that allows for a separate evaluation of projects with sustainable features can help reduce much of the inaccuracies that will occur in the financial models and pro-forma statements that a lender will rely on in making a decision to grant a construction loan.

\textbf{B. Document Driven Adjustments}

Similar to the underwriting process driven adjustments, a lender can prevent a great deal of its exposure to a risk of loss through the construction

\textsuperscript{188} See, e.g., FUERST & MCALLISTER 1, \textit{supra} note 159, at 4 (measuring the effect of voluntary LEED/Energy Star certification on occupational prices (rents) and on asset prices (sales)); MILLER 1, \textit{supra} note 159, at 395 (finding that positive rent differentials exist between LEED/Energy Star certified buildings and non-certified buildings); EICHHOLTZ 1, \textit{supra} note 159, at 3 (investigating the relationship between investments in energy efficiency in design and construction and the rents, effective rents, and selling prices commanded by these properties); WILEY, \textit{supra} note 159, at 220 (finding evidence that LEED-certified and Energy Star properties achieve significantly higher rents than non-certified buildings); EICHHOLTZ 2, \textit{supra} note 159, at 4 (finding that buildings with green ratings command higher rental rates that are substantially higher than those of otherwise identical office buildings); Norman G. Miller, et al., \textit{The Operations and Management of Green Buildings in the United States}, 2 J. OF SUSTAINABLE REAL ESTATE 51, 53 (2010) [hereinafter Miller, Pogue, Saville, & Tu] (comparing the operating performance and green practices between buildings with and without green labels).

\textsuperscript{189} See, e.g., FUERST & MCALLISTER 1, \textit{supra} note 159, at 12–13 (discussing the possible causes of higher Net Operating Incomes of certified buildings, including higher occupancy rates, incentives and subsidies, and lower operating costs); MILLER 1, \textit{supra} note 159, at 387; EICHHOLTZ 1, \textit{supra} note 159, at 2500 (“Taken together, the results [of this study] suggest that the occupancy rate of green buildings is about 11% higher than in otherwise comparable nongreen buildings.”); WILEY, \textit{supra} note 159, at 229 (offering three economic explanations—higher rents, improved occupancy, and lower operating costs—as to why green buildings achieve a premium in both the leasing and commercial office space markets); EICHHOLTZ 2, \textit{supra} note 159, at 3 (finding that “the economic premium to green building has decreased slightly, but rents and occupancy rates are still higher than those of comparable properties.”); FUERST & MCALLISTER 2, \textit{supra} note 159, at 66 (suggesting “a much higher relative sales price premium compared to rental price premia. . . . A possible reason may be lower operating costs, increased occupancy rates, image benefits (to investors) and a lower risk premium.”).

\textsuperscript{191} See, e.g., Miller, Pogue, Saville, & Tu, \textit{supra} note 189, at 53.
agreement. These unique provisions for a green building project will take into account the difference exposures that are not present in traditional construction and will in some instances require the parties to alter their methods of operation when performing. A lender should require some of these provisions as a condition precedent to funding or disbursing the construction loan while others will look to address remedies in the event a breach of contract occurs.

1. Conditions to the Initial Funding of the Loan

In trying to address some of the unique risk issues associated with a green building, a lender can mitigate some of its exposure through additional provisions in the construction agreement. These provisions can assign responsibility and liability for the green aspects of construction as well as preserve any governmental incentives for the lender in the event that it must assume control of the project after default. The provisions can also prescribe the surety’s bonding requirements to fulfill the expectations of the lender so that the final structure delivers a green building with the proper documentation and provides a financial backstop for any lack of performance by a contractor or material supplier.

a. Assignment of Responsibility and Liability

Current approaches to the management of green building construction projects strongly suggest that a project’s owner identify a party as responsible for attaining the green building certification and the various components of the structure. This guideline, now considered a best practice, will enable the owner or lender in the event of default to allocate liability should the building fail to achieve the proper level of certification or a portion thereof.

