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Contractor Proof of Financing

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INTRODUCTION

In the construction industry, Proof of Financing (POF) is a form of evidence that a project owner has sufficient funds available to meet its payment obligations under the terms of the contract with the general contractor. In most cases, POF is necessary when the owner is a private entity and provides only limited visibility into its credit worthiness. A POF is not typically necessary when contracting with a large, well-capitalized corporation or a local or state municipality where financing is provided by a statutory authority to tax or issue bonds.

There are several ways a POF can take form, and some forms provide better evidence than others.

THE PURPOSE OF A POF

Every contractor should expect to be paid in accordance with the terms of their contract for the work they perform. A POF provides contractor reasonable levels of assurance and a line of sight into the source(s) of payment. Such proof enables the contractor to evaluate and manage one of the most significant risks of any project: the risk of not getting paid.

While a typical construction contract does create a legal obligation for an owner to pay the contractor for work performed and to meet other contractual mandates, the POF is designed to demonstrate that the owner currently and/or will have sufficient funds to meet its contractual obligations. Many times owners form entities solely for the purpose of developing and owning a specific project, and it can be very difficult for a contractor to assess the resources that stand behind the ownership entity.

There are countless examples where contractors relied on an established relationship with an entity that:

1. They knew to have sufficient resources, but the actual contractual owner was a special purpose affiliate through which there was limited or no recourse back to the entity where the original relationship existed
2. Had limited capital but was financing the project through an arrangement with a third-party lender through a financing agreement to which the contractor had no contractual rights.

POTENTIAL FORMS OF A POF

There are a variety of forms a POF can take. Each form provides a differing level of evidence and thus a different level of risk mitigation. The most common forms are:

1. **Standard Contract Proof of Financing.** One of the most common versions of this POF can be found in Article 2 of the AIA 201 Contract where contractor's right(s) and owner's obligations to ask for and demonstrate the source(s) of financing are stated. This provision is subject to broad interpretation and in most cases provides very limited assurance. There is a similar provision in the DBIA's standard contract
2. **Construction Loan Commitment Letter.** A commitment letter is often provided to satisfy the contractor's request under Article 2 above. At a minimum, the contractor should request, receive, and review such a letter for any project where the funding will be provided by a loan. As usual, the devil is in the details, and details in commitment letters are often scant. Things to evaluate include:
 - a. Size of loan. Is the loan sufficiently large to fund the project's contract value?

- b. Other costs – how will development, design, construction loan interest, and reasonable contingency costs be funded? Is the loan sufficient to cover all? If not, what are the other sources of financing?
 - c. Has the loan closed? A commitment is always subject to conditions of closing. What are they? Will they be met? How will the contractor confirm loan closing prior to putting costs at risk?
3. **Tri-Party Agreement and/or Disbursement Agreement.** Such agreements are explicit commitments the lender or other funding agent makes to both the owner and the contractor. They create an obligation by the funder(s) to pay the Contractor directly in the event of a payment default by the owner. For many reasons, these are difficult to get. Neither owners nor lenders like to make such commitments. Nevertheless, they are a legitimate means to protect contractors, especially when a project owner is a Special Purpose Entity (SPE) created exclusively for the purpose of developing, building, and owning a single project. It is entirely appropriate for a contractor to request both the owner and lender to provide such type of assurance. Even if the contractor is unable to obtain such a commitment, the request and discussion can be beneficial and lead to some compromise that provides more assurance than a simple commitment letter. An example of a Tri-Party Agreement is attached as an exhibit
4. **Financial Statements (for direct corporate entity funding).** When a project is being funded directly by the owner's balance sheet, a study of the owner's financial statements may be necessary. Is there sufficient cash and/or cash flow to meet the contractual obligations? Is the contractual owner the parent company, or is it an SPE that has been created with limited capitalization? In such cases, it may be legally possible to obligate the parent company to meet its subsidiary's payment obligations. But the purpose of a good POF is to avoid such scenarios by ensuring that the contractual owner will have the cash necessary to meet the contractual obligations
5. **Escrow and/or Letter of Credit (LOC).** Negotiating an amount of cash to place in escrow or a letter of credit with agreements that provide for the contractor to make draws against in the event of a payment default by the owner is a very effective form of POF. The amount of the escrow or LOC is typically based on the amount of payment exposure the contractor might have across the duration of the project (see more below in "Art or Science?")

