

# NORTHERN OHIO NEWS



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## PRESIDENT'S MESSAGE

As I take the helm of the RMA Northern Ohio Chapter for 2013, I would like to first acknowledge the successes of our **2010-2012 President, Jim Horner**, and his outstanding leadership over the last two-years. The continued existence of any public or private organization is reliant upon strong leadership that looks to the future of the industry and successfully adjusts to meet customer needs. As a matter of routine, successful organizations periodically revisit their strategic mission and vision statements, and make tactical adjustments to ensure the ongoing viability and success of their organization. For the RMA Northern Ohio Chapter, Jim provided the strategic direction, leadership and momentum to revive our Chapter and carry us into the future. Under Jim's regime, the Chapter leadership team achieved several significant goals, including:

- ★ Recruiting a solid group of directors and officers to lead our Chapter into the future, filling all vacant positions and establishing a leadership succession plan.
- ★ **Vice President Donald Miehls** lead the initiative to update the Chapter's strategic mission and by-laws, and formally established the RMA Northern Ohio Chapter as an Ohio Unincorporated Association.
- ★ **Program Chair Mary Martin** developed and promoted sell-out general membership programs, as well as initiated this chapter's Young Professional program.
- ★ **Cameron Eckstein**, has developed the Young Professionals program we know today that provides a social atmosphere to network, discuss current risk-related topics, develop risk management professionals, and grow Chapter membership.
- ★ **Educational Chair John Hecker** organized local training courses on advanced cash flow analysis, lending to non-profit organizations, and analyzing personal and business tax returns, which have doubled in frequency and size.

The Northern Ohio Chapter (fka: the Cleveland Chapter) was established in 1920 as the second nationally chartered RMA chapter; the achievements listed above, in part, have poised our Chapter for continued success as we get closer to the 2020 century mark. As a result of Jim's presidential leadership and the dedication of the Chapter directors and officers, the Northern Ohio Chapter was recognized and awarded the RMA's 2011-2012 Gold Star Award. On behalf of the Northern Ohio Chapter's directors, officers and members – ***Thank You Jim!***

In looking ahead, the Chapter leadership team has been busy planning for upcoming membership programs, educational events and other chapter activities. As a local RMA Chapter, we are committed to providing informative and timely events that focus on current risk-related trends and evolving risk management practices. Our events are affordably priced to cover our expenses, with member price discounts offered to both local and national events. On November 8<sup>th</sup>, the Northern Ohio Chapter is hosting an "Evening of Networking," focusing on our Chapter's 'Young Professionals.' The event will be held at the exclusive "Club at Key Center," where your \$15 pre-registration includes hors d'oeuvres and an open bar. **All members and guests are welcome to attend, network and share your risk experiences.** For additional information or registration for our upcoming events, please visit our website at [www.community.rmahq.org/NorthernOhio](http://www.community.rmahq.org/NorthernOhio).

I have been a member of the Northern Ohio Chapter leadership team since 2004, and have held several positions, including Program Chair, Educational Chair, interim-President and most recently, First Vice President. I recognize the value and benefits of the RMA programs, the network of risk professionals, and regularly attending both local and national-level events. I look forward to continuing the strategies initiated under Jim's tenure, and serving as the RMA Northern Ohio Chapter President in 2012-2013.

Richard A. Wilson, President  
Risk Management Association Northern Ohio Chapter

## SCARY LENDING STORIES LUNCHEON—RECAP

The Scary Lending Stories Fall Luncheon event was filled with a few humorous moments, as well as tough lessons.

Many thanks to **KeyBank, Ohio Commerce Bank and PNC Bank** for sponsoring a table.

Thanks to the attendees for completing the 2012 RMA Survey for a chance to win the \$50 Key Possibilities Giftcard. Survey results are considered in future programming events.

Congratulations to Cierra Freeman of Ohio Commerce Bank—the winner of the \$50 giftcard.



L to R: John Hecker, Dennis Kebrdle, Carl Dyczek and Dell Duncan



Attendees checking into event and filling out survey.

Visit us on LinkedIn –  
RMA Northern Ohio  
View upcoming events  
on our group page -  
RMA Northern Ohio  
Chapter



## YOUNG PROFESSIONALS—UPCOMING EVENTS

RMA Northern Ohio Chapter Presents The RMA Young Professionals Forum—an Evening of Networking and Business Card Exchange.

