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## Risk Management for Construction Loans: 2019 Update

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12:00 Noon

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BUCHALTER Webinar

1000 Wilshire Boulevard, Suite 1500

Los Angeles, California 90017

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I. INTRODUCTION

- A. The Impact of the Economy on Construction Loans
- B. The Lender's Motivation to Make Construction Loans
- C. Lender's Due Diligence on the:
  - 1. Borrower
  - 2. Guarantor(s)
  - 3. Source of Funds
  - 4. Regulatory Issues
  - 5. Competition
  - 6. General Contractor
  - 7. Principal Subcontractors
  - 8. Architect
  - 9. Site

I. INTRODUCTION (CONT.)

D. Causes of Construction Loan Defaults

1. **Insufficient Funds**
2. **Faulty Plans and Specifications**
3. **Construction Defects**
4. **Delay in Completion**
5. **Market Conditions**
6. **Loss of Key Tenant(s)**
7. **Loss of Takeout Financing**

## II. Recordation by The Title Company (Escrow Agent) of the Construction Deed of Trust as a First Priority Lien on the Borrower's Property

- **Express** written escrow instructions to title and escrow.
- **Implied** escrow instructions.
- “**Insure**” as opposed to a “**lien priority**” in the Lender’s escrow instructions.
- Lender’s written disclosure to the escrow agent and the title insurer in the escrow instructions of potential commencement of the work of improvement.

### III. Lender's Right to Suspend Disbursements

- Mechanics liens have started to increase. Therefore, now is the time to update your loan documents not after the mechanics lines have been recorded.
- Title insurers have become more stringent on their underwriting of mechanics liens.
- Title insurers have become more aggressive on denying lender's claims for mechanics liens based on Exclusion from Coverage 3(a) for ". . . matters created, suffered, assumed or agreed to. . ." by the Lender.
- The title insurers use of Exclusion 3(a) started in 1979 with Bankers Trust Company v. Transamerica Title Ins. Co. (10<sup>th</sup> Cir (Colo) 1979) 594 F2d 231.

### III. Right to Suspend Disbursements (Cont'd)

- In the next thirty years the lenders won the majority of cases. However, in 2015 the title insurers successfully alleged their Exclusion 3(a) negated coverage for mechanics liens in BB Syndication Services, Inc. v. First American Title Ins. Co. (7<sup>th</sup> Cir. (Wis.) 2015). That victory for the title industry was followed up in 2018 where the title insurer successfully alleged that Exclusion from Coverage 3(a) negated coverage for mechanics lines in Captiva Lake Investments LLC v. Fidelity National Title Ins. Co. (8<sup>th</sup> Cir. (Mo.) 2018) 883 F 3d. 1038.
- Lenders should be able to respond to these decisions by revising their escrow instructions to require that:
  - A. Their Deeds of Trust be recorded by the Title Company as a first priority lien on the borrower's property; and
  - B. The title company agrees to not invoke Exclusion 3(a) if the Lender disburses the Loan funds in substantial compliance with the Loan documents.

## IV. Factors Considered by the Courts in Determining Whether the Lender Created the Mechanics Liens within the Meaning of Exclusion 3(a)

- A. Was the construction Project short of money from the beginning? Bankers Trust Co.
- B. Did the Lender permit the Borrower to use the construction funds for non- construction purposes (i.e., the purchase of the property)? Bankers Trust Co.
- C. Was the Lender unjustly enriched? Bankers Trust Co.
- D. Is there a disbursement agreement between the Lender and the Title Company which creates implied obligation on the part of the lender to pay for the work which was performed? "Brown v. St. Paul Title Ins. Corp"
- E. Was there no fixed budget? BB Syndication Services, Inc.
- F. Did the Lender refuse to disburse its entire loan amount? BB Syndication Services, Inc.
- G. Does the Construction Lender owe a duty to the Title Company ". . . to discover and prevent cost overruns. . .?" BB Syndication Services, Inc.
- H. Did the Lenders forgo an opportunity to purchase a "Seattle Endorsement?" BB Syndication Services, Inc.
- I. Did the Title Company receive an indemnity from the Borrower? American Savings & Loan Ass'n. v. Lawyers Title Ins. Corp.

## V. SELECTION OF A FINANCIALLY RESPONSIBLE ESCROW AGENT

- **Title insurer**
  - *National business unit.*
- **Underwritten** title company
- **Independent** escrow agent



## VI. SELECTION OF A TITLE INSURER WHICH IS CAUTIOUS IN ITS UNDERWRITING AND WHICH PAYS CLAIMS\*

- The “big four” title insurers:
  - Fidelity National Financial, Inc. “Family” of Title Insurers
  - First American Title Insurance Company
  - Stewart Title Guaranty Company
  - Old Republic National Title Insurance Company
- The *remaining one hundred* title insurers.
- Develop a relationship with *local* management.

