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PROJECTS AND CONSTRUCTION

"Why are they asking for that?" - Lenders' construction requirements in development projects

by **Jamie Ritchie**

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As Irish lenders have become more prudent in their lending policies for development finance, their construction requirements have become more detailed and extensive. Consequently, it is incumbent on the borrower's team to focus on these key deliverables at an early stage of the project.

Background

Lenders’ construction requirements reflect the material risks for a project, which participant is best able to bear each such risk and the best way for it to do so. Development finance is characterised by intricate, but balanced, risk allocation arrangements. But what does this mean for the teams on-site who are actually delivering the project?

In order to answer that question, one needs to first look at any hypothetical project from the lender’s perspective. Lenders typically extend credit to a newly-formed, thinly-capitalised project company (generally, the employer) whose core assets at the time of financial close likely consist of a site with planning permission and sometimes little more than a collection of contracts, licences and ambitious plans – hence the focus on prudent risk analysis and allocation. Lenders will want to see the following clearly set out in a credit application:

- A detailed programme of works showing how the project will be completed on time, and the financial model showing the borrower will earn the anticipated income stream from sales or otherwise and that the borrower will not incur liabilities, costs and expenses over and above the budget delivered.
- Full suite of detailed technical, legal and financial due diligence on the project.
- Process for drawdowns, variations and compliance involving the lender's project monitor so that the lender has control over key decisions.
- Contractual framework so that, if things go wrong, the lender can step in and protect itself and the project.

From a legal perspective the lenders obviously take a full suite of borrower covenants as well as comprehensive security over the site, other assets of the borrower and possibly a charge over shares in the borrower company. However, lenders are increasingly imposing their own bespoke form construction contractual documents on the project team. This includes highly refined professional appointments for design team members, bank tailored clauses in the main contract and subcontracts which reduce the level of risk and enforce greater certainty around payment and timescales. Combine this with a myriad of statutory consents, insurance requirements and other corporate deliverables and you have your typical list of conditions precedent (CP list) for a standard medium sized project in Ireland.

How onerous a CP list can be on a borrower will depend on the nature of the lender, pricing and more particularly the level of shareholder equity and support. However, increasingly, as lawyers, we are acting as intermediaries, negotiating and transposing the bank's requirements into the contractual documentation between the borrower and the wider construction team. As such, we are in a good position to explain why certain items are required and (perhaps more to the point) how much room a project team member has to negotiate.

Collateral Warranties

Collateral warranties are an important support instrument because they give the lenders (as third parties) direct recourse against an engineer, construction company or supply company designing, building or providing important technology to the project confirming that it has complied with all relevant professional standards in the provision of the relevant services and products. Without a collateral warranty from the relevant contractor or supplier it may be impossible for the lenders to directly pursue a claim against the relevant contractor or supplier. In addition, collateral warranties give the lenders valuable access rights to important equipment and other warranties provided by a contractor or supplier that may survive for many years after the completion of the project.

One widespread difficulty when using collateral warranties is that they can be problematic to procure, even if the underlying contract is clear that they must be provided. This difficulty arises most often when a project is complete or, even if it is ongoing, where the warrantor has received payment for its particular works or services. The problem can be compounded if there is a dispute relating to the project. Hence prudent lenders insist upon procuring all collateral warranties at the outset of the project, before advancing funds or before the warranty provider commences work for the borrower or development company.

In terms of the content of collateral warranties required by lenders, they merely require the warrantor to comply with the professional appointment or building contract it entered into with the developer. Additionally, where the warrantor has a design responsibility, some collateral warranties include an obligation to both comply with the professional appointment or building contract and an obligation to exercise a specified level of skill, care and diligence in carrying out the design.

Warrantors are usually required to maintain professional indemnity insurance, often for 12 years or 6 years from practical completion if they have a design or management obligation. The lender's ongoing involvement in the construction is via the project monitor and therefore the collateral warranties should state that the lender may not give instructions to the warrantor unless there is a default scenario.

Lender collateral warranties include a lender right to step-in; namely a right to take over the developer’s/employer’s role on a project in a default scenario under the finance or construction documents. Sometimes contractors and consultants wonder why lenders need a grant of copyright licence (or wider intellectual property licence) in their favour under the collateral warranties. Clearly, if the lender is to step in in a default scenario and possibly appoint substitute parties, it will need to be able to use the documents and designs
A right to assign the benefit of the collateral warranty to a person taking the lender’s interest in the project on two occasions is common. Assignment on two occasions is a generally accepted balance between a lender’s desire for flexibility and freedom of assignment and the warrantor’s concern that it may be exposed to claims from many different parties.

Conversely in lender collateral warranties the lender is unlikely to accept a net contribution clause unless there is a wide framework of collateral warranties for every involved party and even so it is likely to be limited to “fair and reasonable”. Furthermore, the collateral warranties will not limit the lender’s losses to repair and/or re-instatement because a lender’s losses will most likely be financial losses.

Project monitoring

Where a borrower is procuring a significant real estate or infrastructure project, a lender is likely to engage the services of a project monitor. The project monitor provides independent advice to its client on all aspects of the project as it progresses. It advises on risk, potential or emerging issues, and material changes associated with the project in the context of the development not being under the lender’s direct control. This allows the lender to make informed decisions, reduce and manage its exposure to risk, and

protect its financial interests.

Developers and their consultants need to appreciate that lenders would expect their independently appointed project monitor to review and advise upon the available project documents, drawings and specifications, appointments, insurance cover, works programme, payment schedules, budgets and overall financial model. The borrower's team need to provide the information that the project monitor requests in a timely manner. How soon a project monitor requires information varies on a case by case basis, but it is common practice to include a project monitor on the electronic distribution lists for all key site minutes and instructions.

Conclusion

There is no doubt that the pendulum has turned both in terms of the financial and construction due diligence undertaken by lenders. This is a good thing for all parties because it ensures a better quality project. The challenge lies with all parties to be more efficient while being diligent in what is a more demanding process that could easily cause considerable costs, delays and/or exposure if poorly undertaken. Hence the selection of one's project team is all the more important for the bottom line.

If you are interested in learning more about lender's requirements, please contact Neil O'Keeffe.

If you require assistance in negotiating with employers in projects where third party funding is involved, please do not hesitate to contact Jamie Ritchie.

The article is for information purposes only and readers ought to obtain specific legal advice.

About the Author

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Jamie Ritchie joined LK Shields in 2017, becoming Partner in 2020 and Head of our Projects and Construction Group in 2022. With over 10 years' experience, Jamie has played a central role in working with some of our largest domestic and international clients on their infrastructure, construction, energy and commercial legal requirements.

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