ARE THEY ART OR SCIENCE?

While there is science to the determination of the need for a POF and the form it should take, much of the work and the associated negotiation is more a form of art than anything else. Contractors generally don't like to ask their clients probing questions about their financial capabilities. They may believe it sends signals of distrust or doubt and is counter to developing sound, trusted relationships. But in an industry where Travelers, the nation's leading surety company, reports that 58% of all contractor failures occur as a result of a single bad project, it's important to be assertive when it comes to the significant risks associated with payment. The following are a few things to keep in mind as you consider these discussions.

1. **Consider the terms of the contract.** When can you bill? What can you bill – actual cost or against a schedule of values? How quickly is the owner required to make payment? What rights does the contractor have to stop work (and stop incurring costs)?

2. Quantify your potential payment exposure

- a. Based on these contract terms, model the cash flow of the project. At what point(s) and by how much might the contractor be funding the project – e.g. using its own cash to build the job?
- b. Identify how much of this exposure is your cost, your fee/profit, or third-party cost (subcontractors)
- c. Factor in obligations to subcontractors. A GC working in a “paid when paid” state, for example, may analyze this differently

3. Determine the preferred sources for a POF.

If you are working with a new client with whom you have no experience, and they are developing the project through an SPE with little to no equity and financing the job through a construction loan, a wise contractor will pursue some meaningful POF protection. In most cases, the best achievable outcome will be somewhere in the middle of the continuum between a loose bank commitment letter and an “iron-clad” Tri-Party Agreement. A LOC sized to match the amount determined in number two above provides strong protection especially when the contract affords the contractor the right to stop work. Where the contract terms are more favorable to the owner (limited rights to stop work, for example), more due diligence on the financing and/or a larger escrow, LOC, or Tri-Party agreement warrants consideration

- ## 4. The art of this is in the approach with the owner.
- Recognizing that clients are understandably protective of their financial information and banking relationships, contractors ought to exercise care when initiating these discussions. This does NOT mean, however, that contractors shouldn’t raise the issue and make the request. Simply avoiding the difficult question will leave you completely exposed. Keep the following in mind:
- a. Remind yourself that this is good business. In asking, contractors are merely validating that they will be paid for meeting their contractual obligations, nothing more. And as GCs and CMs, they are ensuring that their valued trade partners are treated fairly
 - b. Be wary of the owner that is unwilling to engage in a reasonable discussion about this issue. We all want to work with owners that desire a win-win. An owner that “stiff arms” reasonable requests or deflects questions about how payment will be funded may not be an ideal client
 - c. Be flexible. There are numerous ways to get more assurance than is offered by a simple copy of a bank commitment letter. The most common, and in our experience, most effective, are identified above. There are certainly other options that collaborative owners and contractors can achieve when committed to a fair negotiation
 - d. Don’t assume that your lien rights or your right to sue or arbitrate under the contract terms provides adequate protection. Prosecuting these rights consumes enormous time and resources resulting in huge distractions from your core business functions. Be safe, not sorry!

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APPENDIX

Construction Loan Commitment Letter Example page 1 of 1

[Date]

Project XYZ, LLC
1 Main Street
Anytown, USA
Attn: John, Senior VP

Dear Mr. Doe:

This will supplement the Confidential Commitment Letter issued by [Name of Bank] and accepted by Project XYZ, LLC, on [Date] (the "Commitment Letter"). In the Commitment Letter [Name of Bank] committed to endeavor to form a syndicate of institutional lenders and accredited investors to provide the Revolving Facility and C/T Facility. We are pleased to inform you that we have been successful in forming the syndicate of institutional lenders and have procured commitments from such other lenders to fully syndicate both the Revolving Facility in the amount of \$2,500,000.00 and the C/T Facility in the amount of \$32,500,000.00 for total commitments in the amount of \$35,000,000.00. We are now ready to proceed with loan closing subject to finalization of documentation and satisfaction of each of the other conditions precedent for closing as set forth in the Commitment Letter and the Term Sheet attached thereto and your additional agreement to provide a completion guaranty.

In consideration of our successful efforts of fully syndicating the Revolving Facility and the C/T Facility, you agree that the Facility Fee shall be due [Name of Bank] regardless of whether or not the financing is closed, unless the reason that the financing fails to close is caused by [Name of Bank] or by one or more of the lenders.