Because a green building endeavor tends to utilize a holistic approach to construction, a situation could easily occur where the project veers off course because the dynamics bring together so many participants with different points of view and a variety of agreements for services and materials. To this end, a lender looking to mitigate its exposure to a loss or a structure that fails to attain its green building certification should include language that requires the borrower to incorporate best practices such as an assignment of liability provision into the construction loan agreement.

b. Assignment of Liability and Government Benefits

The construction loan agreement should also include language that assigns liability amongst the participants and sets a reasonable standard of care. However, a lender needs to proceed with caution and evaluate the

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192 See Prum & Del Percio 1, supra note 1, at 257.
193 Id.
194 Id.
underlying construction contracts for many different factors. Some form contracts contain a mutual waiver of consequential damages while others do not, and a custom drafted agreement can be tailored to whatever strategy the parties desire.\textsuperscript{195} Should the borrower choose to use a mutual waiver of consequential damages and a performance issue occurs that fails to receive the desired certification, then the provision will likely prevent a future claim for any lost government incentives available for a green building.\textsuperscript{196}

Further adding to the issue, a majority of professional liability policies include a “burning limits” provision, which stipulates that there is little to no recovery if an owner sues for consequential damages and the design professional or contractor incurs defense costs.\textsuperscript{197} In response, an experienced developer will refuse to consent to a waiver of consequential damages but will often reach a compromise whereby the parties agree to cap such a claim at the limits of the design professional’s or contractor’s insurance policy.\textsuperscript{198}

A liquidated damages provision offers another solution to mitigate a loss arising out of a failure to deliver a certified green building. Under this option, the lender could require a liquidated damages provision that corresponds to any lost incentives from the government. Based on these approaches, a lender should include a provision that addresses consequential damages in its construction loan agreement and prohibits a borrower from agreeing to an outright or mutual release. Instead, it should allow for a limited waiver or liquidated damages solution that preserves the claim.

A lender also needs to address the same type of remedy in the event the borrower defaults. Because the government can provide a borrower with very lucrative incentives,\textsuperscript{199} the lender needs assurance that it will receive the same treatment in the event that it ends up owning the building after default. To solve this issue, the construction loan agreement needs to include a provision that assigns any and all government benefits for attaining green building certification to the lender in the event that the borrower defaults.

Finally, the possibility that a portion of the underlying construction contracts might allow some parties to use a standard of care below that of a reasonable person requires attention. Since common law requires all parties that affect safety to meet the reasonable person standard, a lender only

\textsuperscript{195} See Prum & Del Percio 2, supra note 177, at 124–43. Interestingly, the form supplied by the Design-Build Institute of America specifically precludes a breach of contract claim for situations where the project did not attain the promised green building certification, so an injured party must treat such a failure as a consequential damage. Id. at 136.

\textsuperscript{196} Id. at 143. This was most likely the circumstance in Shaw Development v. Southern Builders, where a lawsuit occurred due to a builder’s inability to deliver a certified green building, which caused the owner to lose government tax incentives. Counter-Complaint at 3, 4, 7, Shaw Dev. LLC v. S. Builders, Inc., No. 19-C-07-011405 (Somerset Cnty. Cir. Ct. Md. 2007). The parties used an American Institute of Architects form contract that contained a mutual waiver of consequential damages. Id. at Exhibit A.

\textsuperscript{197} Prum & Del Percio 2, supra note 177, at 144.

\textsuperscript{198} See id.; Prum & Del Percio 1, supra note 1, at 263.

\textsuperscript{199} See, e.g., Prum 1, supra note 156, at 177.
needs to be concerned about those contractors and consultants outside that parameter.\textsuperscript{200} As noted earlier, those parties providing services where safety is not affected may become difficult or impossible to pursue under a negligence claim.\textsuperscript{201} To remedy this possibility, the lender could insert a provision into the construction loan agreement requiring all parties involved in the green building project to use the reasonable person or professional standard of care.

c. Performance Bonds

Another issue the lender must address to mitigate its exposure to a loss in a green building project concerns the performance bonds obtained by contractors and material suppliers for the benefit of the owner. As the contractual backstop for an owner that guarantees performance from the contractors and material suppliers named in the surety’s document, the performance bond fills a critical role in making sure the project is completed.\textsuperscript{202} This becomes an important issue because the third-party certification is generally voluntary and may not be a requirement for performance.\textsuperscript{203} As such, the lender needs to mitigate this exposure in the construction loan agreement.

The most straightforward solution would be to alter the construction loan agreement to require that all performance bonds either receive approval from the lender’s attorney that the language provides suitable protection or that the contractual obligation from the surety cover such conditions outright. With this requirement, a construction lender can turn the risk of a large loss it might not otherwise recognize into a surety to better manage its exposure in this area.


Similar to the contractual provisions that limit a lender’s exposure to losses, some language in the construction loan agreement governing the disbursement of funds may provide mitigation strategies to manage risks unique to constructing a green building. While a lender maintains a contractual obligation to release the construction loan funds upon the occurrence of specific events, it can also place qualifications on when such disbursements may occur and raise the holdback or retainage amounts to better protect its interests.