*\*This is not an endorsement of any particular insurer.*

## VII. THE TITLE INSURER'S DUTY TO DISCLOSE THE COMMENCEMENT OF THE WORK OF IMPROVEMENT TO THE CONSTRUCTION LENDER

- The title insurer's **fiduciary duty** of disclosure.
  - Village Northridge Homeowners Ass'n. v. State Farm Fire & Cas. Co. (2010) 50 Cal.4<sup>th</sup> 913, 929 (“[the insurer] is in a legally recognized special relationship with [the insured], and it has duties that clearly **encompass forthright and affirmative disclosures** . . .”)
- The title insurer's **statutory mutual duty** of disclosure.
  - *Insurance Code § 332* - “*Each party to a contract of insurance shall communicate to the other, in good faith, all facts within his knowledge which are or which he believes to be material to the contract and as to which he makes no warranty, and which the other has not the means of ascertaining.*”
- The title insurer's liability to the lender for misrepresentation.
  - Alliance Mortgage Co. v. Rothwell (1995) 10 Cal.4<sup>th</sup> 1226.
- The **limits** to *Insurance Code* §§ 12340.10 and 12340.11.

## VIII. THE HIDDEN “TRAP” OF EXCLUSION FROM COVERAGE 3(a)

- The policy exclusion:
  - “3. Defects, liens, encumbrances, adverse claims or other matters
    - (a) created, suffered, assumed, or agreed to by the Insured Claimant . . .”

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## IX. THE CONCEALED “PITFALL” OF EXCLUSION FROM COVERAGE 3(b)

- The policy exclusion:
  - “3. Defects, liens, encumbrances, adverse claims or other matters . . .
  - (b) not Known to the Company, not recorded in the Public Records at Date of Policy, but Known to the Insured Claimant and not disclosed in writing to the Company by the Insured Claimant prior to the date the Insured Claimant became an insured under this policy . . .”
- The Lender’s Dilemma:
  - How does the Lender know what is “. . . not Known to the Company . . .”?
  - How does the Lender know what is “. . . not recorded in the Public Records at Date of Policy . . .”?
  - Is “known” limited to “actual knowledge”?
  - Does “imputed knowledge” qualify as “actual knowledge”?

## IX. THE CONCEALED “PITFALL” OF EXCLUSION FROM COVERAGE 3(b) (Cont’d)

- Stewart Title Ins. Co. v. Credit Suisse (D. Idaho 2015) 2015 U.S. Dist. LEXIS 91493 & 2013 U.S. Dist. LEXIS 124843.
  - In this case the title insurer claimed that if the lender had provided a copy of its **appraisal report** to the title insurer it would have been known that there had been a commencement of the work of improvement.
  - **Other issues:** credit reports, closing statements, leases, building permits, etc.

## X. SATISFYING THE LENDER'S DUTY TO DISCLOSE TO THE TITLE INSURER PURSUANT TO INSURANCE CODE SECTION 332 AND EXCLUSION FROM COVERAGE 3(b)

- **Statutory limits** on the insured's duty to disclose:
  - *Insurance Code* §§ 333, 334, 335 and 336
- **Disclosures in Escrow Instructions**

During the course of underwriting this loan, Lender has received documents from the Borrower and other sources which may be inspected by you at Lender's office during regular business hours. **Lender offers you the opportunity to review these documents so that you have the ability to review and consider all documents received by Lender, which you may deem material to your decision to close the Loan or issue the requested loan policy of title insurance. In the alternative, upon your written request, Lender shall send to you copies of these documents.** If you do not inspect these documents or request copies of these documents, Lender shall consider that you have waived your right to require disclosure of these documents to you by Lender prior to your closing of the Loan or issuing the requested loan policy of title insurance.
- **Disclosure of Loan Documents**
  - Selected disclosures? Or entire file?

## XI. THE COMMENCEMENT OF THE WORK OF IMPROVEMENT AND THE ENTITLEMENT TO A MECHANIC'S LIEN

- The commencement of the work of improvement (i.e., visible work or delivery of materials to the jobsite), not the date of the recordation of a mechanic's lien, is the operative date in California for the priority of all mechanic's liens.
- The title company's inspection before the recordation of the construction Deed of Trust.
- The title company's receipt of an indemnity agreement from the borrower and/or guarantors (known *or* concealed and undisclosed?).



## XII. TECHNIQUES TO REDUCE THE RISK OF MECHANIC'S LIENS

- Adequate construction funds.
  - Lender's loan funds
  - Borrower's funds
  - Bonds (see Section XIV)
- Loan Guaranty.
- Proper fund disbursement.
  - Optional/Obligatory advances/Endorsements (see Section XVII)
- Lien Releases.