Registration is open to Young Professionals, Seasoned Employees and nonbankers.

You must pre-register for this event—no walk-ins will be accepted. Hors d'oeuvres & OPEN Bar provided.

November 8th from 5-7:30pm  
Price: \$15  
Pay via credit card at:  
<http://community.rmahq.org/NorthernOhio/Home>



## WELCOME TO OUR NEW MEMBERS!!

- ★ Farmers & Merchants State Bank
- ★ Grace Bacot, Cortland Savings & Banking Co.
- ★ David Cogswell, First Place Bank
- ★ Bob Kempe, First Place Bank
- ★ Eric Johnson, Ohio Commerce Bank
- ★ Ann Montgomery, PNC Bank
- ★ Brad Brinkerhoff, Wayne Savings & Community Bank

## CAREER CORNER

### *10 reasons you need a mentor, especially mid-career*

By: Newell (Grand Rapids, MI)

Behind every corporate logo is a culture filled with personalities, politics, and procedures. How do you navigate this new landscape, excel at your job, and advance your career? Find a mentor.

A report released by the Anita Borg Institute for Women and Technology found that "mentoring has been associated with higher job satisfaction, higher promotion rates, higher future income, increased work success, and higher retention rates."

Dr. Lois Zachary, author of *The Mentor's Guide – Facilitating Effective Learning Rela-*

*tionships, The Mentee's Guide: Making Mentoring Work for You, and Creating a Mentoring Culture: The Organization's Guide*, asserts that mentoring is a leadership competency. "Mentoring shouldn't just be the result of a formal program, leaders should always be looking to grow. Learning is the purpose, process, and product of mentoring."

#### **Why Mentors are Vital for Senior Leaders Too**

Many think that mentors are only for women on their way up. Do you need a mentor once you reach a senior level?

Absolutely, Zachary says, in her article *Help on the Way: Senior Leaders Can Benefit from Working with a Mentor*. In an executive position, time is at a premium and most choose to mentor others instead of spending time on their own learning, but Zachary contends that mentoring is vital at all points in your career.

To read this article in its entirety, please visit:

<http://www.theglasshammer.com/news/2009/12/22/10-reasons-to-have-a-mentor-especially-mid-career/>

## Top 5 Reasons to Invest in Your Future by Joining RMA

1. Increase your exposure to the banking industry.
2. Use RMA's resources to become a resource!
3. Expand your network of professional contacts outside of your own institution.
4. Create your own professional edge via RMA information, training, and updates.
5. Get involved and increase your own skill set: leadership, teamwork, presentation, and delegation skills.

**Joining RMA is an investment in yourself and your future. Make that investment!**

**RMA Northern Ohio Chapter Membership forms can be found on our website:**

**<http://community.rmahq.org/NorthernOhio/Home>**

## CREDIT RISK MANAGEMENT AUDIO CONFERENCE SERIES

**November 13, 2012** – Current Issues in Commercial and Residential Appraisals and Evaluations

**December 11, 2012** – Credit Risk Challenges During the Next 18 Months

**January 15, 2013** – Understanding TDRs and Non-Accrual Recognition

**Time:** All audio conferences will be held at 1:00 p.m. Eastern Time (10:00 a.m. Pacific Time).

#### **Fees\***

**Associate Members:** \$850 for all 10, \$120 for each audio conference (per phone line).

**Nonassociates at member institutions:** \$920 for all 10;

\$130 for each audio conference (per phone line).

**Nonmembers:** \$1,300 for all 10; \$180 for each audio conference (per phone line).

\*Additional listeners cost \$0.

## EDUCATIONAL CLASSES—STAY TUNED

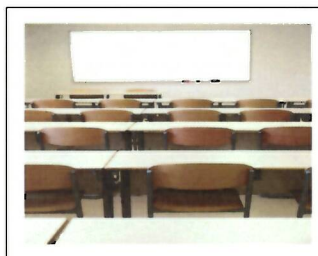
The following educational classes are scheduled to be hosted by the Northern Ohio Chapter. Registration information will be posted soon on our website: <http://community.rmahq.org/NorthernOhio/Home>

Cash Flow Analysis I—UCA Fundamentals  
February 13 & 14, 2013

Business Writing for Bankers  
March 13, 2013

Understanding & Interpreting Appraisals of Commercial Real Estate  
May 2013

Cash Flow Analysis II: Applied Concepts  
June 11 & 12, 2013





RMA is a not-for-profit, member driven professional association whose sole purpose is to advance the use of sound risk principles in the financial services industry.

