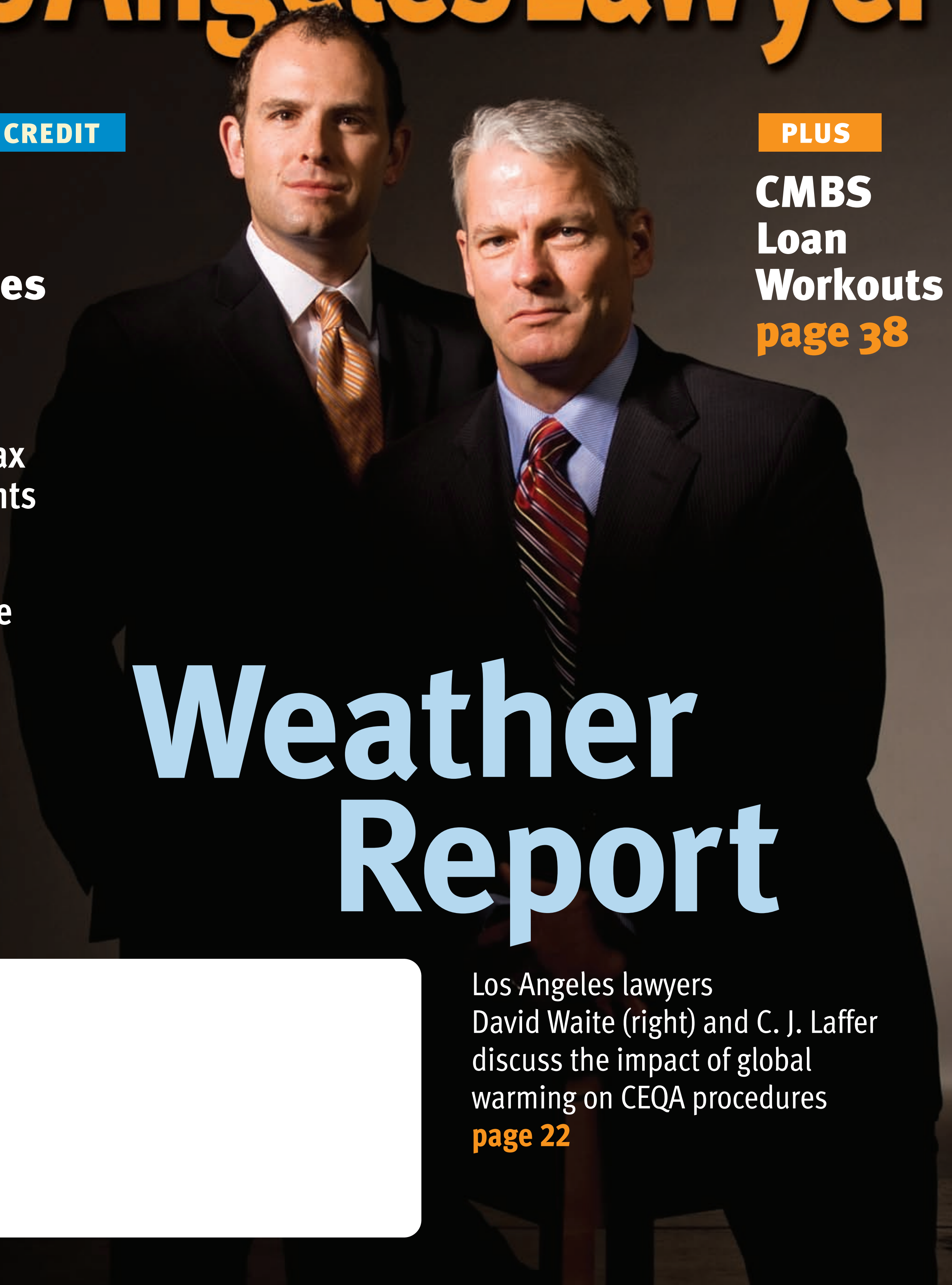
# Los Angeles Lawyer

January 2010 /$4



EARN MCLE CREDIT

**Broken Condo Liabilities**
page 29

**Appealing Property Tax Assessments**
page 10

**Stop Notice Claims**
page 16

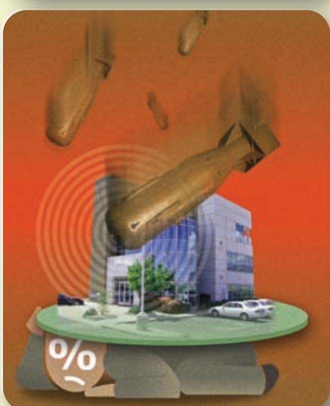
PLUS

**CMBS Loan Workouts**
page 38

## Weather Report

Los Angeles lawyers David Waite (right) and C. J. Laffer discuss the impact of global warming on CEQA procedures
page 22

