California Real Property Journal

OFFICIAL PUBLICATION OF THE REAL PROPERTY LAW SECTION STATE BAR OF CALIFORNIA

Vol. 27, No. 3, 2009 www.calbar.ca.gov/rpsection

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THE REAL PROPERTY LAW SECTION OF THE STATE BAR OF CALIFORNIA

"Broken" Condominium Projects: How to Manage Their Acquisition and Develop a Viable Investment or Exit Strategy

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

First published in the California Real Property Journal,
a quarterly publication of the Real Property Law Section of the State Bar of California

Much of the most recent positive real estate cycle was fueled by the housing market and the unprecedented levels of development and sales of residential condominiums. A substantial portion of these condominiums entered the market as part of the many condominium conversions and high rise residential and mixed use projects completed during this time. As a result, large portfolios of condominium product are now held by lenders and asset managers who, together with potential bulk purchasers, need to develop viable disposition and investment strategies for these more complex residential projects.

These projects present issues and challenges unfamiliar to lenders and asset managers accustomed to the failed commercial and single-family residential projects common in the latest recession. The challenges associated with these projects are found in the variety of parties involved and issues presented that are unique to residential condominium development in California. Many of these condominium projects have been left with a mix of owners, tenants, and unsold condominiums as a result of the economic downturn. If individual sales have closed, homeowner associations have assumed maintenance and other governance obligations in these projects. These parties often have very divergent interests. The resulting condominium structure, where the original development and disposition plan was interrupted before the sale of all of the project units, is often referred to as a "broken" or "fractured" condominium project. As discussed in section II below, because the California Department of Real Estate ("DRE") most likely will regulate the sale of units in these projects, a subsequent owner will need to become familiar with the applicable laws and regulations of the DRE. It is therefore crucial that foreclosing lenders and bulk purchasers thoroughly review and evaluate the following considerations before deciding to acquire (through loan purchase, foreclosure, or bulk purchase) unsold units in a broken condominium project.

I. EVALUATION OF PROJECT STRUCTURE

A. Underlying Subdivision Structure

In a condominium project, it may be difficult to identify the real and personal property being acquired. Since the enactment of California Government Code section 66427,[1] condominium projects and the manner in which they are subdivided and structured have become increasingly complex. Modules, building envelopes, cloud common areas, and other techniques[2] which allow for flexibility in the development and sale of condominium units have been used to create condominium projects. Vertical parcel maps[3] have been used to segregate ownership in highrise projects to allow for mixed uses, which frequently have numerous levels of governance and owners' associations. A lender or bulk purchaser must understand how the project has been established and which portions of the project are encumbered by the lender's liens or have already been conveyed to individual owners or the owners' association.

B. Easements

In addition to identifying the property which will be owned in fee, the lender or purchaser must also determine whether it is acquiring all easements needed to operate and/or sell the property. Specifically, a lender or bulk purchaser must ensure that all easements among any modules or horizontal or vertical parcels are in place and that will have access to or control of any recreational facilities or amenities required to market or sell the balance of the project in the future, as well as ingress and egress throughout the project. If the project is not yet completed, additional easements may be needed to finish construction.

C. Title Review

As with any real estate transaction, a complete review of title documents for the project must be completed to understand its structure, including review of the condominium plan and subdivision maps, as well as recorded easements and other relevant recorded documents. If the project is not yet complete (or has outstanding development obligations), this review should include review of any development documentation, such as development agreements, conditions to project approval, and related entitlement documents. Consultation with the original title officer and civil engineer on the project can be very helpful to understand the structure.

II. OVERVIEW OF DRE REQUIREMENTS: THE "WHITE REPORT"

A. Regulatory Framework

The sale of residential condominium projects by builders in California is regulated by the California Subdivided Lands Act,[4] and is subject to the jurisdiction of the California Department of Real Estate (DRE).[5] This regulatory framework affects many of the decisions and actions an acquirer of these properties may take related to sales of all or a portion of the project. Consequently, a lender or purchaser must be familiar with the requirements of the Subdivided Lands Act and the regulations of the DRE.

In general, a final subdivision public report (known as the "white report") is required to offer to sell or sell five or more condominiums[6]. Failure to comply with these requirements when they are applicable can result in civil penalties, is a criminal offense and may give a buyer (including a bulk purchaser) a right of rescission[7]. However, there are several exemptions from these requirements that must be considered by lenders and bulk purchasers.