RMA promotes an enterprise approach to risk management that focuses on credit risk, market risk and operational risk.

Contact us via e-mail at:  
[rmanohio@gmail.com](mailto:rmanohio@gmail.com)

## RMA CREDIT RISK CERTIFICATION

### Why RMA-CRC?

In today's rapidly changing financial services industry, you need practical, day-to-day knowledge that will help you excel in your profession. You need the latest skills—skills that are current and complete. And you need the demonstrated ability to serve a diverse base of clients. Plus, you need all of your knowledge, skills, and abilities to be validated by a respected organization like RMA.

For more information, check out our website:

[WWW.RMAHQ.ORG/CRC](http://WWW.RMAHQ.ORG/CRC)



## LENDING TO WEALTHY INDIVIDUALS

### COMPLEX PERSONAL FINANCES CALL FOR CAREFUL ANALYSIS.

By Kevin McLaughlin

"Trust but verify" is the best approach when lending to the rich, according to private bankers participating in a recent RMA audio conference, "Issues in Lending to Wealthy Individuals."

Because most personal financial statements submitted for loans are prepared by the applicants, analysis and verification are critical in evaluating repayment ability, said Rick Larson, senior vice president and district credit officer for KeyBank.

"Do we need to verify everything? No, that might put us at a competitive disadvantage," he said. "But certainly we should verify some of those assets."

Larson uses the 15% rule: If an asset makes up 15% or more of total assets listed, it should be verified inde-

pendently. Bank statements, investment statements, income tax returns, and similar documents can reveal a more accurate picture, he said.

In checking the documents, lenders need to understand and evaluate the assets listed. Stocks, real estate, and hedge and private equity funds are among assets that require a deeper look.

Liquidity is another concern. Lenders need to verify liquid assets listed on the borrower's personal financial statement (PSF).

"Some key pitfalls are assuming cash on hand listed on the PFS is owned personally by our borrower or guarantor. It could be in a company or in a trust," said Keith Larson, a wealth management credit approval officer responsible for portfolio management in the Private Client Group at U.S. Bank.

"Assets are not always liquid or marketable securities just because they're listed that way on the PFS," Larson said. "Publicly traded securities are not created equal as it relates to liquidity. Other variables include price, stability, and volatility, the trading volume or demand for the stock.

"Verify and document liquidity and do it often. The frequency will be based on your reliance on the asset." Estate planning can tie up some lenders' assets in illiquid instruments such as grantor retained annuity trusts (GRATs).

To read this article in its entirety, please visit our website: <http://www.rmahq.org/tools-publications/the-rma-journal>

## COMMERCIAL CONSTRUCTION LOAN DOCUMENTS IN OHIO: A PRIMER

By: Donald Miehls, Esq.  
Walter & Haverfield

### **Introduction**

Yes, financial institutions are making commercial construction loans to build or renovate apartment buildings, office buildings, retail centers, and other commercial projects, but not to the extent undertaken in the boom years of 2002 to 2007. Hopefully, commercial construction will steadily increase, as real estate investors willing to take a risk seek new opportunities, and optimistic business owners seek to expand their existing facilities.

With increased construction activity hopefully on the horizon, now may be a good time to review, or examine for the first time, the most common loan documents required by lenders making a commercial construction loan. To that end, this article will focus on the basic loan documents used in the origination of a loan to construct income-producing property, such as apartment buildings, office buildings, and retail centers.

### **Commitment Letter**

The commitment letter for the construction loan, executed by the borrower, all guarantors, and the lender, is not a loan document, but does provide the framework for the lender's attorney to draft the loan documents. The commitment letter will state the maximum amount of loan proceeds that the lender will advance for the project, and other basic terms of the construction loan. That loan amount will usually be a certain percentage of the cost of construction of the project, with the percentage depending on the lender's underwriting analysis of the project as finished, and the creditworthiness of the borrower and the guarantors.

