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CONSTRUCTION FINANCE DOCUMENTS, RISKS AND STRUCTURES UNDER THE SPOTLIGHT

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1. Introduction

Whilst Jane in her presentation has focussed primarily on project financing the emphasis of my presentation will be on general construction projects in New Zealand, the vast majority of which, in recent years, have been high-rise inner-city apartment buildings, boutique hotels and other tourist accommodation. References to *developments* during the course of my presentation are to developments of that nature.

Whilst the financier of such developments, like the project financier, relies on the revenue stream to achieve repayment of the funding provided, these types of development, unlike a project financing situation where repayment is achieved over time from the operation of the project, see repayment occurring from pre-sale receipts within a relatively short time frame. Nonetheless the issues for the financiers of the two types of development are similar.

2. Development Funding in New Zealand

By way of background in New Zealand in recent years there have been more contractor failures on major developments than there have been developer failures. The lower failure rate of developers in the main can be attributed to the fact that most developments are undertaken by single purpose vehicles which have no liabilities or creditors other than those associated with the particular development. Insofar as major developments are concerned, most financiers would not entertain a developer other than a single purpose vehicle unless the developer is substantial and has a proven track record. Most major developments in New Zealand also involve a mezzanine funder who has limited enforcement rights (usually having to wait until practical completion has been achieved or the first securityholder (who I will call *the first financier*) has enforced), has the right to accrue, but not to receive interest and receives no repayment of principal until the first financier has been repaid in full. The equity of the developer and the mezzanine funding must have been put into the project before the first financier is under any obligation to make its funding available.

In most developments the financier will impose as preconditions the requirement that the amount funded be covered by unconditional pre-sales of the units in the development and that the construction contract be for a guaranteed maximum price. The financier's requirement of a guaranteed maximum price contract has led to a number of contractors insisting on the novation to them of the arrangements entered into by the developer with the various consultants involved in the project. Full novation of design risk to the contractor is insisted on by some financiers but is definitely not the norm. On occasions financiers may be comfortable with the inclusion of provisional allowances in a guaranteed maximum price contract but only in respect of items where the setting of the actual cost is transparent and capable of being accommodated well within the contingency allowance.

Furthermore, the injection of the developer's equity and the mezzanine funding before any of the financier's funds are drawn, means that that part of the project below ground level (being the area where there is the greatest potential for cost overruns), is likely to have been completed before the first drawdown of the financier's funds occurs. Any substantial cost overrun in this area is likely to result in additional funds being required from the developer or mezzanine funder before the financier makes its funds available. This provides a reasonable degree of comfort for the financier insofar as cost overruns are concerned and in situations where there is a fully novated guaranteed maximum price contract an even greater level of comfort is provided.

Jane in her paper mentions a recent trend emerging where developers and contractors are looking for ways in which to share more cost overrun risk. With the exception of the inclusion of provisional allowances just discussed (which is not risk sharing in the truest sense), I am not aware of any of these sharing arrangements in general construction projects in New Zealand. There are however examples of the sharing of risk in infrastructure projects, principally in the roading area.

3. Timely Completion of Development

3.1 Completion Delays

As with project finance transactions the completion of the development on time and the risk of late completion is an important issue for a financier. If completion of the development is delayed, that part of the funding allocated for interest capitalisation may be insufficient and there is a risk that any sunset dates contained in the presale agreements may be overrun. Between 2002 and 2004, as a consequence of labour shortages, there were completion delays on most major projects resulting in cost escalations, disputes over liquidated damages and losses for developers on a number of developments. Whilst the escalation in property values in New Zealand over the past 4-5 years has resulted in few purchasers exercising their cancellation rights as a consequence of the sunset date having expired, the levelling out of inner city apartment prices, particularly the less expensive apartments built with Asian student occupants in mind, is likely to result in a greater number of purchasers exercising their cancellation rights in circumstances where the market value of the apartment on completion is significantly less than the purchase price. More than ever before the enforceability of presale agreements is of the utmost importance to financiers and the onus is clearly on the financiers solicitors to ensure the efficacy of the agreements.

3.2 Impact of the Building Act 2004

An additional concern for financiers in New Zealand is the impact of the Building Act 2004 which requires the issue of a Code Compliance Certificate prior to the transfer of title or possession being taken of the residence confirming that the work carried out complies with the Building Code. Whilst the developer and purchaser are able to contract out, utilising a form prescribed by Regulation, the view is that contracting out is unlikely. As the issue of a code compliance certificate will come in some cases well after practical completion has been achieved, prudent developers will be looking to pass the delay costs on to the contractor.

The developer may therefore seek to have the contractor obtain the Code Compliance Certificate as part of practical completion (so any delay is to the contractors account by way of liquidated damages). Alternatively the developer may seek an indemnity for any extra delay in the issue of the Code Compliance Certificate if it delays settlement of presales and/or a greater retention or bond to ensure the Code Compliance Certificate is ultimately obtained. A quantity surveyor I spoke to as part of preparing this paper was of the view that contractors will strenuously resist the issue of the Code Compliance Certificate being linked to practical completion.