B. Applicable Exemptions

1. Lender Exemption

A lender who forecloses or acquires property through a deed in lieu of foreclosure is not required to obtain a new white report as a condition to sale of the units if the lender is a bank, life insurance company, industrial loan company, credit union, or savings and loan association licensed or operating under the provisions of a state or federal law and is selling in conformance with the previously issued white report.[8] In this situation, the lender must give notice to the DRE of the change of ownership within thirty days after the acquisition of title to the property.

The requirement that the property be sold in conformance with the previously issued white report limits the value of this exception. Most white reports need to be amended for various reasons, including budget changes or changes to the information in the white report itself. For example, many lenders would want to disclose in the white report that they did not build the project and include a disclaimer to this effect as well as "as-is" language. Such sellers would also want to obtain the DRE's approval of an update to the original builder's form of consumer sales agreement to include similar provisions. Finally, most lenders acquire condominium projects as a single purpose entity which does not qualify as one of the types of financial institutions referred to in this exception.

2. Bulk Transfer Exemption

Another exemption that a seller may consider is for certain types of bulk transfers.[9] This exception includes conveyances for the purpose of selling property in a subdivision to a purchaser who acquires the property to either engage in the business of constructing residential, commercial, or industrial buildings or for the purpose of resale or lease of the property "to persons engaged in this business." Because this exemption applies only to the conveyances described, the proposed bulk sale transaction must be evaluated in each case to determine if it will be exempt from the Subdivided Lands Act. If it is not, a white report or amendment must be obtained, as described in section III.B. below.

III. DRE DUE DILIGENCE

A. Scope of Review

If a white report will be required for bulk or individual sales, a lender or bulk purchaser should complete adequate due diligence related to prior DRE processing to determine the status of the file and what actions will be required to obtain any additional approvals required from the DRE. The first step in this process, given the lead time involved, is to review the association's budget as last approved by the DRE to consider if it accurately reflects the current expenses of the association. For most lenders and purchasers, an independent consultant experienced with condominium associations should review the existing budget. Additionally, as discussed below, the lender or purchaser should include in this review an analysis of delinquencies and reserve levels to more fully understand the financial status of the association.

The lender or purchaser should also identify the last date the budget was reviewed by the DRE. If an existing white report is being amended, the DRE requires an updated budget to be submitted if the date of the last budget review by the DRE occurred more than two years ago or if the budget has increased by more than 20% or decreased by more than 10%. The DRE may consider waiving this requirement on a case-by-case basis in the context of a bulk sale. The DRE's time periods for budget review are typically thirty days for revisions to a budget in the context of a white report amendment application or sixty days for a budget submitted with an application for a new public report. Amendments to the white report must contain any changes to assessment amounts as reflect in the budget reviewed by the DRE.

It is advisable for a lender or purchaser amending a white report to review the DRE's entire file related to the project, as well as the content of the white report to confirm that all material aspects of the condominiums have been disclosed, and if there have been any changes to the project as originally described in the white report. For example, in a multi-phase project which is not yet complete, does the white report make representations that a recreational facility will be delivered by a particular date? Are these dates still accurate? Will there be changes in the phasing of the project, which would require budget changes and an amended white report? Does the white report adequately identify other material aspects of the project and surrounding uses? If the project is complete, the lender or purchaser will need to confirm whether the information in the white report accurately reflects what was constructed. The failure to build the project as designed may cause the disclosures made in the white report to be misleading, and the white report would therefore require an amendment to avoid giving rise to the enforcement rights and remedies described in Section II.A. above.

B. Amending the White Report

The process and timing for amending the white report will depend upon the scope of changes required. If the change is only to reflect a change in ownership, an expedited amendment may be obtained in as little as fourteen days from the date that a complete amendment application package is filed with the DRE. If there are other changes to the white report or documents filed with the DRE related to the white report, or if as discussed in section II.A. above, a budget review is required, the process will take thirty or sixty days or more from the date of the filing, depending upon the complexity of the changes . If a new white report is required, this processing time may take four to six months. The time for the lender or bulk purchaser to complete the background review and compile the application materials for any DRE submittal must also be taken into account in calculating the overall time period for obtaining any required DRE approvals.