# CONTENTS



## FEATURES




Los Angeles Lawyer
*the magazine of*
*the Los Angeles County*
*Bar Association*
*January 2010*
*Volume 32, No.10*

COVER PHOTO: TOM KELLER


## DEPARTMENTS




LOS ANGELES LAWYER (ISSN 0162-2900) is published monthly, except for a combined issue in July/August, by the Los Angeles County Bar Association, 1055 West 7th Street, Suite 2700, Los Angeles, CA 90017 (213) 896-6503. Periodicals postage paid at Los Angeles, CA and additional mailing offices. Annual subscription price of $14 included in the Association membership dues. Nonmember subscriptions: $28 annually; single copy price: $4 plus handling. Address changes must be submitted six weeks in advance of next issue date. POSTMASTER: Address Service Requested. Send address changes to Los Angeles Lawyer, P. O. Box 55020, Los Angeles CA 90055.


01.10

**25th annual real estate law issue**

MCLE ARTICLE AND SELF-ASSESSMENT TEST

By reading this article and answering the accompanying test questions, you can earn one MCLE credit.

To apply for credit, please follow the instructions on the test answer sheet on page 31.

by Cathy L. Croshaw, Marjorie J. Burchett, and Nancy T. Scull

# Fixer-UPPERS

## Getting a broken condominium project back on track requires a multifaceted approach

**ALL TOO FREQUENTLY** in today's depressed real estate economy, developers attempting to build and sell condominiums are finding their projects derailed by a lack of buyers. "Broken condominium projects" are those projects in which some units have been sold and the homeowners have an operating homeowners association, but the original developer is unable to complete sales of all the units. To complicate matters, the most recent real estate boom fueled significant speculation in condominium construction and conversion, and the reality of the current condominium market is that more and more broken condominium projects are changing hands. The successor owners of these projects generally are lenders, who acquire the property through foreclosure, or third-party bulk purchasers, who acquire the property under bulk sale contracts.[1]

Acquiring broken condominium projects requires a multifaceted due diligence process. It should include an analysis of a broad range of issues involving resales of the property (including statutorily required public reports), owners associations, and developer's rights. However, the most important of the potential issues to be analyzed often is the extent of the potential construction defect liabilities that a successor owner may acquire along with the broken condominium project.

If the construction defect liabilities are extensive and the acquiring party will be the only entity responding to those liabilities, and if there is no statutory or other protections to assert against claims of liability, the acquiring party may decide that it is not advisable to proceed. However, if the liabil-

**Cathy L. Croshaw, Marjorie J. Burchett, and Nancy T. Scull are partners at Luce, Forward, Hamilton & Scripps. Croshaw practices in the firm's San Francisco office, and Burchett and Scull are in the San Diego office. They are members of the firm's Real Estate Practice Group and represent developers, owners, bulk purchasers, and lenders in major commercial and residential real estate developments throughout California.**

ities can be limited or managed or are not the sole responsibility of the acquiring party, the acquisition may be feasible. Identifying the liabilities and developing a strategy to address them may overcome any barriers to acquisition and will be an essential part of the due diligence process.

The most significant factors affecting construction defect liability are 1) the construction, if any, to be completed by a successor owner, 2) whether a successor owner plans to engage in retail sales, and 3) the amount of time that a successor owner plans to hold the property. This last factor must be assessed along with any actions that a successor owner does or does not take during that period regarding maintenance, management, or governance of the project. A successor owner needs to discern 1) the likelihood of construction defect liability, 2) whether the owner will need to make payments to cover any shortfall in assessments or association funds, 3) prospective liability for maintenance, management, or operation of the property, 4) what funds may be available to address potential liabilities, and 5) what additional options may be available to protect against liabilities going forward. Even after the acquisition takes place, actions may still be required to mitigate the risks inherent in a broken condominium project.

In some cases, a foreclosing lender will have some protection from these potential liabilities under statutory and case law. Under other circumstances, the exposure will be the same whether a successor owner is a foreclosing lender or a bulk purchaser. The extent of liability exposure for successor owners ultimately will depend on the nature of their involvement with the property as well as whether they are a foreclosing lender or a bulk purchaser.