If the borrower and the lender change any term in the commitment letter between the date of its execution and the date that the borrower executes the loan documents, the affected loan document should state that the loan documents controls over any conflicting term in the commitment letter. Better yet, the lender should also ask the borrower and the guarantors to execute a revised commitment letter.

### **Promissory Note**

The "promise to pay" given by a borrower to its construction loan lender will usually be contained in a promissory note, but may be in the construction loan agreement instead if the lender does not require the borrower to execute a promissory note. For the purpose of this article, we'll assume that the borrower has executed a promissory note in favor of the construction lender.

If the lender has committed to make only a short-term construction loan, then, prior to the first advance of construction loan proceeds, the borrower must also procure a written commitment for long-term financing from a “take-out lender,” usually an insurance company or other large institutional investor. If the borrower has procured a commitment for long-term financing, sometimes called “permanent financing,” from a take-out lender, the construction loan note will mature on the date of the anticipated completion of the project or shortly thereafter. On the maturity date, the take-out lender will satisfy the outstanding balance of the construction loan and make a permanent loan to the borrower. The construction loan note will usually require the borrower to make interest-only payments during the construction period, with interest accruing on the outstanding construction loan advances.

On the other hand, the construction lender may have agreed to make a construction loan of one to two years, requiring monthly payments of interest only, followed by a term loan of one to two years (a “mini perm loan”), or five to ten years, to commence on the anticipated completion date for the project or shortly thereafter.

If the construction lender has committed to also make a term loan to the borrower, the promissory note, which covers both the construction loan and the term loan, will indicate a “conversion date,” at which time the borrower must begin making periodic payments of principal, in addition to accrued interest, on the term loan. On the conversion date, the loan “converts” from an interest-only construction loan to an amortizing term loan. The term loan may be fully-amortizing, or call for principal payments based on a five, seven, or ten-year amortization schedule.

On the maturity date for the term loan, as specified in the promissory note, the borrower must pay to the lender the remaining principal balance, plus all accrued but unpaid interest. If the term loan is not fully-amortizing, the final principal payment, because it exceeds the amount of each regular periodic principal payment, is often called a “balloon payment.”

The promissory note or the construction loan agreement may provide that a portion of the loan proceeds will be held by the lender as an interest reserve, to be drawn upon by the lender to pay accrued interest on the loan during the construction phase. In the alternative, the lender may require the borrower to deposit its own funds into an interest reserve account, to be maintained, and drawn upon, by the lender.

### **Construction Loan Agreement**

The loan agreement for a construction loan is usually the governing document for the closing and administration of the loan, whether the loan is merely a short-term construction loan or a facility including both construction loan and term loan components. The lender and the borrower, and sometimes the guarantor, will execute the construction loan agreement.

#### *Conditions Precedent to First Advance*

The construction loan agreement will include a list of documents and other information that the borrower must provide to the lender as conditions precedent to the first advance of loan proceeds. The borrower may use the first advance of loan proceeds to purchase the land and/or

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to pay for construction-related expenses, for example, architect's fees, attorney fees, the title insurance commitment, and building permits.

The documents and other information that the lender must receive as a condition to the first advance of loan proceeds include the following, among others, all of which must be acceptable to the lender:

- (1) A loan policy of title insurance for the mortgage securing the loan, which must include a pending disbursement endorsement. That endorsement will increase the amount of title insurance by the amount of each construction loan advance, subject to certain conditions, up to the face amount of the title insurance policy;
- (2) The construction contract between the borrower and a general contractor;
- (3) Copies of the minimum number of executed leases, as required by the lender, if the project is a new office building or a retail center;
- (4) A written budget, sometime referred to as a "cost breakdown," signed by the general contractor and approved by the borrower, setting forth all of the costs related to the construction project;
- (5) A schedule of sources and uses, indicating all of the sources of the funds required for the project, for example, borrower equity (the value of the land and borrower cash), the construction loan proceeds, and subordinate mezzanine financing, and the uses to which the borrower will put all of the equity and borrowed money;
- (6) A list of all major subcontractors and suppliers for the project, and, in the lender's discretion, copies of all contracts between the general contractor and major subcontractors;
- (7) A builder's risk insurance policy (on a completed value, non-reporting form), insuring the borrower against hazards related to construction, and naming the lender as an additional insured;
- (8) The plans and specifications for the project, prepared by the project architect and approved by the borrower and the general contractor; and
- (9) Copies of all permits required to construct the project, usually obtained by the general contractor for the project.

