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Developer's Council News

Loan in Balance Can Be Troublesome

HBA Developer members who develop subdivisions often finance that work through bank loans, starting with a development loan and then permanent financing once the work is complete. While borrowers can sometimes negotiate for non-recourse debt (i.e. no personal responsibility beyond "bad- boy" acts), many loan provisions are not negotiable; among them the "loan-in-balance" provision. This is not ignorable boilerplate but an important term of art borrowers must understand.

Banks' lending limit is dictated by the loan-to-value ratio. In other words, banks will only lend up to X% of the project costs and require borrows to maintain a minimum equity percentage at all times during the term of the applicable loan(s). Borrowers and developers hope their project increases in value as improvements are made, but factors outside of their control can reduce values (e.g., changes in the economy). If a property decreases in value, under a typical loan–in-balance provision, the bank can require the developer to immediately pay down the bank debt to prevent the bank from exceeding the maximum loan-to-value ratio. This can have a devastating effect on a project. Unless the borrower has cash on hand to pay down the debt, the borrower will struggle, the bank may declare an event of default and stop funding, contractors and subcontractors will not be paid, and liens may pile up. This happened to multiple projects during the great recession, causing certain developers to go out of business.

Developers and borrowers are unlikely to have this requirement deleted from loan documents, and as a result, must carefully monitor cashflow and construction progress to ensure adequate working capital is on hand to service both the bank debt and construction costs.

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