Homeowners associations have standing to sue on behalf of multiple owners. As a result, attached residential condominium structures are frequently the target of construction defect claims, whether spurious or legitimate.[2] A broken condominium project may be even more vulnerable to such claims, since it may have suffered from neglect in a variety of ways. Once a project is in trouble, construction funds may be reduced, homeowners associations may be underfunded (which may lead to improper or nonexistent maintenance), assessments may become delinquent, existing construction defects may not be addressed, and reserves may be underfunded. All of this could lead to the accelerated deterioration of the project and a concurrent increase in liabilities.

## Civil Code Section 3434 and SB 800

Many construction lenders assume that, after foreclosure, they are protected from liability for construction defects caused by the developer. They claim the protection of Civil Code Section 3434, which provides that a construction lender is not liable for construction defects under certain circumstances. However, this protection is limited, so lenders need to be alert to circumstances that may fall outside its reach.

Section 3434 provides protection to a lender "unless the loss or damage is a result of an act of the lender outside the scope of the activities of a lender of money."[3] The section does not specify whether the lender is acting outside the scope of the activities of a lender once it has foreclosed and is in possession of the property. It also does not address what, if any, postforeclosure actions constitute acting outside the scope of the activities of a lender.[4]

Typically, a lender who forecloses may be required to assume additional obligations and responsibilities as soon as the foreclosure occurs. For example, it may need to serve on the board of an owners association, engage in the operation of the project, or market and sell the units to the public.[5] In conducting any of these activities, whether the lender acts outside the scope of the activities of a lender is likely to be analyzed as a continuum rather than according to a bright-line test. The longer the lender holds the property, and the more involved the lender becomes in construction, development, management, operation, and maintenance of the property, the more likely that the lender will lose the protection of the statute. While these activities do not automatically exclude a lender from the liability protections of the statute, the lender is advised to conduct these activities in ways that are consistent with protecting its security interest and disposing of collateral.

Many lenders who know that significant involvement in the project is necessary before letting it go will either 1) acquire the project as a single purpose (or special purpose) entity (SPE) to limit their liability exposure to the value of the property they acquire or 2) seek the appointment of a receiver to operate the project while sorting out liabilities and an exit strategy. Provided that the lender is not controlling the activities of the receiver, the lender will be protected by Section 3434 during the receivership, because the lender is not doing anything inconsistent with lending activities. The lender should exercise caution in limiting its involvement in the project so that the lender always stays within the scope of the activities of a lender.

If the property is "original construction," bulk purchasers—as well as lenders who engage in retail sales and are not protected under Civil Code Section 3434—may be liable for construction defects under the California Right to Repair Law, commonly referred to as SB 800.[6] They may also be liable under common law if the property is a condominium conversion or if SB 800 is found not to apply to the successor owner of original construction.[7] Common law principles also may come into play if the successor owner has not engaged in direct retail sales. This happens when the homeowners sue all the entities in the chain of title to the project prior to retail sales.

For construction defects associated with existing or previously owned property and unknown to the seller, the seller is generally not liable under an implied warranty for the defects. According to case law, "The doctrine of implied warranty in a sales contract is based on the actual and presumed knowledge of the seller, reliance on the seller's skill or judgment, and the ordinary expectations of the parties."[8] However, no California case has directly addressed the application of SB 800 or common law to foreclosing lenders or bulk purchasers. In other jurisdictions, when the lender or bulk purchaser has no involvement in any construction on the property, courts have been reluctant to impose liability for construction defects under common law.[9]

To help minimize liability, lenders engaging in retail sales of foreclosed property should specifically disclose that the property is sold in its "as-is" condition. In addition, lenders should disclose if they did not perform any construction on the project. If they did engage in construction, they should list the particular improvements they made in order to define the scope of any potential liability. Lenders should also craft a recital as part of the sale. It should state that they are selling the property to recover the value of loans secured by the property and they are not in the business of constructing or selling residential units for retail purposes.

