



IS A GUARANTY OF COMPLETION RELIABLE FOR A CONSTRUCTION LENDER?

A guaranty of completion is a common part of the documentation for a construction mortgage loan. In a guaranty of completion, a creditworthy principal or affiliate of the borrower guarantees that construction of the project being financed by the construction lender will be completed, even if (or especially if) the borrower defaults.

Construction lenders have long required guaranties of completion. Sometimes a lender will require one in addition to a guaranty of payment; and sometimes a lender will require a guaranty of completion in lieu of a guaranty of payment, where competitive pressure prevents the lender from obtaining a guaranty of payment.

A review of the text of a typical guaranty of completion suggests that it is a straightforward matter. In essence, the guarantor guarantees completion. The text likely also requires that completion be on-time and lien-free. It also likely requires the guarantor to pay deficiency deposits in order to keep the construction loan in balance during the course of construction, if demanded by the lender. All of those concepts are readily understandable by a construction lender, and they may lead the construction lender to perceive the guaranty of completion to be a reliable tool in assuring that the project will be completed as expected by the lender -- or at least that the completion guarantor will be liable for damages if the project is not completed.

However, the reliability of a guaranty of completion is open to question.

The definitive law review article on guaranties of completion was published in 1994. Completion Guaranties: A Review of the Concept and Execution, 23 Real Estate Law Journal 141. The author found only two cases nationwide that discussed the measure of damages under a guaranty of completion. Glendale Fed. Sav. & Loan Assn. v. Marina View, 135 Cal. Rptr. 802 (Ct. App. 1977); and 1633 Assocs. v. Uris Bldgs. Corp., 414 N.Y.S. 2d 125 (App. Div. 1979). Since 1994 through late 2008, only one additional case has been reported. Chase Manhattan Bank, N.A. v. American National Bank and Trust Company of Chicago, 93 F.3d 1064 (2nd Cir., 1996).

The dearth of reported cases (especially when compared to the abundance of cases dealing with litigated guaranties of payment), and the hurdles encountered by lenders in seeking to enforce guaranties of completion in the cases reported, suggest that construction lenders have not found guaranties of completion to be reliable when a construction loan default actually occurs.

The first surprise to a construction lender is that a court will probably not enter a decree of specific performance compelling the guarantor actually to complete construction of the project. Courts are generally reluctant to involve themselves in mandating actual performance of complex commercial undertakings that would entail ongoing supervision on the part of the court as to whether or not, and in what manner, performance is actually being rendered. Moreover, a court will likely hold that a decree of specific performance is unavailable because the lender has an adequate remedy at law in damages.

A second surprise to a construction lender may be that any entitlement of the lender to recover damages from the completion guarantor assumes that the lender has fully advanced all the proceeds of the construction loan. The lender is probably well aware that if a default under the construction loan agreement occurs during the course of construction, the lender is entitled to cease making any further loan advances. The lender may harbor the hope that the completion guarantor is obligated upon default to fund whatever amount needs to be funded in order to achieve completion – even the portion of the loan that the lender refused to fund because of the borrower's default. However, that hope of the lender is not a legitimate one. A guaranty of completion is not an agreement to substitute the guarantor's funds for the construction loan.

The essence of the bargain among the parties is that completion cannot be legitimately expected without the use of the full construction loan. Instead, the completion guarantor is required to bear liability for the costs required to achieve completion to the extent that such costs exceed the undisbursed balance of the construction loan.

That is not to say that the lender is required actually to advance the undisbursed loan proceeds to the completion guarantor, in order to recover such excess costs from the completion guarantor; but the lender must at least credit the undisbursed portion of the loan against the remaining costs to complete, in order to determine the amount of the liability of the completion guarantor.

Perhaps the greatest factor undermining the reliability of a guaranty of completion is the law of damages. It is true that a cardinal principle of the law of damages is that, following a breach of contract, the aggrieved party should be entitled to damages that would put the aggrieved party in the same position as if the contract had been fully performed. That principle might lead a construction lender to believe, for example, that if the lender's underwriting at the outset of a deal was an 80% loan-to-value ratio, and if the building were not completed, then the lender should be entitled to recover damages equal to the cost to complete the building so that the lender would enjoy its 80% LTV.

That belief, however, butts up against a second cardinal principle of the law of damages: that the aggrieved party cannot recover more than the amount of its loss. Courts will not award a "windfall".

That principle has a particular application to a guaranty of completion, because the courts characterize a guaranty of completion as ancillary to the mortgage. It is mere security for the mortgage debt. The lender's paramount contract is repayment of the mortgage debt, and a guaranty of completion is merely an indirect tool to achieve repayment of the mortgage debt. Accordingly, the amount of the mortgage debt is an upper limit on the amount of damages that may be recovered under a guaranty of completion.