Please evidence your acknowledgement and agreement of the foregoing by executing this letter where indicated below.

Very truly yours,

[NAME OF BANK]

(Authorized Officer)

ACKNOWLEDGED AND AGREE TO this ____ day of _____, 20__

PROJECT XYZ, LLC

(Authorized Officer)

APPENDIX

Tri-Party Agreement Example page 1 of 2

[Contractor Letterhead]

[Lender Name and Address]

Re: _____ (the "Project")

Dear sirs:

The undersigned, [Name of Contractor] (the "Contractor") understands that [Name of Lender] (the "Lender") has agreed to make a loan to [Name of Owner] (the "Owner"), which loan will be used to finance the construction by Owner of the Project. The Contractor has been engaged by the Owner to construct the Project pursuant to the provisions of the Form of Agreement Between Owner and Contractor dated, (the "Contract"). The Contractor and the Lender understand that execution of this letter is a condition of the Lender's making the loan and the Contractor's entering into the Contract.

The Contractor and the Lender hereby agree as follows:

1. The Contractor will not amend or modify the Contract, accept changes in the Work (as defined in the Contract), perform extra work, or furnish additional materials, without the prior Written consent of the Lender, which approval shall not be unreasonably withheld or delayed; provided, however, that the Lender's prior written consent shall not be required for individual changes and/or extras to the extent that the individual change order and/or extra does not exceed \$_____ and the total aggregate direct cost of all such unapproved changes and/or extras does not exceed the sum of \$_____.
2. The Contractor agrees to notify the Lender of any material default by the Owner under the Contract within ten (10) days after it notifies the Owner of such default, and the Contractor agrees that it will not terminate the Contract without providing thirty (30) days written notice to the Lender of its intent to terminate the Contract, during which period the Contractor may suspend its performance (if permitted to do so under the Contract), unless it receives written notice from the Lender as set forth in Paragraph 3 below. Material Default shall include any nonpayment within the time frames set forth in the Contract.
3. The Contractor agrees that, if requested to do so by the Lender in writing within thirty (30) days following a default (including nonpayment) by the Owner under either the Contract or the loan documents between the Lender and the Owner (the "Loan Documents"), the Contractor will resume or continue performance under the Contract for the Lender or such other financially responsible entity (in the Contractor's reasonable opinion) designated by the Lender, and will complete the Work in accordance with the Contract and at the guaranteed maximum price set forth therein, as adjusted pursuant to the provisions of the Contract, provided that the Contractor is paid in accordance with the Contract for all amounts due and owing under the Contract from time to time and provided further that the Lender agrees to assume all other obligations of the Owner under the Contract which remain unperformed from time to time.
4. The Lender agrees that, in the event the Owner defaults under the Contract (including nonpayment) and the Lender does not elect to have the Contractor complete the Work prior to termination of the Contract by the Contractor as set forth in Paragraph 3 above, the Lender will pay to the Contractor all sums due and owing under the Contract as of the date of termination.

APPENDIX***Tri-Party Agreement Example page 2 of 2***

5. All sums disbursed to the Contractor under the Contract shall be received and used for the payment of materials, labor, services, and other costs involved in the completion of the Work, including the Contractor's fees, and for no other purpose until all bills, claims and demands for said materials, labor and services have been paid in full.

6. The Contractor hereby represents and warrants to the Lender that, upon execution and delivery of the Contract by the Contractor, assuming valid and binding execution and delivery by the Owner, (i) the Contract will be a valid agreement of the Contractor to perform the Work encompassing all agreements between the Owner and the Contractor (other than the Guaranteed Maximum Price, which shall be agreed upon at a later date); (ii) the Contractor shall not have assigned or otherwise conveyed its interest under the Contract, nor permitted the Owner to assign or otherwise convey its interest under the Contract without the prior written consent of the Lender; and (iii) the Contractor will perform all covenants, conditions and agreements in the Contract to be performed by it as required therein.

7. The provisions set forth in this letter shall be binding upon the Contractor and the Lender and their respective successors and assigns.

Very truly yours,

[Name of Contractor]

(Authorized Officer)

Accepted and agreed to this ____ day of _____, 20__

[Name of Lender]

(Authorized Officer)

Accepted and agreed to this ____ day of _____, 20__

[Name of Owner]

(Authorized Officer)