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Risks of construction loans

by Debra B. Norris

Typical construction loans put substantial obligations on the borrower and seek to exclude liability for the lender if the lender disburses the loan proceeds improperly. Borrowers face the possibility of liens placed on their property if a construction lender disburses loan proceeds to a general contractor and the proceeds are not used to repay subcontractors and suppliers.

Lenders will usually require borrowers to obtain lien waivers from all subcontractors and suppliers who supplied labor and materials before advances are made. Construction lenders are concerned that mechanics liens will take priority over their own liens if the construction loan is not repaid. In some situations

the bank has undertaken to manage the disbursement of funds directly with resulting lender liability.

Lender liability usually arises in consumer situations where the bank has disbursed construction loan funds directly to the general contractor without first obtaining the approval of the borrower.

When an insolvent contractor fails to complete a home, banks have been held liable to borrowers if the bank failed to obtain lien waivers from the subcontractors and suppliers and to otherwise supervise the behavior of the general contractor.

In the case of *Norwest Mortgage, Inc. v. Salinas*, a Texas court found that supervising disbursements of loan proceeds and obtaining lien waivers are "services" under the Deceptive Trade Practices Act. If a bank does more than merely lend money, and in fact takes over the management of the construction loan, the lender may be held liable to homeowners under the DTPA.

The risk for a construction lender who improperly disburses loan proceeds has been expanded, at least in the context of residential construction loans.

Several courts have further held that exculpatory language in the construction loan documents, excluding liability for the lender, is not enough when the bank fails to follow its own lending guidelines.

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