These steps should be taken if the successor owner has undertaken no work at the property or only protective actions (such as securing the property against vandalism) or minor decorating. If, however, lenders or bulk purchasers are required to do construction work to complete or renovate an existing project before they can market the property, they should evaluate their attendant liability exposure. Again, California courts have not directly addressed this issue, but decisions from other states have found foreclosing lenders liable for performance of express representations to buyers, for patent construction defects in the entire project, and for breach of any applicable warranties regarding the work performed by the lenders.[10] Thus, whenever possible, successor owners should refrain from performing construction work to complete a project. Options to construction include seeking the appoint-

# MCLE Test No. 188

**The Los Angeles County Bar Association certifies that this activity has been approved for Minimum Continuing Legal Education credit by the State Bar of California in the amount of 1 hour.**

**1.** Lenders who seek the appointment of a receiver to manage their broken condominium projects while they devise their exit strategies can limit their liability by directing the receiver's day-to-day activities.
True.
False.

**2.** Successor owners of broken condominium projects that do not perform construction work on their projects will not have any liability exposure for construction defects.
True.
False.

**3.** If a foreclosing lender did not perform any construction work on the project, it may still have liability as a "builder" under SB 800.
True.
False.

**4.** If the developer chose to opt in to the provisions of SB 800, the successor owner will be required to do so as well.
True.
False.

**5.** Successor owners that are uncertain whether SB 800 will apply if they engage in retail sales should obtain a waiver of SB 800 claims from buyers to avoid liability under the statute.
True.
False.

**6.** A wrap insurance program purchased by a developer to cover its construction defect liability will transfer automatically to the successor owner because the insurance is intended to cover all construction on the project until the expiration of the statute of limitations.
True.
False.

**7.** The purpose of forming a single purpose entity to foreclose on property in place of the original lender is to limit postforeclosure liability to the assets of the SPE.
True.
False.

**8.** A receiver's liabilities are the same as those for a successor owner of a broken condominium project.
True.
False.

**9.** Successor owners that hold the common area of a project for several months may shield themselves from liability for maintenance and management if they do not participate on the board of directors of the homeowners association and in the operation of the property.
True.
False.

**10.** Civil Code Section 3434 provides protection for lenders from construction defect claims even after lenders foreclose and take possession of a property.
True.
False.

**11.** Potential construction defect liability is only one of several risks to be evaluated in deciding whether to purchase a broken condominium project.
True.
False.

**12.** One of the most significant factors affecting construction defect liability for successor owners is whether they engage in retail sales.
True.
False.

**13.** A broken condominium project may be uninsured even if it is under a wrap insurance program, because the program's limits may be exhausted by other projects covered by the same program.
True.
False.

**14.** Bulk sales of units in a broken condominium project present the same construction defect risks and liabilities as retail sales.
True.
False.

**15.** SB 800 defines "original construction" as the portion of a project that existed prior to the project's refurbishment as a condominium conversion.
True.
False.

**16.** Civil Code Section 2782 limits express contractual indemnities provided from subcontractors to the contractor.
True.
False.

**17.** A condominium project is designated as "broken" when it lacks a homeowners association.
True.
False.

**18.** "Hold and wait" is often the best investment strategy for a broken condominium project.
True.
False.

**19.** The successor owner of a broken condominium conversion is not liable under SB 800 for construction defects.
True.
False.

**20.** The California Court of Appeal has ruled that SB 800 applies to foreclosing lenders and bulk purchasers.
True.
False.

## MCLE Answer Sheet #188

**FIXER-UPPERS**

Name ______________________

Law Firm/Organization ______________________

Address ______________________

City ______________________

State/Zip ______________________

E-mail ______________________

Phone ______________________

State Bar # ______________________

**INSTRUCTIONS FOR OBTAINING MCLE CREDITS**

1. Study the MCLE article in this issue.
2. Answer the test questions opposite by marking the appropriate boxes below. Each question has only one answer. Photocopies of this answer sheet may be submitted; however, this form should not be enlarged or reduced.
3. Mail the answer sheet and the $15 testing fee ($20 for non-LACBA members) to:

   Los Angeles Lawyer
   MCLE Test
   P.O. Box 55020
   Los Angeles, CA 90055

**Make checks payable to Los Angeles Lawyer.**

4. Within six weeks, Los Angeles Lawyer will return your test with the correct answers, a rationale for the correct answers, and a certificate verifying the MCLE credit you earned through this self-assessment activity.
5. For future reference, please retain the MCLE test materials returned to you.