The courts say that the starting point in measuring the damages recoverable is not the cost to complete. Instead, the starting point is the difference between (i) the value of the project in a completed state, and (ii) the value of the project in its uncompleted state.

More precisely, the legal rule for the measurement of damages under a guaranty of completion is this: the lender can recover so much of the excess of:

- (i) the value of the project as if the building were completed, over
- (ii) the value of the project as partially completed,

as will equal, when added to the value of the project as partially completed, the amount of the outstanding mortgage debt. That rule is articulated in the 1994 law review article referred to above. The rule derives, in part, from cases in the late 19th century and early 20th century involving completion bonds issued by surety companies.

The application of that convoluted formula to a few garden-variety default situations is indicated below. However, two general observations are worth noting. First, the "value of the project" includes the land. Accordingly, if the value of the incomplete project, including the land value, exceeds the amount of the outstanding mortgage debt, then the

amount of the recovery that the lender may obtain against the completion guarantor will likely be zero.

The second general observation is that to undertake an examination of “values” (for purposes of ascertaining the amount of damages) generally means the use of appraisals. The cost to complete is not necessarily the determinant of the amount of recovery. The amount of the lender’s recovery (if any) may be dependent on a battle of appraisals. Even worse, it might be easy for a court to find that the value of the incomplete project is approximately equal to the amount of the loan advances made (plus, without duplication, the land value); if the court does so find, then (again) the amount of recovery against the completion guarantor would likely be zero.

The following chart indicates the application of the above-described rule for the measurement of damages to three different garden-variety default situations:

	<u>#1</u>	<u>#2</u>	<u>#3</u>
A. Value of project (land and building) <u>as if</u> the building were completed	100	100	85
B. Maximum loan commitment	80	80	80
C. Land equity (at closing)	20	20	20
D. Outstanding mortgage debt	55	55	55
E. Undisbursed loan proceeds	25	25	25
F. Cost to complete	35	47	35
G. Cost to complete less undisbursed loan proceeds (i.e., amount of lender’s desired recovery from guarantor of completion)	10	22	10
H. Value of project as partially completed (valued at A minus F. However, partially completed project may arguably be valued in different ways; if valued higher, then amount of recovery from guarantor is reduced. For example, partially completed project might be valued at outstanding mortgage debt plus land equity, which would be more favorable to guarantor.)	65	53	50
I. Amount recoverable from guarantor of completion	0	2	5

To repeat, the rule for the measurement of damages is this: the lender may recover so much of the excess of:

- (i) the value of the project as if the building were completed [A], over
- (ii) the value of the project as partially completed [H]

as will equal, when added to the value of the project as partially completed [H], the outstanding mortgage debt [D].

In situation #1 above, the amount recoverable is zero. Applying the rule: so much of \$35 [the excess of \$100

over \$65] as will equal, when added to \$65, the outstanding mortgage debt of \$55. The recovery is zero, because \$65 exceeds \$55.

In situation #2 above, the amount recoverable is \$2. Applying the rule: so much of \$47 [the excess of \$100 over \$53] as will equal, when added to \$53, the outstanding mortgage debt of \$55.

In situation #3 above, the amount recoverable is \$5. Applying the rule: so much of \$35 [the excess of \$85 over \$50] as will equal, when added to \$50, the outstanding mortgage debt of \$55.

Comparing the amount recoverable from the completion guarantor in those three situations (zero, \$2 and \$5) with the amounts the lender would hope, at a minimum, to recover in those situations (Line G above - \$10, \$22 and \$10) gives some indication of the shortcomings of a guaranty of completion. Moreover, those amounts recoverable are a far cry from the indicated costs to complete (Line F above - \$35, \$47 and \$35).

The amounts in each of the above situations can be changed to account for different assumptions. The amount recoverable from the completion guarantor will depend on the particular combination of the variables.

A guaranty of completion may implicate other issues beyond those touched on in this article (e.g., to what extent, if at all, can the lender recover ongoing real estate taxes if completion is delayed? ongoing interest carry? tenant-improvement costs? what risks are involved if the lender binds itself in the guaranty of completion to advance to the completion guarantor the undisbursed loan proceeds following a default? how do you value an uncompleted project? when is value measured? can the basic principles of damages law be altered by agreement?). However, even in the absence of exploring those complicating issues, the foregoing discussion suggests that a guaranty of completion – even at its most straightforward – offers considerably less benefit than a construction lender might expect.

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