#### *Borrower Covenants*

The construction loan agreement will also contain standard borrower covenants, and additional covenants particular to a construction loan, including, among others, that:

- (a) The construction of the project will be completed by a date certain (the "completion date"), and that the borrower will continuously and diligently work to complete the project by that date.

- (b) Neither the borrower, nor the general contractor, will commence construction of the project before the recordation of the lender's mortgage and the recordation of the borrower's "notice of commencement" of construction;
- (c) The borrower will not alter the plans or specifications for the project without the lender's prior written consent;
- (d) The borrower and the general contractor will allow representatives of the lender, including the lender's project inspector, complete access to the construction site during normal business hours;
- (e) The borrower will provide the lender with copies of all notices from government agencies, received by the borrower or the general contractor, that are related to the project; and
- (f) The borrower will provide, to the lender and the title agent, a copy of each "notice of furnishing" that the borrower receives from a supplier or subcontractor on the project.

#### *Subsequent Advance Procedure*

The construction loan agreement may call for the lender to advance loan proceeds based on the percentage of completion of the project, as determined by the lender's inspector. In the alternative, the lender and the borrower may include a draw schedule in the construction loan agreement, with the borrower to receive a stated amount of loan proceeds at a scheduled draw, if certain aspects of construction have been completed. For example, the draw schedule may condition an advance on the completion of one or more items, including completion of excavation, laying the foundation, the construction of exterior walls, installation of exterior siding, installation of the roof, installation of plumbing and the HVAC system, laying the flooring, and completion of other interior work.

After the first advance of construction loan proceeds, the lender will usually advance the loan proceeds in intermittent draws, either directly to the borrower, or to an escrow agent (usually the title agency) who will disburse the funds to the borrower. The lender may require a "trading of checks" as part of each loan advance transaction, in which case the escrow agent (or the lender) disburses the loan advance to the borrower after the borrower gives the escrow agent (or the lender) the borrower's check payable to the general contractor for the amount due the general contractor from the advance.

The construction loan agreement will usually provide that the lender will hold back a certain percentage of the committed amount of the construction loan, usually 5 to 10 percent, as retainage, to be released to the borrower as the final draw. The construction contract will also usually provide that the borrower will withhold the same percentage of the contract amount from the general contractor, pending the lender's release of the retainage to the borrower.

#### *Conditions Precedent to Each Subsequent Advance*



Each construction loan advance should be contingent upon the satisfaction of certain conditions. Those conditions precedent are usually contained in the construction loan agreement and include, among other things, that:

- (i) No event of default on the promissory note, the mortgage, the construction loan agreement, or any other loan document has occurred and is continuing;
- (ii) The lender has received a certificate, signed by the project architect or the project engineer, or the lender's project inspector, certifying that all work on the project, as of the date of the certificate, has been performed in accordance with the plans and specifications and the budget, and that the remaining loan proceeds are sufficient to complete the project;
- (iii) The borrower has provided the lender with a draw request form, signed by the borrower, with a list of all suppliers and subcontractors that will be paid from the draw, and invoices from those suppliers and subcontractors (the lender may require that the draw request be in the form of American Institute of Architects Form G702/703);
- (iv) The title agency has issued an endorsement to the title insurance policy, with coverage increased by the amount of the pending draw and indicating that no mechanic's liens or judgment liens have been filed against the project, and that real estate taxes and assessments have been paid current; and
- (v) The lender has received a mechanic's lien waiver from the general contractor and from each supplier and subcontractor on the project, indicating that they have been paid for all work furnished, and materials supplied, to the project through the date of the previous draw. The lender may also require a conditional lien waiver from each supplier and subcontractor to be paid from the pending draw. In a conditional lien waiver, a supplier or subcontractor waives the right to a mechanic's lien, through the date of the pending draw, if the supplier or subcontractor is paid in accordance with the borrower's draw request.