**ANSWERS**

**Mark your answers to the test by checking the appropriate boxes below. Each question has only one answer.**

| | | |
|---|---|---|
| 1. | ☐ True | ☐ False |
| 2. | ☐ True | ☐ False |
| 3. | ☐ True | ☐ False |
| 4. | ☐ True | ☐ False |
| 5. | ☐ True | ☐ False |
| 6. | ☐ True | ☐ False |
| 7. | ☐ True | ☐ False |
| 8. | ☐ True | ☐ False |
| 9. | ☐ True | ☐ False |
| 10. | ☐ True | ☐ False |
| 11. | ☐ True | ☐ False |
| 12. | ☐ True | ☐ False |
| 13. | ☐ True | ☐ False |
| 14. | ☐ True | ☐ False |
| 15. | ☐ True | ☐ False |
| 16. | ☐ True | ☐ False |
| 17. | ☐ True | ☐ False |
| 18. | ☐ True | ☐ False |
| 19. | ☐ True | ☐ False |
| 20. | ☐ True | ☐ False |

ment of a receiver and completing work pre-foreclosure, selling the units as is, or offering the purchasers an option to contract with a third party to perform any finish work that may be necessary.

SB 800 further complicates the picture for lenders, since courts have provided no guidance about how to interpret the law together with Civil Code Section 3434. If a lender acquires property for resale to a bulk purchaser, without performing any construction prior to the resale, the acquiring party does not appear to fall within the definition of a "builder" in SB 800. However, when acquiring new construction with the intent of engaging in retail sales now or in the future,[11] the lender will need to consider whether it has builder obligations and liabilities under SB 800. The definition of "builder" under the statute includes the "original seller…in the business of selling residential units to the public."[12] Further, the statute applies to "original construction intended to be sold as an individual dwelling unit."[13] SB 800 does not define "original construction," but lenders may argue that, for the acquiring entity, the project is not "new" or "original" construction, and the successor entity is not necessarily "in the business of selling residential units to the public." Until the law is settled in this area, the safer approach for successor owners is to assume that SB 800 could be applied to the acquiring entity as the seller of "original construction" and assure compliance with the statute while specifying that such compliance is not an admission of the applicability of the statute.

In complying with the statute, successor owners should make their own decisions regarding whether to opt in or opt out of the nonadversarial provisions of SB 800. These provisions establish an optional nonlitigation path for resolution of construction defect claims.[14] Successor owners should make this decision carefully since the approach taken by the original developer may not apply or may make compliance difficult for any successor owner. For example, the original developer may have opted out of the statutory nonadversarial provisions in favor of procedures dictated by its insurer and, in connection with its insurance requirements, issued a warranty provided by the insurer that did not also insure the successor owner. In this situation, there is no reason for the successor owner to adopt the same approach. Similarly, if the original developer opted into the statutory nonadversarial provisions, the successor owner needs to independently evaluate whether it will be able to comply given that it may not have access to construction documents that it may need to produce to a claimant on relatively short notice.[15] If SB 800 is applicable, the successor owner is subject to strict construction defect liability for the project's failure to meet the functionality standards[16] and may be liable for obligations of the minimum fit and finish warranty required by the statute.[17]

Although SB 800 liability cannot be waived if it does apply,[18] the successor owner should consider a provision in its sales agreements that if SB 800 does not apply to the project, the acquiring entity disclaims responsibility for the original construction and acknowledges that the property is sold in its as-is condition. Even if successor owners engage in retail sales but do not consider themselves to be governed by SB 800, they will need to decide whether to provide a fit and finish warranty or some other express warranty to buyers to avoid the warranty being "implied" under the statute.[19] Whether the property is sold as is or subject to some type of express warranty, the purchase agreement should contain a waiver of implied warranties.

In the majority of situations, at least a potential for construction defect liability will exist even though actual liabilities have not yet materialized. However, identifying potential or actual liability is not the end of the inquiry. Successor owners also must evaluate the extent of their exposure, whether they can protect themselves either by the appointment of a receiver or by the manner in which they take title to the property, and whether any funds other than the resources of the successor owner may be available to allay the cost of any liabilities.

## To help minimize liability, lenders engaging in retail sales of foreclosed property should specifically disclose that the property is sold in its "as-is" condition. In addition, lenders should disclose if they did not perform any construction on the project. If they did engage in construction, they should list the particular improvements they made in order to define the scope of any potential liability.

### Insurance

Another way to address defect liability risk is through insurance. The first general inquiry for successor owners is whether they can benefit from the liability insurance purchased by the developer. This starts with an investigation of what insurance the developer had—and by the time foreclosure has occurred, this information may be somewhat elusive. Policies and premium payment records may be difficult to locate; if the developer, contractor, and subcontractors were insured by a single insurer under a "wrap" insurance program, then manuals containing the conditions for continuation of coverage may not be available, and audit information or other critical documents may have disappeared. Moreover, a wrap insurance program is typically coordinated and administered through a third-party administrator paid by the developer. Once a project is in trouble, the administrator's contract may no longer be current, and the administrator may no longer be in place.