### **XIII. TENDERING A COMPLAINT TO FORECLOSE A MECHANIC'S LIEN TO THE LENDER'S ESCROW AGENT TITLE INSURER AND**

- Claims against the escrow agent.
- Claims against the title insurer.
- The California *Insurance Code* and the California *Fair Claims Settlement Practices Regulations*.
- Should you have a tolling agreement?
- Monitoring the representation provided by the title insurer and/or escrow agent.

**XIV. KEY PROVISIONS IN THE CONSTRUCTION LOAN AGREEMENT**

- A. Assignment of Plans and Specifications to the Lender**
- B. Assignment of Construction Contract to the Lender**
- C. Assignment of Permits and Entitlements**
- D. The Lender's Right to Communicate with the Architect, General Contractor, Subcontractors, Suppliers and Guarantor(s) and the Borrower's and the Guarantor(s) Waiver of Any Rights to be Informed of the Communications**

## XV. KEY PROVISIONS IN THE CONSTRUCTION LOAN AGREEMENT (Cont'd)

### E. Dispute Resolution Provisions

**The Borrower's Architect is the Person Who Determines Ambiguities, etc. in the Plans and Specifications and the Right to Compensation for Change Orders. The architect's decisions are only reviewable by binding arbitration.**

### F. Mandatory Mediation

### G. Binding Arbitration

- 1. Retired Judge or Justice is the arbitrator**
- 2. The mediation/arbitration is preselected**
- 3. Only Receive Evidence Which is Admissible Under California Law**
- 4. Only Decide Dispute Based on Substantive California Law**
- 5. Issue a Reasoned Decision Based Only on Admissible Evidence and Substantive California Law**

## XV. KEY PROVISIONS IN THE CONSTRUCTION LOAN AGREEMENT (Cont'd)

### H. Lender's Right to Complete Construction

1. Mortgagee in Possession
2. Receivership
3. Bankruptcy Trustee

### I. Payment Systems

1. Progress Payment
2. Voucher System
3. Direct Payment to the Borrower
4. Joint Checks

### J. The Contract Price to Construct the Project

1. Fixed Cost Contract or Lump Sum Contract
2. Cost Plus Contract
3. GMAX

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## **XV. KEY PROVISIONS IN THE CONSTRUCTION LOAN AGREEMENT (Cont'd)**

### **K. Duties of the Lender's Agents, Including its Inspectors and/or Consultants**

- 1. Borrower and Guarantor(s) agree that any Inspection or Knowledge possessed by the Lender is for the Sole Benefit of the Lender**
- 2. Borrower and Guarantor(s) Waive Any Right to be Informed of Any Knowledge possessed By the Lender or the Lender's Agents**
- 3. Substandard Status Reviews and Misreporting**
- 4. Failure to Identify and Report Denied, Disputed and Pending Changes**
- 5. Failure to Properly Forecast Final Completion Costs**

### **L. Waiver of Bonds**

- 1. Written Request of Borrower and Guarantor(s) to save them money**
- 2. Right of Lender in the future, in its sole and absolute discretion, to require bonds**
- 3. Borrower's failure to provide requested bonds is material breach of loan agreement which impairs Lender's security which justifies termination of loan disbursement and foreclosure**

## **XV. KEY PROVISIONS IN THE CONSTRUCTION LOAN AGREEMENT (Cont'd)**

### **M. Completion of Construction**

#### **1. Certificate of Completion**

#### **2. Certificate of Occupancy**

##### **a. Temporary Certificate of Occupancy**

##### **b. Final Certificate of Occupancy**

#### **3. Release of Retainage**

### **N. Progress Payments by Lender do not Constitute Approval of Contractor's Work**

### **O. The Borrower's Obligation to Immediately Eliminate any Mechanic's Lien, Stop Notice on Other Lien(s) on Claim(s).**



## **XVI. LOAN ADMINISTRATION**

- A. The Implied Covenant of Good Faith and Fair Dealing**
- B. The Risk of Fiduciary Duty Being Imposed on the Lender**
- C. Communication and Miscommunication**
- D. Dealing With Loan Participants**
- E. Lender's Initial Review of the Borrower's Proposed Plans, Specifications and Budget**
- F. Scheduling and Monitoring Progress, etc.**
  - 1. Substandard Scheduling Causes Misreporting Progress**
  - 2. Best Practices – examples**

**XVI. LOAN ADMINISTRATION (Cont'd)**

**G. Lender's Review of Borrower's Payment Applications**

- 1. Problems with overpayment**
- 2. Front end loading**
- 3. Nuances of a GMP Contract**