C. Completion and Assessment Bonds

The Subdivided Lands Act and DRE Regulations require developers to post bonds as security for various reasons. If a developer is advertising recreational facilities, the developer must bond for completion to assure that there is a source of funds to complete the facilities if the developer does not.[10] Additionally, a developer must bond for the obligation to pay six months assessments for all units in a phase until eighty percent of the units in the phase have closed.[11] There are other possible bonding obligations, as well.[12]

Lenders and bulk purchasers will want to confirm the existence of such bonds, and whether or not they will have any obligation to renew or replace existing bonds or other security in connection with an amendment to the white report. Additionally, the lender or bulk purchaser will need to determine if the association will have any right to "draw" against the bonds or other security due to defaults of the prior developer, and if so, whether the bonds will serve to offset any outstanding liabilities.

IV. ADDITIONAL CONSIDERATIONS FOR MULTI-PHASED HORIZONTAL PROJECTS

A. Subdivision Mapping Considerations

Multi-phased broken condominium projects can pose several additional issues, primarily related to the desire to operate unsold portions of these projects as apartment projects outside the jurisdiction of a homeowners association. One issue to be considered when a portion of any project is being transferred is if the transfer is in compliance with the California Subdivision Map Act, which generally prohibits the conveyance of land which has not been legally subdivided.[13] Legal subdivisions include lots subdivided under a final or parcel map or condominiums created under a condominium plan. Similar to the Subdivided Lands Act, the transfer of land in violation of the Subdivision Map Act can result in criminal liability or give the transferee the right to void the transaction.

This issue arises with horizontal condominium projects established as one lot subdivisions. A typical "horizontal" condominium project may consist of multiple low- to mid-rise buildings with central recreational facilities with multiple legal phases allowed under California Government Code section 66427 discussed in section I.A. above. Although section 66427 allows three dimensional modules to be created for phasing purposes, these are not recognized as either a legal lot or condominium that can be separately transferred. Many lenders foreclose upon unsold phases of horizontal condominium projects based upon an assumption that they will be able to bulk sale the phases in which no condominium sales have been made to an apartment operator. However, prior to foreclosure, the lender should evaluate whether it can achieve this exit strategy or will be required to transfer individual condominiums to avoid a Subdivision Map Act violation.

B. Operating Within a Homeowners Association

Bulk purchasers also need to consider potential constraints that a horizontal condominium structure may impose on the ability to operate, finance, or sell the project as an apartment project. If it is determined that compliance with the Subdivision Map Act requires the conveyance of individual condominiums rather than bulk sale, the units will be subject to the jurisdiction of an owners association. In that case, although a bulk purchaser can still rent the condominiums, it must do so as a member of an association and must pay assessments, including reserves, which may affect the economic viability of the transaction, as well as the financing available. Control within the association in terms of votes and association board membership is also an issue that must be examined, as discussed below.

C. Shared Use Agreements

Another challenge for completed projects relates to the operation and use of recreational facilities within the project. Not only are these facilities critical for operating and marketing the project as expected, but rights to their use and standards for their maintenance are very sensitive issues to existing homeowners associations and their members and tenants on the one hand as well as to a new owner on the other hand, both of which have competing and possibly conflicting interests. If a project is to be split into for-sale and for-rent components, the lender or acquiring purchaser needs to consider such issues as the location of the recreational facilities; whether the recreational facilities will be controlled by the association or apartment operator; whether there is a reciprocal easement agreement in place or whether the foreclosing lender or bulk purchaser will be forced to "negotiate" with a reluctant or antagonistic homeowners association; and how the lender or purchaser will assure the maintenance and quality of the recreational facilities.

V. HOMEOWNERS ASSOCIATION ASSESSMENT OBLIGATIONS OF SUCCESSOR OWNERS

A lender or bulk purchaser is responsible for all assessments payable on units where assessments have commenced.[14] Monthly assessment payments, especially in high rise projects, may be substantial. It is not uncommon to have assessment amounts in excess of $500 per unit per month. If a lender forecloses in a high rise building and only 50 of 200 units have been sold, the lender or purchaser will be liable for the assessments levied upon the 150 unsold units. If the original developer entered into an agreement with the association to provide maintenance, then liabilities may be reduced because certain of the costs will be less during periods of lower occupancy, but then the lender or purchaser may be obligated to manage maintenance obligations that it may be much less equipped to oversee than the original developer.

