



Law Alert

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Construction Loan Draw Procedures - Residential and Commercial

Construction lending requires a high degree of diligence to mitigate its inherent risks. One small but often neglected aspect of construction lending is the draw process. Construction lenders do not typically disburse the entire amount of a construction loan at the time of the loan closing or on the date the project starts. “Draws,” or releases of portions of the loan proceeds, usually occur upon completion of a pre-designated stage (pouring of the foundation, building under roof, etc.) or periodically (once a month for a specified number of months followed by a “final draw”) and certain precautions must be observed to reduce the risk of loss and lawsuit.

Draw requests

Upon completion of a designated stage of work or at a time specified in the construction loan agreement, the contractor will submit a draw request to the lender for review and approval. This submission causes a flurry of activity, in part because the approval process is very involved and in part because the contractor needs the draw request processed quickly to have ready access to funds necessary for timely payment of subcontractors. The draw request may be on a form supplied by the lender, but often the American Institute of Architects (AIA) G-702 (Contractors Application for Payment) and G-703 forms (Continuation) are used.

The purpose of these forms is to provide the information necessary for the lender to verify what work is supposed to have been completed and by whom to make sure the loan remains “in balance,” no mechanic’s liens have been filed and work is progressing on schedule. The forms include, most importantly, the balance available to finish the project as well as the architects certification of the percentage of completion and confirmation that the work completed meets the contract specifications. The latter two items are very important for the lender to know in reviewing and approving any draw requests.

Title insurance

The lender will have required the issuance of an ALTA (6-17-16) Lender’s Policy of Title Insurance at the time the loan closed, in an amount equal to the loan. However, the nature of a Lender’s Policy is that the policy limits decrease, dollar for dollar, based on reductions in the principal balance of the loan. Therefore, it is only logical (yes, the law is not always logical) that the policy limits of a construction loan increase, dollar for dollar, based on the amount of the principal actually outstanding. As a result, though the face amount of a Lender’s Policy will be equal



to the amount of the loan, the amount of coverage will only be equal to the amount actually disbursed in accordance with the terms of the policy. It is for this reason that a Lender's Policy – and the ALTA Commitment For Title Insurance (6-17-06) – contain a "pending disbursement" provision.

Each time the contractor requests a draw from the undisbursed loan proceeds, the lender must contact the title company, who will update the title from the date of the policy or the date of the last update, as applicable. Assuming there are no adverse changes, such as a mechanic's lien affidavit having been recorded since the date and time of the last update, the title company will issue an endorsement that will increase the amount of the coverage by the amount of the current draw. The cumulative effect is that the amount of coverage available under the policy will be the total of the amounts disbursed in accordance with the requirements of the pending disbursement provision.

Residential loans: duties to the buyers

The Ohio Revised Code imposes potential liability on lenders providing mortgage financing for construction contracts and home purchases. Lenders for these types of projects have two types of duties to the buyers.

First, Sections 1311.011 B(4) and B(5) require that the lender obtain certain types of documentation before making a loan disbursement to an "original contractor" as compared to the property owner. The duties imposed by Section B(4) are mandatory and if not satisfied, can lead to responsibility to the homeowner as well as the unpaid subcontractors. Basically, Section B(4) requires the lender to obtain conforming signed affidavits. These requirements include the following:

- A statement that the original contractor has paid in full for all labor and work performed and for all materials furnished by the original contractor and all subcontractors, material suppliers and laborers prior to the date of the closing of the purchase or during and prior to the payment period; or
- A statement that the original contractor has not paid in full for all labor and work performed and for all materials furnished, identifying such unpaid claims both by claimant and by amount claimed; and
- That no claims exist other than those claims set forth and identified in the affidavit required by division B(4) of this section.

Section B(5) states that the lender may rely on the affidavit unless it appears on its face to be fraudulent. However, the lender cannot ignore notices from claimants. It is very likely to be responsible to the homeowner and the subcontractor if it relies on an affidavit of payment in full after the lender has received notice of a claim from a subcontractor.

Second, the lender has certain obligations in terms of the resolution of disputes between the original contractor and the subcontractors. This section of Ohio law requires the lender to withhold certain monies in the event of disputes between the parties.

While the architect is reviewing the work in the field and the title company is reviewing the title in the public records, the lender is also reviewing the lien waivers and affidavits submitted along with the draw request by the general contractor. Lien waivers and affidavits should match forms G-702 and G-703 in terms of the names of subcontractors, amounts paid to date, amount due for the current draw and balance remaining on the contract. The lien waivers and affidavits relate only to the period covered by the draw, and the lender will make sure there is a lien waiver and affidavit in place for each subcontractor and supplier listed in the draw request form. As you can imagine, a large job will involve a mountain of paperwork.

To make sure monies are properly applied, the lender or disbursing agent can make checks payable to the subcontractor directly. Or, checks can be made payable to both the contractor and the applicable subcontractor. The latter is the most conservative way to proceed, hypothetically requiring both parties to endorse the check and ensuring that the subcontractor and or supplier is paid if the check is cashed. It is not unusual however for lenders to make checks payable directly to the contractor if no liens have shown up and no notices from unhappy subcontractors have been received.

Lenders usually withhold a specified percentage of the loan proceeds ("retainage") from each draw as extra protection or a safety net against not having enough money to finish the job in the event of a problem and to give the contractor an incentive to finish the work in accordance with the contract requirements. Following completion the contractor will receive the final draw and the retainage. Having this money available is a benefit to both the lender and the borrower. In Kentucky, the law prohibits retainage of more than 10 percent initially or 5 percent once more than 50 percent of the work is completed.



By comparison, for private construction projects in Ohio, despite some recent attempts to change the situation, there is currently no limit on the percentage of retainage.

The lender also needs the project budget to remain “in balance.” This means that there will always be enough undisbursed funds available to finish the job if the contractor were to be unable to complete the project for any reason. It is for this reason that an inspector and or architect will visit the site and inspect the work. They need to feel comfortable that the percentage of the work claimed by the contractor to be complete is, in fact, complete because the lender is basing approval of the draw on that representation.

Credit union lenders

Though Section 1311.011 imposes certain duties on residential construction lenders, Ohio Administrative Code Section 1301:9-2-22 imposes additional requirements on credit unions making real estate construction loans. This section requires that the credit union lender use one of three methods for the disbursement of loan proceeds. These are:

- “Progress payments” or a “draw plan,” which is essentially the payment of loan proceeds to the contractor upon completion of specified stages of the project. This is generally less than optimal since it does not provide a mechanism for the lender to verify that the subcontractors have been paid.
- The “Voucher” method, which requires the credit union make payments directly to the subcontractors and material suppliers. The vouchers are based on lien waivers provided by the subcontractors and material suppliers and may involve a retainage held by the lender.
- The “Title Insurance” method, which involves a title company updating the title for each draw, issuing an endorsement for each draw showing the lender to still be in first lien position and disbursing the funds. The credit union however is still responsible to inspect the work to make sure that the loan remains in balance.

Construction lending can be financially rewarding but must be documented and administered with attention to detail. With the help of an experienced team of professionals, construction lenders can successfully navigate these challenging waters.