*Conditions Precedent to Final Advance*

The construction loan agreement will provide that, for the lender to be obligated to make the final advance of loan proceeds, including the retainage, the borrower must have satisfied each condition precedent to an advance, as mentioned above, and provided the lender with the following documents:

- (A) A final certificate of completion, signed by the borrower, the general contractor, and the architect or the engineer for the project, or lender's project inspector, certifying that the project has been completed in accordance with the plans and specifications;
- (B) A certificate of occupancy for the project, as required by the local building department;

- (C) A final as-built survey of the project, showing, among other items, the location of all improvements on the subject land; and
- (D) An endorsement to the title insurance policy insuring that no improvement on the borrower's land encroaches on any adjoining land.

#### *Events of Default*

The construction loan agreement will contain standard events of default for a commercial real estate loan, and additional events of default related to construction financing, including, among others, the following events:

- (I) The borrower abandons construction of the project or construction is halted for a continuous number of days, as specified in the construction loan agreement, other than for reasons beyond the borrower's control, such as severe weather or a fire;
- (II) The recordation with the county recorder of an affidavit for mechanic's lien against the project, or the lender has determined that the borrower failed to pay the general contractor as called for in a previous draw request;
- (III) Based on the results of inspections by the lender's project inspector, the remaining loan proceeds are insufficient to complete the project, according to the plans and specifications, and to pay all outstanding invoices related to the project (the project is "out-of-balance"), and the borrower and the guarantors have failed to provide the required additional funds.

The construction loan agreement will usually provide that, upon the occurrence of an event of default and the passage of any "cure" period without the completion of the cure, the lender may declare the loan in default, refuse to advance additional loan proceeds, accelerate the unpaid balance of the loan, and commence a legal action to: (1) obtain a judgment on the promissory note, (2) have the court appoint a receiver for the project to supervise the completion of construction, and (3) foreclose the lender's mortgage against the project.

The construction loan agreement may also give the lender the option, upon default, of completing the project under the construction contract with the general contractor, if the borrower assigned its rights under the general contract to the lender, effective upon a loan default, and the general contractor consented to that assignment. The lender will also have the option of pursuing its remedies against the guarantors, as provided in each guaranty.

#### *Notice of Commencement and Notices of Furnishing*

As noted above, a condition precedent to the first advance of loan proceeds is the borrower's recordation, with the county recorder, of a "notice of commencement" immediately after the recordation of the lender's mortgage, assignment of rents, and Uniform Commercial  
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Code Financing Statement. The notice of commencement, governed by section 1311.04 of the Ohio Revised Code, serves several purposes, including providing:

- (a) The name and mailing address of the owner of the land where the project is being constructed, and the name of the part owner or lessee that executed the construction contract, if such is the case;
- (b) The name and mailing address of the general contractor for the project (referred to as an “original contractor” in section 1311.04);
- (c) A brief description of the improvements to be constructed;
- (d) The date of the construction contract between the owner, part owner, or lessee and the general contractor;
- (e) The legal description of the land where the project is being constructed;
- (f) The name and mailing address of the lender, if any;
- (g) The name and address of each surety, if any, that is providing a payment bond for the project; and
- (h) The name and address of any person (a “designee”) whom the owner, part owner, or lessee may have designated to receive “notices of furnishing” from suppliers and subcontractors to the project.

Section 1311.04 requires the party that executed the construction contract with the general contractor (called the original contractor in that Section) to record the notice of commencement. Unless the project is the subject of a home purchase contract, the owner, part owner, or lessee that executed the construction contract must also place a copy of the notice of commencement in a conspicuous place on the land described in the notice of commencement. The owner, part owner, or lessee, must also provide a copy of the notice of commencement to the general contractor. If the owner, part owner, or lessee, as applicable, fails to record a notice of commencement, the lender may do so on behalf of the owner, lessee, or part owner, and must indicate on the notice of commencement that it is being recorded by the lender for the project.

The notice of commencement must also include language, specified in Section 1311.04, that a person desiring to preserve mechanic’s lien rights against the project must serve a notice of furnishing upon the owner, or the designee of the owner, and upon the general contractor, in accordance with section 1311.06 of the Ohio Revised Code.

If a notice of commencement is not recorded and posted in accordance with Section 1311.04, among other consequences, no person need provide a notice of furnishing to the owner, part owner, or lessee, as applicable, to preserve valid mechanic’s lien rights.