Another critical issue is whether a bulk conveyance will trigger the payment of assessments. Most CC&Rs will state that the conveyance of a condominium under authority of a white report triggers the payment of assessments. But if the CC&Rs do not limit this trigger to individual condominium sales, then the sale of condominiums to a bulk purchaser under the white report may trigger the obligation to pay assessments.

VI. EVALUATING FINANCIAL CONDITION OF THE ASSOCIATION

Levels of delinquent assessments in condominium projects have exploded in the existing market conditions. A lender who forecloses on a condominium project will extinguish pre-foreclosure delinquent assessments. However, if there is a budget shortfall and the association needs funds to operate, the foreclosing lender or purchaser who sits on the board of the homeowners' association may have a fiduciary duty to levy a special assessment on all units, including the units the lender or bulk purchaser now owns. The end result is that the lender may still be obligated to make up the shortfall. In fact, as a practical matter, some lenders have found it necessary to make up shortfalls in order to placate existing unit owners.

A foreclosing lender or bulk purchaser also needs to review the levels of reserves and whether they are adequate. Many lend-

ers or bulk purchasers who acquire broken condominium projects have been unpleasantly surprised when they have discovered that the original developer failed to fund significant reserves. In some cases these shortfalls may be hundreds of thousands of dollars.

VII. REVIEW OF HOMEOWNERS' ASSOCIATION GOVERNING DOCUMENTS AND PROJECT GOVERNANCE

The CC&Rs, bylaws, and articles of incorporation of the homeowners' association establish the governance for the project. A foreclosing lender or bulk purchaser needs to be familiar with these documents and the issues they can present.

A. Declarant Rights

The project developer sets up the governing structure for a condominium project by the CC&Rs it records against the property before any condominiums are conveyed. The developer will generally be referred to as the "declarant" under the CC&Rs and will reserve certain rights to itself in the CC&Rs to insure that it is able to complete the construction, marketing, and sale of the units within the project. These "declarant rights" may include the right to control the association through weighted voting or board appointment rights and the right to amend the CC&Rs, among other rights to facilitate the development and sale of the project. Whether or not a lender or purchaser is able to acquire these rights may affect the value of the property. However, it is not always immediately clear under the CC&Rs or under the law whether a foreclosing lender or a bulk purchaser becomes the declarant upon acquisition, or whether and to what extent the declarant's rights may be assigned to future bulk owners of the project.

Many CC&Rs provide that an acquiring lender automatically acquires the declarant's rights, but some do not. The lender or purchaser will need to determine in advance whether and to what degree they wish to acquire the declarant's rights, and to what extent having the declarant's rights may be critical to the ongoing ability to market and sell residences. Without typical declarant's rights, the new owner may not have the ability to maintain a sales center, post signs or banners, or have the right to complete any necessary repairs or improvements.

B. Declarant Obligations

A developer may also have obligations either under the CC&Rs or pursuant to other agreements, which a lender or purchaser must evaluate. For example, the developer may have agreed to provide a subsidy to the homeowners for assessments in the early phases of a multi-phase project or the developer may have entered into a "use agreement" allowing existing homeowners to use a facility that the developer still owns, before the facility is transferred to the association. The lender in the current down market has likely already suffered a loss on the project and will have little interest in incurring more obligations, some of which may require construction activities which the lender is rarely in the business of doing. However, lenders must also balance this concern with the desire to transfer as much value and control as possible to a future bulk purchaser (lenders rarely sell broken condominium projects on a retail basis). For bulk purchasers, the issue will more often be one of assigning value—or loss of value—to the declarant's rights and obligations to arrive at the right purchase price.

C. Control of the Association Board of Directors

Another issue related to the declarant's rights is how long the declarant will control the association. Typically, CC&Rs will give the declarant weighted voting rights for a specified period of time so that, for example, the declarant will have three votes for every unit owned, while individual owners would have one vote per unit. It is essential to know if the declarant's control will continue through the anticipated sell-out of the project, or whether declarant will have the same input as any other homeowner.