Wrap insurance covers the acts or omissions of owners, general contractors, and subcontractors for a construction contract in a single policy. It has become the standard for most condominium projects in

California in lieu of separate policies for each party. This is because wrap insurance can reduce the overwhelming litigation costs associated with multiple insurers on a single project. Each wrap insurance program must be evaluated individually as to whether it is likely to provide any meaningful insurance coverage once the developer is no longer in the picture.

The fundamental analysis of any liability insurance involves identifying the policy limits. With wrap insurance, the available limits will depend on the scope of the program. For example, if a wrap insurance program covers multiple projects, the entire limits of liability may be eroded by a single project, leaving others under the same program virtually uninsured. The determination of available policy limits does not end with the total limits of liability per occurrence and in the aggregate but also encompasses all out-of-pocket costs to the developer or other insureds. Included in this calculation should be the amount of the self-insured retention or deductible and whether the cost of defending litigation is in addition to the stated limits of liability or is included within the stated limits.[20]

Part of the policy review will involve determining who is insured under the policy either as a named insured or as an additional insured. Typically, lenders will require that they be named as an additional insured under the contractor's liability policies. The term "additional insured" describes a party added to the coverage of the policy by endorsement. However, the endorsement creating this status also may contain coverage limitations. As an additional insured, a lender may not have coverage for completed operations, which typically is the coverage that applies to construction defect claims. At a minimum, the additional insured endorsement for a lender will typically exclude any alterations, construction, or demolition by the lender. Therefore, lenders generally will require separate insurance if they perform any work at the project.[21]

However, even if the insurance includes the lender, wrap insurance policies carry a number of ongoing obligations that the developer may or may not have met, particularly with a distressed asset. If the lender is named in the developer's liability insurance policy, the lender will have to explore whether coverage was properly maintained by the developer and whether the developer's insurer contends that the insurance was compromised either by the developer's conduct prior to the foreclosure or as a result of the foreclosure. If the lender is not directly covered under the developer's policy, the lender should explore whether it can be added to the policy and continue with it after the foreclosure.

Another likely obligation of wrap insurance is that each subcontractor meet certain qualifications and complete an application form. Subcontractors that did not qualify for the wrap insurance program may have provided evidence of insurance and performed work on the project with independent coverage—despite the fact that the bulk of the project was covered by a wrap program. If so, the acquiring entity should also explore the additional policies that may exist apart from the wrap program.

Additionally, the norm for the past decade for any construction insurer in California is to require the developer to implement quality control measures in order to monitor the project as it progresses and make recommendations to minimize liability. In those projects that have encountered financial trouble, the developers may not have followed the quality control measures required by the insurer. This failure may be grounds for a denial of coverage when claims materialize.

Any investigation regarding potential insurance coverage must include a review of the specific policy language applicable to the project in question. Most often, wrap insurance programs are built upon the same basic general liability policy forms as traditional liability insurance. Endorsements added to the program can change—or even obliterate—this coverage.[22] Any assumptions about what may be covered are unreliable without a review of the entire policy. Successor owners should engage an attorney, agent, and/or broker experienced in construction liability insurance coverage to make this analysis. Insurance coverage issues may be obvious in some cases but more often they are esoteric, counterintuitive, or obscure.[23]

Many wrap insurance programs do not include design professionals, who most likely have separate errors and omissions coverage. Depending on the anticipated liabilities that the successor owner has identified for the project, these policies may be significant. However, unlike insurance issued directly to the developer, design professionals should not be expected to name the lender as an additional insured. For that reason, these policies cannot be considered as a source of funds directly available to the successor owner but rather as an additional pool of money that may be available to cover claims.

Insurance maintained by the existing homeowners association may provide another source of funds to cover potential liabilities. The association's property insurance policy may cover claims arising from a problem caused or exacerbated by the association's failure to maintain a component. Similarly, if the statute of limitations has run for a claim against the developer, the association may become the primary entity responsible for damages within the project. The acquiring entity should obtain and review copies of the association's liability insurance, property insurance, and directors and officers insurance policies.