More likely, at the behest of their financier, developers will make the building consent documents contract documents so that full compliance with the consent documents will minimise the risk that practical completion measured against the building consent documents won't also achieve full Code Compliance. Some developers have adopted the practice of having the territorial authority approve works on a progressive basis as each floor is completed so that on practical completion outstanding issues are likely to be confined to the top two or three floors thus streamlining the issue of the Code Compliance Certificate. Of course, significant variations to the development during the course of construction may necessitate a new building consent to ensure full Code Compliance is achieved at or shortly after practical completion.

Particular attention should be paid as to what triggers the satisfaction of the sunset date condition. From the financier's point of view, satisfaction of the condition should be triggered at the earliest opportunity either on the issue of separate title or practical completion being achieved (assuming that the obtaining of the Code Compliance Certificate is not part of practical completion). It is predicted that there could be considerable delays in obtaining Code Compliance Certificates with the consequent risk to financiers of purchasers cancelling presale agreements due to non satisfaction of the sunset date condition and units having to be resold in a declining market.

4. Securing Completion of Development

Jane in her paper has dealt with the guarantees, undertakings and other safeguards which financiers commonly require the developer to obtain from the contractor. These include direct agreements, retentions or bank undertakings or bonds and guarantees from the contractor's parent company. The practice in New Zealand with respect to retentions, bank undertakings and bonds is similar to that in Australia. The major contractors prefer retentions to be drawn on a monthly basis and held by a stakeholder however in most situations the retention remains undrawn until the time comes for payment to be made to the contractor. Bonds or bank guarantees are required in the case of most developments to a level of around 5% of the contract price. Guarantees from the contractor's parent are not common in the New Zealand context.

4.1 Direct Agreements

Direct agreements are a relatively recent arrival in New Zealand having been on the scene for the last 3-4 years. It is interesting to note Jane's comment that "*by entering into a direct agreement, the construction contractor is effectively being asked to weaken its position under the construction contract ...*". Although not disputing the comment, in New Zealand the entry into direct agreements was initially driven by the major contractors, in particular, Multiplex, rather than the Banks. This was brought about as a consequence of contractors not receiving their final payment or retention moneys from developers due to the financier having been repaid in full from pre-sale proceeds and the developer either not being in a position to make, or choosing not to make, the payment from its own resources.

Some financiers then determined that there was benefit to them in having the ability to control payments made to the contractor, being made aware of defaults on the part of the developer, having the opportunity to remedy any default on the part of the developer, and, as a last resort, stepping into the shoes of the developer and completing the development. One or two financiers insisted on direct agreements in almost every case, whereas others were selective of the transactions in which a direct agreement was a precondition to the loan being made available. Now all major developments and most developments over $10 million have direct agreements.

4.2 An Alternative to a Direct Agreement

The legal costs involved in putting into place a direct agreement are significant and in some cases have been as much as the legal costs for the rest of the funding transaction. Obviously this has been a concern for developers and prompted Westpac to look for a viable alternative. It was a strongly held view of Westpac Credit in New Zealand, that Westpac was not a developer and would accordingly, in no circumstances, exercise step-in rights and in effect become the developer. As indicated earlier, due to most developers being SPVs, developer failure on major projects in New Zealand in recent times has been rare and Westpac, in the unlikely event of a developer failure, would either appoint a receiver or, depending on the stage of the development and its exposure, sell the development warts and all.

The considerable cost referred to earlier and Westpac's decision not to require step-in rights led to Westpac negotiating with the major contractors a form of direct payment letter of two pages which has annexed a page of acknowledgments and undertakings from the contractor and a page of acknowledgements and authorisations from the developer.

The direct payment letter records the basis upon which funds will be made available by Westpac to the developer for direct payment to the contractor. That portion of the loan allocated specifically for payments to the contractor is identified as the *Allocated Sum*. Direct credit payments are made to the contractor's bank account by the Bank of amounts certified by the Bank's quantity surveyor on a cost-to-complete basis. The amount certified by the quantity surveyor may not necessarily equate to the developer's payment obligations under the construction contract but this seems to have been accepted by contractors and I am not aware of any contractor calling a default as a result.

Under the letter the Bank is under no obligation to make any payment if there are outstanding defaults under the loan facility or securities, if the loan facility or securities have ceased to be enforceable or if it is not satisfied with the form and substance of the quantity surveyor's certificate. In such event the Bank must give a *Withheld Payment Notice* to the contractor advising that it will not be making the payment which, but for the default, unenforceability or unacceptable nature of the quantity surveyor's certificate, would otherwise have been made. If the Bank issues a *Withheld Payment Notice* the contractor is able to request the Bank's quantity surveyor to prepare a cost-to-complete certificate as at the date the Withheld Payment Notice was issued and the Bank is required to pay to the contractor the lesser of the amount certified for payment by the quantity surveyor and the *Undrawn Allocated Sum* (the *Undrawn Allocated Sum* being that part of the loan allocated specifically for payments to the contractor which has not been drawn). Following the making of such payment the Bank has no further obligations to the contractor.

