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Exposure and Remedies under Completion Guaranties

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Under a completion guaranty, sometimes referred to as a "cost overrun guaranty," the guarantor typically guarantees any excess of the cost of completing construction over the portion of the construction loan allocated to funding construction costs.

The lender will usually have all or some of the following three remedies: (i) requiring the guarantor to complete construction, in which case the guarantor will be entitled to draw undisbursed amounts of the construction loan allocated to construction costs, as these costs are incurred; (ii) the lender itself completing the construction, with the guarantor being obligated to reimburse the lender for costs incurred to the extent they exceed the undisbursed loan amount allocated to construction; and (iii) most importantly, collecting from the guarantor a payment in an amount equal to the estimated cost of completion less any undisbursed loan proceeds allocated to construction, which is referred to as a "liquidated damages" remedy. The guaranty will usually provide that the cost estimate is to be made by the lender's construction consultant, sometimes with the lender having the right to approve or override the consultant's estimate. The construction consultant and/or the lender will typically be required to make the estimate in good faith, sometimes with a reasonableness standard, and, although not typical, under some completion guaranties the guarantor will have the right to have the liquidated damages determined by arbitration.

The liquidated damages remedy is important to the lender for several reasons. This remedy gives the lender maximum flexibility in that it allows the lender to terminate the guarantor's involvement in the project, as opposed to requiring the guarantor to complete construction, and does not require the lender to itself perform any construction, as would the remedy of being reimbursed by the guarantor for cost overruns. The liquidated damages remedy allows the lender to monetize the guarantor's obligation and collect it irrespective of whether the lender completes construction. In addition, since the liquidated damages can be rapidly determined (assuming no arbitration provision), it affords the lender additional leverage in negotiating a settlement or workout. The party liable under the completion guaranty will often also be the guarantor under a carry guaranty, under which the guarantor guarantees to the lender the payment of interest, taxes, insurance and other carry costs. A carry guaranty may allow the guarantor to terminate the guaranty and cut off its continuing liability thereunder by tendering to the lender a deed-in-lieu of foreclosure upon satisfying specified tender conditions. These conditions will often include that the guarantor has satisfied its obligations that are then due and owing under all other guaranties relating to the loan. Because liquidated damages can be quickly determined and demanded, this remedy under a completion guaranty affords the lender the ability to exert pressure on the guarantor by requiring that it pay the liquidated damages in order to satisfy the tender conditions under the carry guaranty and terminate its ongoing liability for carry costs.

The guarantor, in negotiating a completion guaranty, will want to make sure that it is guarantying nothing more than construction cost overruns, and that it is given full credit for undisbursed construction proceeds, as well as any reserves held by the lender that are intended to cover construction costs, including reserves funded due to balancing calls. Loan documents typically give the lender the right during the continuance of an event of default to apply reserves against any obligations under the loan documents, as determined by the lender in its sole discretion. Although usually overlooked by the guarantor, the guarantor should want the completion guaranty to provide that it will be given credit for any funded balancing calls covering construction costs and other construction reserve amounts that the lender applies to obligations other than the guarantied construction costs. If the lender requires the guarantor to complete construction, the guarantor will want to exclude from the conditions that it is required to satisfy in order to draw construction proceeds any conditions that it is incapable of satisfying (*e.g.*, the failure of the borrower to comply with

special purpose entity requirements), as well as any conditions that would require it to expend funds beyond the amounts that it is otherwise liable for under the completion guaranty. The most favorable outcome for the guarantor is to limit its draw conditions to those that directly relate to the construction (*e.g.*, adequate performance of the work, delivery of architect's or contractor's certifications and delivery of lien waivers).

In the event that the lender chooses to complete the construction and seek reimbursement from the guarantor, the guarantor will want to limit the lender's ability to do things that can potentially increase costs, such as modifying plans and specifications and replacing construction and design contracts. The lender, however, will want at least some flexibility to modify plans and specifications and to replace contractors when it believes it is necessary to do so. Finally, bad act guaranties sometimes cover losses arising out of mechanics' liens. The guarantor will want to exclude mechanics' liens arising out of the construction work guaranteed under a completion guaranty because, unlike a completion guaranty, under a bad act guaranty the guarantor is not entitled to credit for undisbursed construction proceeds.

As the above is intended to demonstrate, completion guaranties require careful attention at the negotiation phase, including coordination with other guaranties, from the guarantor's perspective, to ensure that the guarantor is not taking on exposure beyond construction cost overruns, and from the lender's perspective, to ensure that the lender has adequate remedies should it become necessary to invoke the guaranty.