



Risk Management Legal Strategies for Lenders Acquiring Residential and Mixed Use Projects

Lenders acquiring California residential and mixed use projects will step into the legal liability exposures typically confronted by landowners. When the lender elects to complete construction of the project and sell homes to consumers, it may be subject to the liability exposures of a builder. But by implementing a *comprehensive* and *integrated* strategy for managing and insuring construction defect and other residential and mixed use project risks, lenders can mitigate these exposures and successfully complete and sell the projects.

1. Civil Code Section 3434: The Lender's Safe Harbor. California Civil Code Section 3434 has long offered lenders a safe harbor so long as they act "within the scope of the activities of a lender". Section 3434 provides:

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 be held 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. (Emphasis added.)

When the lender undertakes completion of construction and sale of the residential units, it arguably is acting outside the scope of a pure lender and no longer enjoys the protection of Section 3434. As a result, the lender must modify its perspective to that of a builder and deploy advanced risk management tactics to reduce its exposure.

2. Dealing with SB 800, California's Right to Repair Law.

The lender must have well-structured procedures for compliance with California Civil Code §895 et seq., commonly known as SB 800, California's Right to Repair Law. The Law applies to all new residences and condominium units sold on or after January 1, 2003.

a. Is the Lender Subject to SB 800? Some lenders believe they are exempt from the requirements of the Right to Repair Law, at least where the lender did not construct the homes. The Right to Repair Law suggests otherwise. California Civil Code Section 911(a) provides, in pertinent part:

(a) For purposes of this title, ... "builder" means any entity or individual, including, but not limited to a builder, developer, general

contractor, contractor, *or original seller*, who, at the time of sale, was also in the business of selling residential units to the public for the property that is the subject of the homeowner’s claim or was in the business of building, developing, or constructing residential units for public purchase for the property that is the subject of the homeowner’s claim. (Emphasis added.)

If the lender is the “original seller” of the home to a consumer, the lender may well be deemed to be a “builder”, and thus subject to the requirements of SB 800. No reported case has yet addressed this issue. Accordingly, lenders should include in their planning a comprehensive strategy for compliance with the Right to Repair Law.

b. SB 800 Basics.

The Right to Repair Law contains two major elements. First, Chapter 2 of the Law creates functionality standards (akin to performance standards) for every component of the residences and the project common area. These broad – and in many instances, vague – standards now define the conditions that qualify as construction defects in California. This element of the Law creates heightened liability exposures for residential builders

Second, Chapter 4 of the Law provides that the builder shall receive notice of the alleged defects, shall have an opportunity to inspect and shall have a conditional right to repair, before the homeowner or the homeowners association (“HOA”) may file a construction defect suit. The builder may opt out of the Chapter 4 pre-litigation procedures and instead adopt its own contractual pre-litigation roadmap. The decision to opt out or to remain under Chapter 4 is complex, with advantages and disadvantages to both options.

The Right to Repair Law is subject to important exceptions:

- Lots. Sale of a lot to a consumer does not fall under the Right to Repair Law. Nevertheless, if the lot is defectively prepared and causes damage to the residences or the common area above, both the builder and the seller still face liability on multiple legal theories, including negligence and possibly strict liability.
- Condominium Conversions. The Right to Repair Law is inapplicable to condominium conversions. Such projects require a customized risk mitigation and insurance program.
- Fraud Claims; Bodily Injury Claims; Class Actions. The Law is inapplicable to claims by homeowners or HOAs for fraud and misrepresentation; to claims by homeowners for bodily injury; and to litigation structured as a class action. These claims likewise demand tailored risk management legal and insurance strategies.

While SB 800 provides detailed pre-litigation procedures and a conditional right to repair, it does not materially reduce the construction defect liability of builders and sellers. Indeed, in some instances, the functionality standards increase this exposure, when compared with pre-SB 800 law. The problem is particularly acute for lenders acquiring partially-completed projects. Typically, the lender cannot readily verify the quality of the design and construction, yet it is subject to significant legal liability risks even though it did not construct all of the improvements. Thorough property assessments by a qualified consultant can mitigate these risks.

3. Managing Risks Throughout the Life Cycle of the Project. In our experience, each step in the residential development, construction and sales process offers opportunities to identify and mitigate risk. Among the questions the lender must answer are the following:

- Insurance. Are the existing project insurance policies (general liability, builder's risk, pollution legal liability, directors and officers liability, and others) adequate for the lender's protection? Frequently, we find that the policies must be replaced in order to remedy deficiencies in the borrower/developer's insurance program.
- Construction Contracts and Operations. Are the contractors and subcontractors performing and are the construction contracts adequately protective of the acquiring party? On some projects, the contractor and one or more subcontractors must be replaced and the construction contracts revised.
- Department of Real Estate ("DRE") Documents. Are the existing project documents adequate for the lender's protection? The consumer sales agreements, CC&Rs, disclosures, and warranty documents may require amendments or revisions to add advanced seller-protective provisions.
- Warranty and Customer Service. Will the lender offer a home warranty? How will the lender handle servicing of the home? Effective long term customer service is a critical risk mitigation tool. Outsource customer service providers can be engaged successfully for this purpose.
- Transition To Homeowner Control. What protocols will the lender follow in transitioning condominium projects from seller control to homeowner control? Turnover of the common area must be adequately documented and an HOA relations program must be implemented in order to assure that the seller retains a presence at the project.

These are merely a few examples of the questions that must be addressed in order to maximize the probability of a successful build-out and sales effort and to minimize legal liability risks. Cox, Castle & Nicholson LLP has extensive experience assisting lenders handle these and other challenging residential and mixed use project risk management and insurance issues. For a



more detailed discussion, see “Managing Liability Risks in REO Operations”, *LexisNexis Real Estate Report* (June 2008).