Most CC&Rs or association bylaws will also give the developer the right to appoint (or replace) the initial members of the board of directors of the association. By the time a broken condominium project is acquired by a lender or purchaser, the developer may or may not continue to control the board through these appointment rights. In some cases, the developer may not be represented on the board at all. If the association already has homeowner board members, a lender or bulk purchaser is advised to interview the members of the board, as well as any management company the board has engaged, and understand any outstanding issues the board is facing. In many cases, homeowners who have purchased in the now distressed condominium project may be very antagonistic toward a lender or bulk purchaser, since the lender or purchaser in this economy may be interested in converting the balance of the units to rentals rather than for-sale condominiums, or at a minimum may sell units at bargain prices, and thereby drag down the value of the existing owners' units.

In cases where the board of directors includes members that were appointed by the developer, the foreclosing lender or bulk purchaser will need to consider if it will (or can) appoint its own representatives as replacements upon its acquisition.

The foreclosing lender or bulk purchaser should also confirm that the association has been properly formed and is it in good standing with the Secretary of State, and whether the association has asserted any claims against the developer.

VIII. THE SALES PROGRAM AND DOCUMENTATION

A. Pending Sales

If a foreclosing lender or bulk purchaser is acquiring rights to pending sales transactions or intends to rely upon the original sales documents for future transactions, the lender or bulk purchaser must evaluate the sales documents and program. Among other things, the lender or purchaser will need to determine if the original sales program is in conformance with the requirements of the federal Interstate Land Sales Full Disclosure Act which requires the issuance of a property report meeting the requirements of the Act or qualification under an exemption.[15] As discussed above, any changes to the sales program or documents will require DRE approval before such documents can be used with new home buyers.

If there are pending escrows that the lender or bulk purchaser will acquire an interest in, the lender or purchaser needs to determine the status of deposits for those escrows. The DRE Regulations provide restrictions on when those deposits can be accessed and for what purposes,[16] and if the developer has improperly withdrawn escrow funds, the lender or bulk purchaser may need to replace them. Of course, a lender will want to confirm that it has a security interest in the escrow deposits.

In today's economy, some existing unit purchasers will be unable to close their purchase. Others may be unwilling to close their purchase because of the distressed nature of the project and the uncertainty that creates. In some cases, such purchasers may still have the right to cancel their contracts. On other cases, where there is no such right and purchasers who fail or refuse to close are in default under their contracts, the developer may be engaged in pending arbitrations over the right to retain the deposits of the defaulting buyers. The lender or bulk purchaser needs to determine the status of such escrows and any related arbitration proceedings to understand how they will affect rights to deposits, possession or other property related issues.

B. Future Sales

If a lender or bulk purchaser plans to sell individual condominium units to members of the homebuying public, not only will it need to review the white report in even greater detail to update it factually, it should also review and update the entire sales document package originally submitted to and approved by the DRE. For example, any documentation for future sales should include full disclosures of a lender's or bulk purchaser's status, including a statement that it did not construct the project. Provisions relating to the "as is" nature of the property to be acquired may be included in sales documents, but a lender or bulk purchaser should understand these provisions may not be binding upon subsequent owners. All of these changes will of course be subject to review by the DRE.

IX. CONSTRUCTION DEFECTS OR OTHER LIABILITIES OF THE ORIGINAL DEVELOPER.

A. Statutory Protection for Lender

Many lenders assume that, after foreclosure, they will not have construction defect liability under California Civil Code section 3434, which says that a construction lender is not liable for construction defects under certain circumstances.[17] However, this may not be the case. 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." Importantly, periodic inspections of the project's construction for purposes of protecting its security interest are not sufficient to impose liability upon a lender for construction defects. "Approval of plans and specifications, and periodic inspection of houses during the construction is normal procedure for any construction money lender…[and]… did not take on 'ramifications beyond the domain of the usual money lender.'" [18] However, section 3434 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. Typically, a lender who forecloses may be required to assume additional obligations and responsibilities as soon as the foreclosure occurs, since 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. While these activities to 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, and not treating the property as long-term investor might.

B. Liability Where Statutory Protection Does Not Apply

For a bulk purchaser or a lender who is not protected under the Civil Code, construction defect liability may be determined under the California Right to Repair law ("SB 800")[19] if the property is "original construction" or under common law if the property is a condominium conversion.[20] There are no California cases which directly address foreclosing lender or bulk purchaser liability under common law. In other jurisdictions, however, where the lender or bulk purchaser has no involvement in any construction on the property, under common law, courts have been reluctant to impose liability for construction defects.[21] Similarly, if there are construction defects associated with used property which are unknown to the seller,[22] a seller of used property is not liable under an implied warranty for defects in the property.[23] "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." [24] Thus, under common law, a court will likely evaluate on a case-by-case basis whether a lender or bulk purchaser is in a better position to know of and cure defects than a buyer.