A single homeowner in an attached condominium project has the potential to cause damage to multiple units. Thus many projects now contain requirements in their governing documents that individual homeowners maintain liability insurance in specified minimum amounts. Even in the absence of a requirement, an individual homeowner may obtain liability insurance, which will only become a factor when the damage for which the successor owner is sued was either caused or exacerbated by the homeowner's conduct. Reviewing the governing documents to ascertain the insurance requirements imposed upon the project's homeowners will at least allow the successor owner to assess the likelihood that an individual homeowner (or the homeowner's insurer) will be in a position to bear a share of any damage to the project.

Even when liability insurance is ostensibly available to the project either through the developer or some other source, whether that insurance will actually cover a particular claim cannot be tested until the claim is asserted. Successor owners who have done their investigatory homework and uncovered the existence of insurance may find that the policies offer false hope. For this reason, successor owners should consider the option of obtaining their own insurance, which will apply retroactively to the construction that is already in place.[24]

In a wrap insurance program, the contractor and subcontractors generally will have waived any claims against each other to the extent that they are covered under the program. However, if there is a large deductible or self-insured retention, the contractor and subcontractors may have reserved the right to seek indemnity against each other for those amounts. Also, successor owners may have indemnity and/or subrogation rights if a project is insured by traditional insurance—with each party insured under its own general liability policy—or if some of the subcontractors are ineligible for the program and are insured independently. To determine whether the contractor, subcontractors, or their insurers may be a source of contribution to any construction defect liabilities, successor owners should review the construction contracts and subcontracts. If the contract review reveals the potential for indemnity from these parties, any indemnity agreements must be further analyzed to confirm that they are enforceable in light of recent California legislation restricting the circumstances under which a subcontractor may be required to indemnify the contractor.[25]

### Completing Construction

Acquisition of an incomplete project presents additional challenges. Successor owners may choose to enhance the value of their projects and take on any possible risks by completing construction themselves for a bulk resale or for retail sales. Alternatively, they may choose the safe route of not completing construction and simply conducting a bulk resale. Another option is to look at potential exit strategies as part of a continuum. By doing so, successor owners can seek mechanisms for limiting liability at various levels of construction.

The purpose of forming an SPE to foreclose on property in place of the original lender is to limit postforeclosure liability to the assets of the SPE. Ideally, the SPE should succeed to the rights and obligations of the original lender and thus have whatever statutory protection may be available to the lender under Civil Code Section 3434. To do so, the lender should transfer the loan and all related documentation, rights, and obligations to the SPE prior to the foreclosure, so that the SPE is effectively the lender at the time of foreclosure. With regard to both common law and SB 800 liability for construction defects, the analysis should be same for the SPE as it is for an original lender. The SPE also must take appropriate precautions to maintain its separateness from the original lender to protect against ultra vires claims or claims alleging that the corporate veil has been pierced.

Risk assessment and risk management can minimize the element of surprise in the acquisition of a broken condominium project. This is particularly true regarding construction defects. While not all issues regarding potential liability have been settled, any lender or bulk purchaser considering whether to pick up the pieces of a broken condominium project should identify any potential problems that could lead to exposure and the extent to which they can be mitigated or eliminated. ■

---

1 Some broken condominium projects will involve court-appointed receivers, whose liabilities are different from those of successor owners because receivers act at the direction of the court. *See* Andrea C. Chang, *Giving and Receiving*, Los Angeles Lawyer, Dec. 2009, at 22.

2 Civ. Code §1375.

3 Civ. Code §3434.

4 However, there is some precedent in other areas of the law for the idea that merely foreclosing and becoming an owner does not by itself cause the loss of lender protections—so long as the lender's postforeclosure actions continue to be consistent with the protection of its security interest. *See*, *e.g.*, 42 U.S.C. §9601(20)(A) (creating the so-called security interest exemption for lenders from the otherwise automatic liability under the Comprehensive Environmental Response, Compensation and Liability Act). Of course, this still raises the

question of when a lender crosses the line of no longer acting in a manner consistent with the protection of its security interest.

[5] A bulk sale of units does not present the same risks and liabilities as retail sales, because the risks in bulk sales may be contractually allocated, and bulk sales do not have the same regulatory and disclosure requirements as retail sales. In addition, SB 800, the construction defect law in California (*see* nn.6-21, *infra*, and accompanying text) applies to the builder or the original seller to the public. If the lender is neither the builder nor the original seller, it would not incur strict liability under SB 800 for construction defects. *See* Civ. Code §911. However, to the extent that the foreclosing lender engages in some construction activity to resell the project, it could risk construction defect exposure under common law. *See* text, *infra*.

