Why Your Construction Contract and Loan Documents Should Sing the Same Tune

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Introduction

The design of your future home is now down on paper, you have been approved for a construction loan, chosen a builder, and signed a GHBA Construction Contract: congratulations! Now you can sit back and relax — well, not really.

Turning your ideas for a new Home into reality will require a lot of input from you; and hopefully that will be part of the fun. But even before construction begins, there is one subject to which you should turn your attention; one subject that can either help the building process move smoothly toward a harmonious conclusion or cause it to grind to a dissonant halt. That subject is the interplay between your GHBA Construction Contract and the loan documents prepared by your construction lender.

Your lender will not only want you to sign a promissory note for your construction loan, but will also prepare a "Mechanic's Lien Contract" for you and your builder to sign. In many ways, the ML Contract serves the same purpose as the GHBA Construction Contract you already signed with your builder. **Unfortunately, ML Contracts often have provisions that conflict with the GHBA Construction Contract. And, these conflicts impose limitations on the construction process that can complicate construction and slow its progress.**

The good news is that you can make a difference by helping *your* Lender and *your* Builder work together to harmonize the ML Contract and the Construction Contract. This Article will help you to recognize some of the conflicting provisions and understand the potential problems so you can take steps to alleviate them.

Modifications to the Payment Procedure

Nothing will delay a project like an overly complicated payment procedure. And, funding a construction loan, in general, is straightforward. Your lender will develop a list of values for various categories of the construction process (for example, the foundation, the framing, and the plumbing). As the builder performs work in each of those areas, the builder can request payments (called "Draw Requests") for that portion of the work. Similarly, the GHBA Construction Contracts offer a practical, streamlined, and simple payment process designed to help the parties achieve the purpose of the Construction Contract: building your home. Many ML Contracts, however, impose cumbersome rules and procedures that weigh the payment process down.

One of the ways ML Contracts modify and complicate the payment procedure is to limit how often Draw Requests can be submitted. Your builder should not have to finance the construction from its operating funds (that is why the lender is there). But, if Draw Requests are limited, the builder and its subcontractors have to shoulder that burden and a slower pace can result.

Secondly, the lender may require the builder to secure "lien releases" from those subcontractors who have performed work and are to be paid. Not only does requiring lien releases add to your builder's administrative burdens (taking focus away from actual construction activities), but obtaining lien releases from *all* subcontractors and suppliers may simply be impossible. For example, your builder will not be in contact with the suppliers and sub-tier contractors used by your Builder's subcontractors and therefore will not have the opportunity to secure lien releases from them. Also, some suppliers and retailers simply will not provide lien releases. And, the amounts the builder pays to many subcontractors (miscellaneous hardware purchases, trash removal, etc.) are simply insignificant in the context of the entire project.

Finally, requiring the builder to secure lien releases before receiving payment of a Draw Request requires the builder to pay those subcontractors and suppliers *before the builder receives payment from the lender*. That means that the builder is required to fund construction from its operating accounts rather than using the funds from the lender to pay the subcontractors and suppliers. The builder should not be burdened with this obligation. A better alternative is to ask the builder to show that it paid major subcontractors and suppliers from the *preceding* Draw Request before paying a *current* Draw Request.

Your builder will also be quick to point out that the GHBA Construction Contract includes an agreement by the builder to protect the Owner against all lien claims, even those of sub-tier contractors and suppliers who the builder does not pay directly. So, requiring lien releases imposes undue financial burdens on the builder and will only slow the building process.

Other Issues Raised by ML Contracts

ML Contracts often have provisions that modify the standards for performance. The GHBA Contract establishes objective criteria for judging contract performance (e.g., detailed specifications of materials and plans that show how they will be assembled). ML Contracts, on the other hand, will include subjective criteria, such as "good and workmanlike" and "to the lender's satisfaction." These conflicting standards undermine the "meeting of the minds" that took place when you and your builder entered into the construction contract. It is important to limit subjective criteria so that the parties know when compliance with the contract has occurred.

Other conflicting provisions in ML Contracts involve the process by which you and the builder will address and resolve any conflicts that arise, and the procedure for changing the scope of the Work. This latter topic is particularly important, because the lender should not unduly restrict your freedom to make changes as construction progresses; ***that is what a custom home project is all about***. All of these areas, and others, can seriously impact the Builder's and Owner's legal rights and make performance of the Construction Contract more costly and difficult.

So what can be done? Remember: this is *your* construction project and *your* loan. Work with your Builder and your Lender to harmonize the ML Contract and the Construction Contract, and soon everyone will be singing the same happy tune.