A detailed discussion of the Ohio mechanic’s lien law is beyond the scope of this article. Suffice it to say that a lender should consult an attorney well-versed in mechanic’s lien law if an affidavit for mechanic’s lien is filed against a project funded by the lender.

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## The Construction Loan Mortgage

The mortgage securing a construction loan will include all of the representations, warranties, and conditions found in a mortgage securing a non-construction commercial real estate loan, including statements that the mortgage is an “open-end mortgage” contemplating loan advances after the date that the mortgage is filed for record with the county recorder, and a statement of the maximum principal indebtedness that will be secured by the mortgage. A mortgage securing a construction loan will usually include other provisions designed specifically for construction loans, including that the mortgage is a “construction mortgage” under the Uniform Commercial Code and an “improvement mortgage:” under Section 1311.14 of the Ohio Revised Code.

### *Construction Mortgage under the Uniform Commercial Code*

The mortgage securing a construction loan will usually state that it is a “construction mortgage” as described in Section 1309.334 of the Ohio Revised Code. Chapter 1309 of the Ohio Revised Code is Ohio’s adoption of Article 9 (Secured Transactions) of the Uniform Commercial Code (the “UCC”). Section 1309.334 provides lien priority rules for security interests in goods that are fixtures, or goods that will become fixtures, without displacing a lender’s ability to obtain a security interest in fixtures under real property law. Section 1309.334 does not provide a vehicle for lenders to obtain a security interest in ordinary building materials that are incorporated into an improvement on land (for example, lumber or roofing materials).

Under Section 1309.334, in most instances, a mortgage will have lien priority over a conflicting security interest in fixtures if (1) the recorded mortgage states that it secures an obligation incurred for the construction of an improvement on land, including the acquisition cost of the land, (2) the mortgage is filed for record before the goods become fixtures, and (3) the goods become fixtures before the construction is completed. Under Section 1309.334, a mortgage given to re-finance a construction mortgage that qualifies for lien priority under Section 1309.334 will enjoy the same priority as the construction mortgage.

### *Improvement Mortgage under Section 1311.14 of the Ohio Revised Code*

A mortgage securing a construction loan will also usually include a provision stating the mortgage is an “improvement mortgage” under Section 1311.14 of the Ohio Revised Code, and authorizing the mortgagee (lender) to do all things provided to be done by the mortgagee under Section 1311.14. Section 1311.14 applies to mortgages that both include the foregoing language and secure funds used to improve real estate or pay off a prior encumbrance on real estate. **Section 1311.14 does not displace other protections afforded to mortgagees, as, for example, the lien priority afforded to mortgagees making future advances under Section 2323.232 of the Ohio Revised Code, which is the open-end mortgage statute.**

A lender will usually look to the lien priority afforded by Section 1311.14 if visible work on the project began before the lender filed its mortgage, or a mechanic’s lien against the project has already been recorded. Under Section 1311.14, an improvement mortgage will enjoy lien priority over mechanic’s liens, and similar liens, that are filed for record after the filing of the improvement mortgage, to the extent that the funds secured by the improvement mortgage

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are (1) used to improve the subject real estate or to pay off prior encumbrances, and (2) advanced in accordance with the procedure set forth in Section 1311.14.

Section 1311.14 allows the mortgagee of an improvement mortgage to withhold loan funds for the 15-day period following the filing of the improvement mortgage for record. Upon the expiration of that period, the mortgagee may either start advancing funds, or cancel the loan and discharge the mortgage of record. If the mortgagee decides to begin advancing loan funds, the improvement mortgage will enjoy lien priority over mechanic's lien for visible work done before the recordation of the improvement mortgage if the mortgagee advances the loan proceeds in accordance with the requirements of Section 1311.14.

Under Section 1311.14, to enjoy lien priority, a mortgagee may advance, or withhold, loan proceeds to pay off prior encumbrances (for example, a recorded mechanic's lien), and then at all times retain loan funds sufficient to complete the improvement in accordance with then original plans, specifications, and contracts, within the original contract price. The mortgagee, upon the owner's order, may pay (1) labor payrolls for the improvement, (2) the accounts of laborers and material suppliers that have provided notices to the mortgagee in accordance with Section 1311.14, and (3) directly the material suppliers or laborers who performed labor or work, or furnished materials, for the improvement. In the unlikely event that any construction loan funds remain after the payment of prior encumbrances against the project and the claims of the general contractor, subcontractors, suppliers, and laborers that provided materials, labor, or services to the project, the mortgagee is obligated to advance that remainder to the owner of the project.