In many cases, the lender or bulk purchaser is required to do construction to complete or renovate an existing project in order to market the project and should evaluate potential liability exposure created by such construction. While California case law has not directly addressed this issue either, decisions from other states have held that a foreclosing lender was liable for performance of express representations to buyers, for patent construction defects in the entire project, and for breach of any applicable warranties relating only to the work performed by the lender. [25]

When acquiring new construction, the lender or bulk purchaser will need to consider whether it has obligations and liabilities under SB 800. There is currently a debate within the legal community as to whether a successor entity to the developer is a "builder", bound by SB 800. The definition of "builder" under the statute includes the "original seller. . . in the business of selling residential units to the public." [26] Further, the statute applies to ". . . original construction intended to be sold as an individual dwelling unit."[27] "Original construction", is not defined anywhere in the SB 800 statute. It could be argued that, as to the acquiring entity, the project is not "new [or original] construction" or that a successor entity is not "in the business of selling residential units to the public." However, SB 800 was intended to be a broad-sweeping consumer protection statute. Since the only distinction in the statute is between "original construction" and "condominium conversions", this could lead to the conclusion that everything that is not a "condominium conversion" is "original construction".

Until the law is settled in this area, the safer approach is to assume that SB 800 could be applied to the acquiring entity as the seller of "original construction," assure compliance with the statute and analyze potential liabilities accordingly. If SB 800 is applicable, the lender or bulk purchaser would be subject to strict construction defect liability for the project's failure to meet the functionality standards and may be liable for obligations set forth in the fit and finish warranty.

Where there is potential liability to the acquiring entity, that entity should thoroughly evaluate whether there are any funds available from other sources to mitigate that liability. For example, if liability insurance is available to the original developer, such insurance respond to claims against the original developer, but may or may not directly protect the acquiring entity. In most cases, the lender will be either a named insured or an additional insured under the developer's liability policy, but the bulk purchaser will not have this protection. Even where the lender is named in the developer's 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. Any acquiring entity should evaluate the existing insurance, whether the entity is covered by such insurance, and what additional liability insurance it should obtain. In many situations retroactive liability insurance is an alternative to be considered. For a condominium conversion, the developer may have bonded for correction of construction defects as part of its "renovations" to the project. In other situations, the responsibility for construction defects may belong to the association. Whatever the situation, it is important to not only evaluate the liabilities that are being acquired in a broken condominium situation, but also the extent to which other sources of funds may be available to reduce the impact of those liabilities on the acquiring entity.

The acquiring entity will also need to assess the approach taken by the original developer to SB800 in its sales and governing documents and determine: 1) whether existing sales were in compliance with the statute; 2) whether the developer offered warranties beyond the statutory minimums; and 3) whether the acquiring entity will simply adopt the approach taken by the developer as to some of the elections under SB800 or will change them for future sales.

X. CONCLUSIONS

The acquisition and disposition of a "broken" residential condominium project can create pitfalls for the unwary lender or bulk purchaser that impact the value of the property. A lender or other purchaser acquiring such a project should conduct a complete review of the issues described above before it forecloses or acquires a "broken" condominium project to make sure it has a full understanding of the associated risks and liabilities to confirm that its investment or exit strategy is viable.

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ENDNOTES

1 This section states that the further division of a map created for condominium purposes into three-dimensional portions on a condominium plan is not a subdivision for purposes of the Subdivision Map Act.

2 "Modules" and "building envelopes" are three-dimensional portions of a lot which typically include a portion of the project's improvements, "cloud" common area is used to describe a three-dimensional space above the improvements in a project in which the owners own an undivided interest. These concepts are allowed under CAL. GOV'T CODE § 66427(e) discussed further below.

3 A vertical parcel map creates one or more three-dimensional lots which may be used to separate different portions of a project vertically.

4 *See* BUS. & PROF. CODE § 11000, et seq. (hereinafter "Subdivided Lands Act").

5 *See* CAL. CODE REGS. tit. 10, § 2790, et seq.

6 *See* BUS. & PROF. CODE §§ 11000 & 11010.