Upon practical completion being achieved, the Bank is required to pay to a stakeholder (usually the developer's solicitor), the *Undrawn Allocated Sum* which is held by the stakeholder upon the terms agreed between the developer and the contractor thus affording protection to the contractor in respect of the final payment and retentions.

Each of the Bank and the contractor agree to notify the other of any default on the part of the developer as a consequence of which, in the case of the Bank, there is likely to be a delay in a payment being made (or payment not being made at all) and, in the case of the contractor, the contractor intends suspending performance under the construction contract, cancelling the construction contract or commencing enforcement proceedings against the developer. Upon receipt of any such notice from the contractor, the Bank has 5 days within which to remedy the default and keep the construction contract on foot.

Under the developer's acknowledgment and authorisation annexed to the letter, the Bank is authorised to pay directly to the contractor all payments envisaged by the letter and the developer acknowledges that the Bank is entitled to maintain all of its securities until such time as the Bank is satisfied that it has no further obligations to the contractor. The contractor in its acknowledgement and undertaking agrees, inter alia not to vary the terms and conditions of the construction contract without the Bank's consent.

The form of the direct payment letter, having been accepted by the major contractors, is issued by Westpac and signed by the parties without negotiation. The time and cost involved in putting such a letter in place is negligible and it is interesting to note that a number of those contractors who have accepted the letter, when entering into a fully fledged Tripartite Deed or Direct Payment Agreement, still negotiate aggressively on issues in respect of which they have made concessions when agreeing to Westpac's Direct Payment Letter.

5. Typical Securities

In addition to a mortgage over the land involved and a general security agreement over present and after acquired property, financiers in New Zealand typically take security over the construction contract, the presale agreements, and, in the case of a commercial or industrial development, the leases or agreements to lease.

5.1 Contractual Remedies Act 1979

When taking security over construction contracts, pre-sale agreements and leases or agreements to lease a financier in New Zealand needs to be aware of the implications of section 11 of the Contractual Remedies Act 1979. The first two subsections of that section provide as follows:

> *"11. **Assignees -** (1) Subject to this section, if a contract, or the benefit or burden of a contract, is assigned, the remedies of damages and cancellation shall, except to the extent that it is otherwise provided in the assigned contract, be enforceable by or against the assignee.*
> *(2) Except to the extent that it is otherwise agreed by the assignee or provided in the assigned contract, the assignee shall not be liable in damages, whether by way of set-off, counterclaim, or otherwise, in a sum exceeding the value of the performance of the assigned contract to which he is entitled by virtue of the assignment."*

The section makes no distinction between contracts assigned absolutely and those assigned by way of security. In taking such securities there is clearly an inherent risk to the financier of the financier being liable for damages under the contract the benefit of which has been assigned or provided to the financier by way of security.

In *Gray v UDC Finance Limited* [2000] 3 NZLR 192 the contractor for an apartment development required a payment guarantee before it was prepared to start work. UDC Finance Limited provided the requisite guarantee and as security the developer assigned to UDC by way of mortgage the agreements for sale and purchase and the amounts payable by the purchasers under the agreements. The development was unsuccessful and the developer was wound up. The purchasers settled their respective purchases but then alleged that they had suffered losses as a result of various misrepresentations made to them by the developer. As the developer was in liquidation the plaintiffs sued UDC for damages for breach of contract under the agreements for sale and purchase relying on the provisions of section 11(1). UDC did not dispute its liability under section 11(1) but unsuccessfully put forward the argument that, in the particular case, the "performance" referred to in section 11(2) had no present value due to the amounts payable by the various purchasers having already been paid to the contractor. This argument was not accepted in the first instance by the Master and the Master's decision was upheld on review by the High Court.

Accordingly it can be argued with some certainty that by virtue of Section 11 financiers are at risk in losing the benefit assigned as a consequence of a subsequent claim brought by a purchaser or lessee.

In most scenarios the assignee financier could expect to be indemnified by the assignor in respect of any loss suffered, but this is likely to be cold comfort in circumstances where the developer is a special purpose vehicle and has no assets other than the development itself. The typical form of notice of assignment stipulates that the assignee is not liable to perform the assignor's obligations under the contract however such a provision is unlikely to provide total protection for the financier under section 11. Some forms of notice provide for the party to whom the notice is addressed to acknowledge that for the purposes of section 11 the remedy of damages is not enforceable against the financier in respect of the contract assigned. Whilst this may constitute an estoppel if the acknowledgement is signed by the recipient of the notice, section 11(1) requires any exclusion from the liability to pay damages to be in the assigned contract. As the majority of major developments in New Zealand are undertaken by a relatively small group of developers, it is my view that financiers as a group, should be requiring those developers to include in their standard form contracts an acknowledgement to the effect that the remedy of damages is not available against the developer's financiers.

More often than not the forms of notice are held by the financier and the decision as to whether or not they should be served on the purchaser or lessee made at the point in time when enforcement action is imminent. It may well be that the best course of action is to leave such notices in the bottom drawer but if they are to be served a possible solution to the problem could be the inclusion in the acknowledgement to be signed by the recipient of the notice of wording which in effect varies the contract by excluding the remedy of damages against the financier. The difficulty is of course, achieving execution of the acknowledgement by the purchaser or lessee at that time.