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Long Term Construction Defect Liability Claims May Await Lenders Who Foreclose on New Condominium and Tract Housing Projects in California

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The lender that understands and has carefully assessed the risks associated with long term construction defect claims on new condominium, town home and tract housing projects in California, has taken the first step to minimizing its exposure before it makes the decision to foreclose on their non-performing for-sale housing development construction loans.

What is SB 800 and why should lenders and receivers be knowledgeable or concerned about it? The issues raised in this article should play a significant role in determining the disposition of Non-Performing For-Sale Housing. California has led the nation in construction defect litigation resulting in large multi-million dollar judgments against builders. It is likely to now become a significant pitfall for lenders who decide to place in receivership or foreclose on new for-sale housing development projects and especially those that require further construction to complete and/or to repair. Many lenders have been advised that they are exempt from such claims because of the protections afforded by California Civil Code Section 3434. As discussed below, 3434 may <u>not</u> provide the perceived lender protections.

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By far and away these judgments are a result of run-away juries in civil actions. Even in those situations where the claims are meritless, the builder and the insurance companies have often incurred extremely large defense fees and costs defending the actions. Senate Bill 800 (contained in Title 7 of Part 2 of the Civil Code) ("SB 800"), is a complex piece of legislation which was enacted to attempt to reduce the number of potential actions. Even worse, this problem is further compounded by the fact that homeowners and homeowners associations have up to 10 years (in most cases) to file an action for construction defects, with most construction defect claims occurring more than eight years after the project was completed.

Although no court in California has specifically ruled on the topic, it is highly likely that plaintiff's attorneys will file suit and name commercial lenders who: foreclose on unfinished for-sale housing projects and subsequently undertake the completion of the improvements, have to make significant post-completion repairs (as is often the case when new housing developments get in trouble), or decide to sell out the balance of the units/lots to members of the general public. It will be argued that such lenders fit within the broad definition of "Builder" for the purposes of SB 800.

In defense of such claims, lenders' counsel will more than likely argue that lenders are exempt from such claims by asserting the protections of California Civil Code Section 3434,enacted in 1969, which provides lenders with protection from the acts and actions of the builder/borrower.

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California Civil Code Section 3434 reads:

> "A lender who makes a loan of money, the proceeds of which are used or may be used by the borrower to finance the design, manufacture, construction, repair, modification or improvement of real or personal property for sale or lease to others, shall not beheld liable to third persons for any loss or damage occasioned by any defect in the real or personal property so designed, manufactured, constructed, repaired, modified or improved or for any loss or damage resulting from the failure of the borrower to use due care in the design, manufacture, construction, repair, modification or improvement of such real or personal property, unless such loss or damage is a result of an act of the lender outside the scope of the activities of a lender of money or unless the lender has been a party to misrepresentations with respect to such real or personal property."

It is the portion of the legislation that I have bolded and highlighted in red above that is going to be the fertile ground for allegations by plaintiffs lawyers and as supported by the especially broad definition of builder in SB 800. Although the California courts have traditionally provided lenders with significant protections for lenders acting within the scope of their duties as a lender, the cases don't give much "on point" direction or comfort upon which to give guidance to handle the new factual situations that we will be confronting. The goal is to make sure that clients are aware of the risks and don't simply take situations for granted because of the historical benefits that have emanated out of 3434. Failure to adequately prepare for these risks is likely to force lenders to expend substantial monetary and staff resources to defend SB

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800 claims and to incur possible liability in a court system that has demonstrated a strong intention to protect consumer protection rights and options.

The good news is that lenders can avoid long term construction defects liability in four ways:

1) Support the original builder so that he can complete and sell out the project;

2) Sell the fee title project to an investor or developer, in bulk, post foreclosure;

3) Sell the beneficial interest in the note and trust deed; or,

4) Appoint a Receiver to complete and sell the project.

Many lenders have found the appointment of a receiver to be an excellent option as option 1 above is often impractical and the discounted value of the asset is not financially reasonable.

One of the particular challenges that lenders face is that it is unlikely that they will have the necessary documentation or the ability to comply with the stringent timelines to satisfy the statutory requirements of SB 800. Under this scenario, the lender may be prevented from availing itself of the opportunity to inspect and repair, but more importantly would be exposing itself to civil litigation as opposed to the alternative dispute resolution of claims.

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The appointment of a receiver to complete and sell a new for-sale housing project allows the developer entity to remain in place in the event of a construction defect claim, and keeps the lender and/or its related entities off title, thereby creating a layer of liability protection for the lender. However, even where the lender has obtained the appointment of a receiver, lenders should be careful to limit the scope of their involvement in the completion of construction and/or disposition of units/lots to activities that would be typical of a lender/borrower relationship, since the appearance of over-involvement in the activities of the receivership may expose lenders to additional liability.

In response to the proliferation of construction defect claims, California Senate Bill 800 was enacted to allow builders to receive a notice of potential claims from a homeowner or association before it filed litigation, a right to inspect the purported claims and to give builders the opportunity to repair or replace the defective improvement before homeowners and or associations could file civil actions.

Builders are required to make an "election" prior to going to sale as to whether they will comply with the strict statutory obligations of the statute or whether they will create their own contractual alternatives to the strict compliance requirements of the statute. This election may have a significant effect on successors. If the builder has elected in the project documents to strictly comply with requirements of the statute, the "Builder" is required to fulfill various onerous procedural requirements, including the delivery of various certain construction

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documents in order to avail itself of the benefits described herein. Failure to comply with each and every obligation and time restriction under SB 800, the builder forfeits the right to effectuate repairs at the property, and the homeowner is free to file a civil action against the builder. As a result, the "election" becomes very important.

A partial checklist of issues that receivers and lenders should consider prior to making the decision to foreclose on a non-performing for-sale housing development loan include the following:

Are the dispute resolution provisions relating to construction defect claims in the CC&R's and the Purchase and Sales Agreement crafted strongly enough to provide the borrower/developer and the lender, as successor in interest, with procedural protections to possibly avoid protracted and expensive litigation?

Have the project documents been coordinated with the construction documents?

Is "wrap insurance" in place? Is the project covered by wrap insurance and can the lender take advantage of it? Did the borrower/builder have wrap insurance? If not, there will probably be no insurance. Is it possible to secure new insurance under the current set of facts and, if available, is the coverage adequate and at what cost?

Is the wrap insurance coverage still in effect to cover construction defect claims or has the borrower/developer or contractor done anything that might have affected coverage or given rise for the insurer to deny coverage?

Does there need to be an assignment of rights or is the coverage transferable to the lender as a successor or is there coverage as the additional insured?

Is the coverage adequate for the lender's protection?

How much are the deductibles and are they reasonable for the coverage?

What happens to the existing liabilities of the original contractor and subcontractors when the foreclosing lender brings in a new contractor and subcontractors to rework or finish the unfinished or defective construction?

Have appropriate steps been taken in the project documents to provide the borrower/developer and the lender to be able to secure the benefits of the Calderon Procedure (Chapter 9 of Title 6 of Part 4 of the Civil Code)?

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