**H. Documentation of the Borrower's (General Contractor's) Defaults and the Impairment of the Lender's Security**

## **XVII. COST OVERRUNS**

### **A. Cause of Cost Overruns**

**1. Defective plans and specifications**

**2. Bid mistakes**

**3. Site conditions**

**4. Construction defects**

**5. Governmental Requirements**

**6. Labor Issues**

**7. Extra work**

**a. Extra work which was not required by the construction contract**

**b. Extra work which was required because of defective plans and specifications**

**c. The general contractor's right to compensation for extra work**

## **XVII. COST OVERRUNS** (Cont'd)

### **B. Response to the Need for Additional Funds Required by Cost Overruns**

- 1. Borrower**
- 2. Guarantor(s)**
- 3. Bonding company**
- 4. General contractor**
- 5. Lender**

### **C. Consequences of Cost Overruns**

- 1. Delay in completion**
- 2. Mechanic's Liens**
  - a. Escrow claim*
  - b. Title Policy claim*
- 3. Stop Notice**
  - a. Foreclosure*
  - b. Litigation*
  - c. Bankruptcy*

## **XVIII. CHANGE ORDERS**

- A. Requests by the Owner**
- B. Requests by the General Contractor**
- C. Review and Approval of the Change Order Requests by the Owner's Architect**
- D. Lack of Objections to the Change Order by the Lender because There Are Not Sufficient Funds which Remain in the Budget to Pay for the Work**

## XIX. THE LENDER'S OBLIGATION TO WITHHOLD FUNDS UPON RECEIPT OF THE STOP NOTICE

- Discretionary - if the stop notice is not bonded.
- Obligatory - if the stop notice is bonded.
- The lender's liability for failure to withhold funds.
- Clawback of your earned interest, points and fees?  
Familian Corp. v. Imperial Bank (1989) 213 Cal.App. 3d 681 and Steiny & Co. v. Citicorp Real Estate, Inc. (1999) 72 Cal.App.4<sup>th</sup> 199.

## XX. CONSTRUCTION LOAN ADVANCES: OBLIGATORY AND OPTIONAL

- Can the construction lender disburse loan funds, without the risk of a loss of lien priority, if there is a “technical” default in the loan (i.e. absence of a financial statement.)?
- Can the construction lender disburse loan funds, without the risk of a lack of lien priority, if the Lender has commenced foreclosure?
- Obtaining advance endorsements to the loan policy for each advance. [ALTA Forms 14-06, 14.1-06, 14.2-06 and 14.3-06 and CLTA Forms 111.14-06, 111.14.1-06, 111.14.2-06 and 111.14.3-06]

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## **XXI. REDUCING THE RISK OF LIABILITY FOR IMPROPER DISBURSEMENT OF LOAN FUNDS**

- Advance Endorsement(s) to the Loan Policy (as noted in prior slide).
- Fund Control Services:
  - Title Company Fund Control
  - Non-Title Company Fund Control

## XXII. CONSENSUAL WORKOUT OF A DEFAULTED LOAN

Modification Endorsement for the Loan Policy of Title Insurance. [ALTA Forms 11-06, 11.1-06 and 11.2-06 and CLTA Forms 110.11-06, 110.11-06 and 110.11.2-06]

- Inclusion of all necessary parties. [First California Bank v. McDonald (2014) 231 Cal. App. 4th 550]
- The potential for the Borrower to disrupt the workout:
  - Litigation
  - Bankruptcy

## XXIII. LOAN DEFAULT AND DISPUTE RESOLUTION

- Jury waivers Grafton Partners v. Sup. Ct. (2005) 36 Cal.4<sup>th</sup> 944. (unenforceable in California)
- Mediation (*adding a requirement in the loan documents requiring mediation before a lawsuit may be filed?*)
- Arbitration
  - Do you have one? Is it enforceable?
  - Recommended provisions: opt-outs, retired judge, follows California law, based on admissible evidence and the decision follows the law and the facts.
  - Federal arbitration act?
- Judicial Reference
- Litigation
  - State Court
  - Federal Court

## XXIV. THE DEED IN LIEU OF FORECLOSURE

- The “True” Deed in Lieu of Foreclosure.
- The “Modified” Deed in Lieu of Foreclosure.
- The risk of a merger and the anti-merger endorsement to the loan policy of title insurance.

## XXV. FORECLOSURE OF A CONSTRUCTION LOAN DEED OF TRUST

- Assign defaulted loan to a special purpose entity.
- Non-judicial foreclosure.
- Judicial foreclosure.
- Appointment of a receiver
- Concurrent non-judicial and judicial foreclosures.
- Credit bid risks.
- Attacking the foreclosure sale:
  - Attacks by the borrower.
  - Attacks by junior creditors.
  - Attacks by third parties.

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