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A Primer for Lenders: Legal Aspects of Practical Solutions for Defaulted Residential Development Projects & Loans

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(Last issue of the RN featured a "Primer for Lenders: Practical Solutions for Defaulted Residential Development Projects." This is Part II, discussing the evolving legal developments in this national real estate crisis. Ed.)

Practical business solutions for lenders and receivers with residential construction and develop-ment projects and loans in default were the focus of Part I of this article. We identified a number of legal issues that we now address. We will refer to general principles of law, but be warned: your particular issue or set of facts may differ from those discussed, and/or the applicable law[1] may have changed by court decision or legislative action. Readers may not (and should not) rely on anything discussed herein as legal advice applicable to your situation. Our article is not meant to cover all construction and development project and loan legal issues, but rather to address issues that appear in many receiverships. We hope this will assist lenders, receivers and their attorneys in considering all reasonable alternatives.

Can a Bank[2] Incur Lender Liability if It Takes Back a Real Estate Project but Does Not Maintain It While Attempting to Sell the Asset?
If the bank takes a deed in lieu of foreclosure and, as part of that arrangement, extinguishes the debt of the borrower, maybe not. But if the obligations of the borrower (developer) under the deed of trust increase because the underlying collateral (real estate project) deteriorates through lack of care while the bank holds the property, borrower bad faith claims may arise against the bank. When banks seek to hold borrowers liable for a deficiency after a judicial foreclosure, borrowers often assert counterclaims (sometimes in amounts substantially greater than the defaulted debt) against the bank, claiming that the bank violated its implied duty to act fairly under the contractual agreement (whether the original loan agreement or a later workout agreement).

Whether a bank did or did not act fairly would depend upon the particular circumstances of the case. But a duty to act fairly seems to arise frequently when a bank exercises its discretion under a loan agreement, particularly when the loan agreement permits a lender to exercise some power exclusively in its sole discretion.

This exercise of power by the lender without restriction seems to draw the most interest from plaintiffs' lawyers alleging bad faith, i.e. that the lender acted unfairly without sufficient regard for the interests of the borrower. There is less likelihood of a successful claim for bad faith where the loan agreement requires that certain specified objective criteria must be met (conditions that first must be satisfied) before the bank can exercise such power under a loan agreement. In those situations, the factual issue presented is simpler — did the bank act reasonably in deciding whether the conditions were satisfied, rather than the more complex inquiry into whether the bank acted in bad faith toward the borrower. For an excellent discussion of these issues see, Storek & Storek, Inc. v. Citicorp Real Estate, Inc., (2002) 2002 Ca. App.1st Unpub. LEXIS 3948 and the cases cited therein, rev'd on appeal, (2002) 100 Cal. App. 4th 44.

Is a Lender Liable to Pay Mechanics' Liens if It Takes a Deed in Lieu of Foreclosure on the Deed of Trust?
Probably. Generally, where a bank takes a deed in lieu of foreclosure, it in effect merges the deed (the greater interest) with the lien (the lesser interest) extinguishing the lien except where it is necessary for the protection of the buyer's rights that the lien be maintained. Alliance Mortg. Co. v. Rothwell, (1995) 10 Cal. 4th 1226. But junior liens including mechanics' liens are not extinguished by the mere taking of the deed in lieu.

Taking a deed in lieu is a negotiated, consensual transaction, giving the bank an opportunity to work out all claims in advance or gain some indemnity from the borrower. Stewart Title Guar. Co. v. Fallgatter, (2006) 2006 Cal. App. Unpub. LEXIS 2023. One could write a volume on how to deal with mechanics' liens as receiver. Receivers appointed to protect and preserve construction and development projects should obtain a qualified industry lawyer to assist them as soon as possible. By way of contrast, a recorded deed of trust given as security for the purchase price of property or for construction has priority over subsequent mechanics' liens and a trustee's sale of the property (rather than engaging in a deed in lieu transaction) extinguishes such liens. Rheem Mfg. Co. v. United States, (1962) 57 Cal. 2d 621.

Judicial Foreclosure Contrasted with Non-Judicial Foreclosure.
The principal difference between these two processes is that in a judicial foreclosure (or judicial sale) the lender preserves the right to pursue the borrower for any deficiency, i.e. the amount still due after the private sale of the property. Of course, the borrower has his/her statutory right of redemption after a judicial sale.

In contrast, when a lender exercises its power under the deed of trust ("a trustee's sale") in a non-judicial foreclosure, it gets the proceeds from the private sale, but is not entitled to pursue the borrower for any deficiency (unless the borrower has committed either fraud in the inducement of the loan

or has committed bad faith waste). Alliance Mortg. Co. v. Rothwell, (1995) 10 Cal. 4th 1226 and Sumitomo Bank of Calif. v. Taurus Developers, Inc., (1986) 185 Ca. App. 3d 211.

The latter case, Sumitomo, provides a lender with some practical guidance when it comes to making its bid in a trustee's sale. Making the wrong bid may preclude a lender bringing breach of contract, bad faith waste or fraud claims against a developer/borrower in the event the lender later discovers defects known to the developer prior to the trustee sale.

Sumitomo holds that the lender may proceed against the developer for negligent construction in the event the lender makes a full credit bid, but only after satisfying a difficult standard of proof and possible defenses that might be difficult for a lender to overcome.