7 *See* BUS. & PROF. CODE §§ 11019 & 11023. *Barrett v. Hammer Builders, Inc.*, 195 Cal. App. 2d 305 (1961); *Perkins v. Sommers*, 117 Cal. App. 2d 32 (1953).

8 Subdivided Lands Act § 11010.5.

9 *Id.* § 11010.35.

10 BUS. & PROF. CODE § 11018.5(a)(2).

11 DRE Regulations § 2972.9(a) & (b).

12 *See e.g.,* DRE Regulations §§ 2791 & 2792.10.

13 *See* CAL. GOV'T CODE § 66410, et seq. Although the similarity of names can be confusing, the Subdivided Lands Act governs the sale of homes, lots, and condominiums by builders to a retail purchaser of the property, and it was developed largely to combat the fraud that historically occurred when land subdividers sold worthless land to unsuspecting buyers, the proverbial

swamp land in Florida, or more often in California, desert land with no utilities or access. The Subdivision Map Act, on the other hand, governs the process of dividing land into smaller lots.

14 Assessments will normally commence on the first day of the first month following the first close of escrow in the project, or in a phased project, the first close of escrow in the phase.

15 15 U.S.C.A. §§ 1701, et seq.

16 DRE Regulations § 2791.

17 CAL. CIV. CODE § 3434. Lender's liability to third parties. 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.

18 *Bradler v. Craig*, 274 Cal. App. 2d 466, 475 (1969); see also *Roundtree Villas Ass'n v. 4701 Kings Corp*., 282 S.C. 415, 422 (S.C. 1984). "Traditionally, lenders, in making a construction loan, make periodic inspections to assure that the construction loan advancements are being applied appropriately. This is fundamentally for the protection of the lending institution and does not impose upon the lending institution a duty to see that the builder is getting a job free of defects."

19 CAL. CIV. CODE §§ 895-945.5.

20 CAL. CIV. CODE § 896.

21 Jeffrey T. Walter, *Financing Agency's Liability to Purchaser of New Home or Structure for Consequence of Construction Defects,* 20 A.L.R. 5th 499 at 1 (1994).

22 "An auctioneer who sells personal property is not liable for defects in the property that are unknown to him or her." *Brejcha v. Wilson Machinery, Inc.*, 160 Cal. App. 3d 630, 641 (1984); *Tauber-Arons Auctioneers Co. v. Super. Ct.*, 101 Cal. App. 3d 268, 284 (1980).

23 *Shapiro v. Hu*, 188 Cal. App. 3d 324, 332-333 (1986); *East Hilton Drive Homeowners' Ass'n v. Western Real Estate Exchange, Inc.*, 136 Cal. App. 3d 630, 633 (1982); *Larosa v. Super. Ct.*, 122 Cal. App. 3d 741, 753 (1981).

24 *Id*. at 379; See also *Allison v. Home Savings Ass'n of Kansas*, 643 S.W.2d 847, 851 (Mo. Ct. App. 1982), relying on *Pollard v. Saxe & Yolles Dev. Co.,* 12 Cal. 3d 374 (1974) and limiting implied warranty to builder-vendor's and refusing to extend to lender-seller ("the abandonment of caveat emptor can be applied only to those who have the opportunity to observe and correct construction defects"). The court in *Allison* further stated that "the rationale for allowing recovery by a purchaser of a new house, on a theory of breach of implied warranty of habitability or quality, is applicable only against that person who not only had an opportunity to observe but failed to correct a structural defect, which, in turn, became latent, i.e., the builder-vendor." *Id*. at 851.

25 *Chotka v. Fidelco Growth Investors*, 383 So. 2d 1169, 1170 (Fla. Dist. Ct. App. 1980); see also *Port Sewall Harbor and Tennis Club Owners Ass'n, Inc. v. First Federal Savings and Loan Ass'n of Martin County*, 463 So. 2d 530, 532 (Fla. Dist. Ct. App. 1985) (reaffirming limit to foreclosing lender's liability and stated, "were this not the case no lender could buy in the property at public sale without potential catastrophic exposure to 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 (S.C. 1984). However, more recently in *Kirkman v. Parex*, 369 S.C. 477 (S.C. 2006), 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, premised on the fact that the lender became substantially involved in completion of the home beyond the normal practices of a lender.

26 CAL. CIV. CODE § 911.

27 CAL. CIV. CODE § 896.