[6] Civ. Code §§895-945.5.

[7] Civ. Code §896.

[8] Pollard v. Saxe & Yolles Dev. Co., 12 Cal. 3d 374, 379 (1974). *See also* Shapiro v. Hu, 188 Cal. App. 3d 324, 379 (1986); East Hilton Drive Homeowners' Ass'n v. Western Real Estate Exch., Inc., 136 Cal. App. 3d 630, 633 (1982); Larosa v. Superior Court, 122 Cal. App. 3d 741, 753 (1981); Allison v. Home Sav. Ass'n of Kansas, 643 S.W. 2d 847, 851 (1982) (citing *Pollard*, limiting implied warranty to builder-vendors, and refusing to extend the warranty to lender-sellers: "[T]he abandonment of caveat emptor can be applied only to those who have the opportunity to observe and correct construction defects."). *See also* Brejcha v. Wilson Mach., Inc., 160 Cal. App. 3d 630, 641 (1984) *and* Tauber-Arons Auctioneers Co. v. Superior Court, 101 Cal. App. 3d 268, 284 (1980) (Auctioneers who sell personal property are not liable for defects in the property that are unknown to them.).

[9] 20 A.L.R. 5th 499, at 1.

[10] Chotka v. Fidelco Growth Investors, 383 So. 2d 1169, 1170 (1980); *see also* Port Sewall Harbor & Tennis Club Owners Ass'n, Inc. v. First Fed. Sav. & Loan Ass'n of Martin County, 463 So. 2d 530, 532 (1985) (reaffirmed limit to foreclosing lender's liability). Similarly, the Supreme Court of South Carolina decided in 1984 that a lender who marketed newly constructed units following its purchase of the units from the builder but did not participate in the original construction was only liable to purchasers for negligence related to the repairs it performed. Roundtree Villas Ass'n, Inc. v. 4701 Kings Corp., 282 S.C. 415 (1984). However, more recently, the Supreme Court of South Carolina extended a foreclosing lender's potential liability to include defects resulting from the original developer's construction through a theory of implied warranty. The ruling was premised on the fact that the lender became substantially involved in completion of the home, beyond the normal practices of a lender. Kirkman v. Parex, 369 S.C. 477 (2006).

[11] SB 800 applies only to residential sales to the public, not to a foreclosing lender who engages in a bulk sale to a third party. Civ. Code §911.

[12] *Id*.

[13] Civ. Code §896.

[14] Civ. Code §§914 *et seq*.

[15] Civ. Code §912. Successor owners should make every effort to obtain complete construction documents and insurance files from the developer at the earliest time possible in the transaction rather than waiting until a claim arises.

[16] Civ. Code §896. The minimum standards required for new construction apply to potential water intrusion, structural integrity, soils, fire protection, plumbing and sewer, and electrical matters, among others.

[17] Civ. Code §900.

[18] Civ. Code §926.

[19] Civ. Code §900.

[20] If the insurance program provides for defense costs in addition to the liability limits of a $3 million general liability policy, the insurer could spend $1.5 million in defending construction defect litigation, but $3 million in coverage would still remain to satisfy claims. If, under the same scenario, defense costs are "within limits," only $1.5 million would remain for claims. Because of the high cost of construction defect litigation, if the defense costs are within limits, the full amount of coverage may be exhausted by the payment of those costs, leaving nothing for repair or replacement of the defective building component.

[21] A typical precautionary step is to include the developer's rights in any existing insurance coverage as part of the assets upon which the lender is foreclosing. Similarly, the bulk purchaser should seek an assignment of those rights as part of its acquisition of the project. These actions are particularly helpful when any party's policies cannot be located or if the successor owners question whether the policies they have obtained are complete.

[22] Some developers have had the unpleasant surprise of discovering that a wrap insurance program purchased for a condominium project does not cover multifamily construction.

[23] With the use of standardized policy forms so prevalent, courts in various jurisdictions have interpreted the same policy language in different contexts. Thus, dozens of courts in many states have analyzed the meaning of a commonly used term such as "sudden."

[24] If existing insurance can be confirmed and if the successor owner is either covered or can obtain coverage under the insurance, there are advantages to doing so. For instance, having a single insurer covering all construction defect claims at the project eliminates the conflict between multiple insurers regarding whose coverage applies in the event of a loss.

[25] *See* Civ. Code §2782.