If the mortgagee elects to proceed with advancing loan proceeds for a construction project under Section 1311.14, but does not advance those proceeds in accordance with Section 1311.14, the lien of the mortgage to the extent of the wrongly advanced proceeds is inferior in priority to the lien of the general contractor on the project and the liens of all subcontractors, suppliers, and laborers on the project.

Because most mortgages securing a construction loan are filed for record before any visible work or materials have been furnished at the project (or the mortgagee is confident that the work or materials have been paid for), mortgagees rarely utilize the construction loan advance procedure set forth in Section 1311.14.

### **Borrower's Assignments**

A construction loan lender will require the borrower, and possibly one or more principals of the borrower to execute an environmental indemnity agreement in favor of the lender, and require the borrower to execute an assignment of leases and rents in favor of the lender. The environmental indemnity agreement, and the assignment of leases and rents, for a construction loan will not differ substantially from an environmental indemnity agreement, or an assignment of leases and rents, given for non-construction commercial real estate loans.

A construction loan lender will also require the borrower to execute the following assignments in favor of the lender:

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- (1) An assignment of the general construction contract, which is also signed by the general contractor, and of related construction contracts to which the borrower is a party;
- (2) An assignment of the plans and specification for the project, which is also signed by the architect for the project; and
- (3) An assignment of the building permits and other construction-related permits for the project, which is also signed by the general contractor.

Depending on the complexity of the project, the construction lender may require other assignments, such as an assignment of the borrower's rights under a development agreement with a municipality. One purpose of the construction-related assignments is to allow the lender to "step into the shoes" of the borrower and complete the project with the assigned contracts and permits if the borrower default on the construction loan.

### **Guaranties**

A lender will usually require a guaranty of payment, and a guaranty of performance (sometimes called a guaranty of completion), as conditions for making a construction loan. The guaranty of payment and the guaranty of performance may be contained in the same document or in different documents, and may be given by the same person (individual or entity) or by different persons.

The guaranty of payment for a construction loan is similar to a guaranty of payment for other commercial loans – the guarantor unconditionally and absolutely guaranties the full repayment of the loan upon the occurrence of an event of default on the loan and a written demand form the lender.

On the other hand, under a performance guaranty, the guarantor absolutely and unconditionally guaranties the full performance of all of the borrower's obligations under the construction loan agreement, including the completion of the project according to the original plans and specification. Upon the occurrence of an event of default on the loan and the giving of a written demand by the lender, the performance guarantor will be obligated to complete the construction of the project, using the remaining loan funds and the guarantor's own funds, if necessary, to pay the general contractor and all subcontractors, suppliers, and laborers who furnished work or materials for the project.

A lender may invoke the performance guaranty if the remaining loan funds are insufficient to finish the project (the project is "out-of-balance") and the borrower has insufficient resources of its own to supply the required additional capital.

### **Conclusion**

This article only briefly discusses the most common loan documents required by a lender making a loan to construct or renovate an office building, an apartment building, or a retail center. A particular project may require additional instruments, agreements, or other documents,

depending on the circumstances. The lender and its attorney should jointly produce a due diligence and loan document checklist to ensure that the lender will receive all items and documents necessary to make, secure, and administer the loan in accordance with the lender's credit approval and the commitment letter.

The lender's attorney should also work closely with the title insurance agent and its attorney to ensure that the title agent receives the borrower's affidavit and other closing items necessary for the title agent to issue the policy and endorsements insuring the mortgage. Finally, if the borrower's attorney is experienced in closing construction loans, he or she will probably cooperate reasonably with the lender's attorney and the title agent to close the loan and allow the borrower to begin construction of the project and receive loan proceeds in response to each draw request.

**This overview is intended as general information only. Please note that this information is not legal advice. The reader should consult an attorney with knowledge in this area of the law to determine how the information applies to any specific situation.**

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