\textsuperscript{200} See Prum 3, supra note 179, at 53.
\textsuperscript{201} \textit{Id.} at 61–63.
a. Draw Requirements

For instance, one commentator suggests a lender should insert conditions into the construction loan agreement that address the green building process and certification by third-party organizations as a means for mitigating some of the risks.204 He recommends the lender create three different conditions that address the start of the project, the ongoing draws, and the final disbursement.205

In the first draw, he proposes a precondition that requires a “borrower [to] have prepared, completed and filed all documentation” for the applicable third-party certification program for the project.206 His recommendation goes on to include an additional requirement that a named consultant certified by the third-party program review and find acceptable the submission.207 This way the project will get off to the proper start and will possess the minimum documents necessary to continue seeking third-party certification.

To address ongoing draws, Mr. Britell suggests a provision calling for the certified consultant to issue a certificate reviewing all approved change orders on the project as well as all bulletins and other documents an architect might release during construction.208 He further adds an obligation for the certified consultant to confirm that none of the prior or current changes will cause the project to lose recognition for the anticipated sustainable features that count toward a green building rating or place in jeopardy the ability to deliver such recognition.209 By including this type of provision, a lender can create a paper trail along with an acceptance of responsibility that the project continues to meet and move forward toward a third-party certification.

Lastly, Mr. Britell recommends a condition that limits a lender’s ability to release the final draw on the loan until the borrower delivers four distinct documents that will provide final assurances that the building will attain its goals.210 Besides the delivery of a temporary certificate of occupancy from the government granting legal permission to occupy the building, he also recognizes that many of the green building certification requirements occur after occupancy begins.211 His proposal additionally conditions the last payment on the requirements that a borrower supply copies of the final application given to the third party providing the green recognition, a confirmation that any applicable enhanced commissioning has proceeded pursuant to the verification organization’s directives, and an attestation from the certified consultant clarifying that the project maintains the ability to

204 See BRITELL, supra note 170, at §§ 8.01–.02.
205 Id. at § 8.02(1)(a).
206 Id.
207 Id.
208 See id.
209 Id.
210 Id.
211 Id.
receive certification and that no reduction in sustainable features occurred during the project.212

By including three different provisions, Mr. Britell puts forward a strategy that takes into account other best practices such as identifying and relying upon a responsible party for gaining third-party certification and uses the power of the purse to compel the borrower, contractor, and material suppliers to deliver a completed building with all of the required documentation that recognizes all of its sustainable features.

b. Higher Holdback or Retainage Levels

Another possible mitigation strategy includes the use of a higher than normal holdback or retainage percentage for green building projects. As an already proven technique and industry standard for risk mitigation in a construction loan, holdbacks, or retainage provisions direct the setting aside of a percentage of the disbursed funds for remedying performance issues with a contractor or material supplier without the need for litigation.213

Undoubtedly, the applicable rate will remain a point of negotiation between the borrower and lender; however, a higher percentage could provide an offset for some of the increased performance risks associated with a green building project and avoid the need for litigation. As noted earlier, a typical construction project uses a rate between 5 and 10%, but one court already approved the use of 15% when all the parties agree to such terms.214 Thus, a lender can also manage some of the performance risks in a green building project by setting aside a larger percentage of the construction loan up to the final disbursements of the project for issues that may occur.

Hence, the unique characteristics of a green building present risks to the lender but most, if not all, of the extra exposure becomes manageable through the construction loan agreement and disbursement controls.

V. CONCLUSION

As a whole, a lender for a construction project faces a tremendous amount of exposure to loss from a number of different sources. A lender must take precautions to ensure that its status for its mortgage on the real property remains in an unsubordinated position, that its participation in a construction project does not overstep its loan activities, and that it does not become responsible for issues that emanate out of environmental clean up costs. However, the addition of sustainable construction practices and third-party certification requirements supply an added layer of risk that many lenders inadvertently accept due to ignorance on the subject matter despite the new exposures they present.

212 Id.
213 See, e.g., Livingston, supra note 3, at 799; SWEET & SCHNEIDER, supra note 6, at § 19.04.
214 See supra note 118.
Traditional methods of analysis and mitigation do not adequately address the new issues presented by a green building, so a lender must consider additional approaches that can help identify, explain, and quantify the exposures for such loans. With a firm understanding of the unique characteristics associated with a green building project, a lender can find straightforward solutions to the risks posed by sustainable construction. These solutions include the augmenting and modifying of specific protocols and strategies to better evaluate and address the various exposures while protecting the lender and applicant’s interest in seeing the green building completed and placed into service.

Thus, a lender can successfully adjust to these changes in the real estate development market while assessing and funding loan applicants that put forward solid green building projects that help demonstrate all participants’ commitment to environmental sensitivity.