In Sumitomo the bank exercised its power of sale under the deed of trust and bid the entire amount of the outstanding debt at the sale, a so-called "full credit bid". After it took possession, the lender discovered numerous latent defects in the property, i.e. improperly designed and built structural retaining walls, improperly designed drainage, inadequate water proofing, and leaking roofs. The lender bank repaired these defects and sought to recover against the developer for breach of contract, bad faith waste and fraud. The bank claimed that the developer had a duty under the loan agreement to report known defects, that the builder intentionally constructed the condominium project in an improper manner in order to use the loan proceeds for other purposes and that the developer concealed the defects in order to induce the lender to make a full credit bid.

The Court applied the so-called "full credit bid rule," declaring that the lender had no recourse against the developer for breach of contract, bad faith waste or fraud for impairment of the collateral because the full credit bid established that there was no impairment. For good measure, the Court held that the developer had no duty to disclose the defects since the developer did not control the trustee's sale and thus the bank/lender could not reasonably rely on the developer's failure to disclose the defects or, indeed, for any representations that might have been made.

The Court did allow a claim by the lender against the developer for negligent construction, however, but ruled that the lender must satisfy a "five-factor test" in order to recover, while noting a possible defense that could be raised by the developer, i.e. that the lender always had a right to make inspections of the project.

All in all, a lender should carefully consider the likelihood of construction defects in deciding on how much to bid for property at a trustee's sale. It appears that a lender should make the same calculation when accepting a deed in lieu of foreclosure in exchange for full payment of the underlying indebtedness. Stewart Title Guar. Co. v. Fallgatter, (2006) 2006 Cal. App. Unpub. LEXIS 2023.

Where there is a dispute about the priority of liens, lenders usually opt for a judicial foreclosure because the court's rules on the priority of liens in the context of a sale wipes out those liens and the lender gets the property free and clear to the extent that proceeds are not available for junior lien holders.

The same rule applies when there is a non-judicial sale under a power granted in the deed of trust. The sale in that instance wipes out junior liens to the extent funds from the sale are not available to satisfy them after the senior lien holders are paid. This rule doesn't apply, however, where the owner/borrower or a successor in interest to the owner/borrower purchases the property in such a sale. In those instances, the junior liens are unaffected for equitable reasons, namely that the borrower cannot escape from these liens by purchasing his own property at a trustee's sale. Stewart Title.

Should the Receiver Make Repairs to a Property?

There is legal authority in California for a receiver to repair property. Hozz v. Varga, (1958) 166 Cal. App. 2d 539. Generally, however, orders appointing receivers prohibit the receiver from making capital improvements without prior order of the court. Further, California's rules of court prohibit the receiver and the party seeking the appointment of the receiver from entering into any contracts or understandings regarding what capital improvements will be made. Rule 3.1179(b)(4).

It appears that a lender would be better served having the repairs done within a receivership prior to a foreclosure sale, rather than undertaking the repairs itself and without the possible protection of a court order. In a receivership, the receiver presumably would seek instructions from the court regarding the repairs and costs thereof and the court would likely require that the receiver obtain sufficient insurance coverage for defective work. While the estate would be liable for any negligence by the receiver in having the repairs made, the receiver would not be personally liable save for egregious misconduct well beyond mere negligence. Chiesur v. Superior Court, (1946) 76 Cal. App. 2d 198.

In a receivership setting, the scope of the required work and its costs would be court approved and the liability of the receivership would be limited to its assets. Of course, the costs of the repairs and any liabilities beyond applicable insurance coverage would be payable out of the receivership estate. We could not find any authority for the proposition that the lender, as the party requesting the appointment of the receiver, would be liable.

In the event that no funds were available within the estate to fund the repairs, the receiver could obtain funds from a third party or the lender with court approval and issue a receiver's certificate which should be notarized and recorded. The lien document should also state that it is in a super priority position after administrative expense of the estate.

Does a Lender Have Any Recourse Under the Owners and Contractors Insurance Policy aka "OCIP" Wrap If Construction Defects are Discovered?

The answer is maybe, if the lender moves quickly and appoints a qualified receiver who gives a "provisionary notice" of claims to the insurance company and confirms that the premiums have been maintained by the borrower/developer.

Prior to 2000, developers, contactors and subcontractors held separate insurance for each protection desired or required by the lender. However, the insurance industry, a creative bunch, grouped such coverage into wraps. According to industry specialists, a wrap-up insurance program is a single insurance policy or group of policies issued by an insurance carrier that affords insurance coverage to all enrolled construction participants for all covered work performed on a designated construction project, subject to the limits of the policy. In California, the coverage usually does not include workers' compensation, as that coverage is available through a state program.

Wraps may be purchased either by an owner or a general contractor, and provide many benefits to the lender relating to quality control of the project. However, in the best laid plans of "mice and men (or women)", projects may still end up with construction defects. A receiver appointed to a construction

and development project should investigate all insurance coverage and communicate as quickly as possible with the agents or companies in an effort to try to understand and preserve this potentially valuable coverage for the estate.

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[1] William Crispin is licensed to practice in Washington D.C., Virginia and Illinois and has represented receivers with local counsel before California courts pro hac vice, but is not licensed to practice law in California.

[2] Many lenders are now dealing with defaulted construction and development loans more aggressively as it pertains to residential projects. The FDIC is also dealing with the financial crisis a bit more aggressively by hiring more staff members and obtaining administrative enforcement actions against banks and individuals.
(see http://www.fdic.gov/bank/individual/enforcement/index.html "The FDIC processed a total of 23 orders in February. These included eight cease-and-desist orders; eight removal and prohibition orders; four civil money penalties; two terminations of cease-and-desist order; and one termination of a supervisory prompt corrective action directive").