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# Risk Management for Construction Loans

John L. Hosack, Esq., Jason E. Goldstein, Esq., Mr. Joffrey Long and Mr. Rick Rodriguez

12:00 Noon

May 17, 2016

Webinar

Buchalter Nemer

1000 Wilshire Boulevard, Suite 1500

Los Angeles, California 90017

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## I. INTRODUCTION

- This webinar *primarily* focuses on the management of specific risks faced by lenders in making construction loans, including lien priority, lender liability, mechanic's liens and dispute resolution.
- This webinar will not *primarily* focus on the following typical construction risks:
  - *Completion risk*
  - *Marketing risk*
  - *Environmental risk*
  - *Repayment risk*

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**SAVE THE DATE**

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**Risk Management for Construction Loans Part II:  
*Avoiding Time and Cost Overruns,  
Construction Defects and Faulty Designs***

**12:00 Noon**

**June 21, 2016**

**Buchalter Nemer - Webinar**

**John L. Hosack, Esq., Jason E. Goldstein, Esq.,  
Mr. Rick Rodriguez and Mr. Matt Becica**

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## II. RECORDATION OF THE CONSTRUCTION DEED OF TRUST AS A FIRST PRIORITY LIEN ON THE BORROWER'S PROPERTY

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

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- Lender's written disclosure to the escrow agent and the title insurer in the escrow instructions of potential commencement of the work of improvement.

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## III. SELECTION OF A FINANCIALLY RESPONSIBLE ESCROW AGENT

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

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## IV. 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

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

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- The *remaining one hundred* title insurers.
- Develop a relationship with *local* management.

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## V. 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.4th 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.*”

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- The title insurer's liability to the lender for misrepresentation.
  - Alliance Mortgage Co. v. Rothwell (1995) 10 Cal.4th 1226.
- The **limits** to *Insurance Code* §§ 12340.10 and 12340.11.

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## VI. 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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- B&B Syndication, Inc. v. First American Title Insurance Company (7<sup>th</sup> Cir. 2015) 780 F.3d 825
  - In this case the Court of Appeals held that the construction lender's failure to make available sufficient funds to pay for the mechanic's liens "created" the liens and excluded the lender from its title insurance coverage.

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## VII. 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** . . .”?

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- Is “known” limited to “actual knowledge”?
- Does “imputed knowledge” qualify as “actual knowledge”?

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

- 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.

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## VIII. SATISFYING THE LENDER'S DUTY TO DISCLOSURE 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**

Sample Instructions, Pages 4-5, Paragraph 2(r)

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.**

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- **Disclosure of Loan Documents**
  - Selected disclosures? Or entire file?

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## IX. 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.

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## X. 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.

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## XI. DEMAND UPON AND RECOVERY FROM THE GUARANTOR

- The secured guarantor.
- The unsecured guarantor.
- The “sham” guarantee defense. [CADC/RAD Venture 2011-1 LLC v. Bradley (2015) 235 Cal. App 4th 775; California Bank & Trust v. Del Ponti (2014) 232 Cal. App. 4th 162 and California Bank & Trust v. Lawlor (2013) 222 Cal. App. 4th 625]

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

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

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## XIII. 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.

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## XIV. CONSTRUCTION BONDS AVAILABLE ON PRIVATE WORKS OF IMPROVEMENT

- Performance bonds.
- Payment (*labor and materials*) bonds. [*Civil Code* §§ 8030 and 8600-8614]
- Lien priority reversal bonds. [*Civil Code* § 8452]
- Mechanic's lien release bonds. [*Civil Code* § 8424]
- Stop payment notice release bonds. [*Civil Code* § 8510]

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## XV. CONSENSUAL MODIFICATION OF A NON-DEFAULTED CONSTRUCTION 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 “Protocol” Agreement.

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## XVI. THE SPECTER OF “LENDER LIABILITY”

- Loan origination
  - Participation interests.
- Loan administration
  - Loan sales and participation interests.
- Loan workouts
  - The “Protocol” Agreement.
- Loan foreclosure

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## XVII. 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?

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- 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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## XVIII. 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

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## XIX. 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]

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- The potential for the Borrower to disrupt the workout:
  - Litigation
  - Bankruptcy

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## XX. 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?

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- Temporary Judge [Cal. Rules of Court, 2.831 et seq.]
- Litigation
  - State Court
  - Federal Court

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## XXI. THE ONE ACTION RULE: CODE OF CIVIL PROCEDURE § 726(a)

- Application of Section 726(a) to a construction loan.
- The “*Security First*” rule.
- Consequences of violating the “one action rule.”
- Matters not prohibited by the “one action rule”:
  - Non-judicial foreclosure.
  - Fraud.
  - Waste by the trustor.

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## XXII. 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.

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

- Non-judicial foreclosure.
- Judicial foreclosure.
- 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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## XXIV. THE BORROWER'S BANKRUPTCY AND THE RIGHTS OF THE CONSTRUCTION LENDER

- The automatic stay.
- Violation of the automatic stay.
- Relief from the automatic stay.
- Sale by the Bankruptcy Court.

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**SAVE THE DATE**

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**Risk Management for Construction Loans Part II:  
*Avoiding Time and Cost Overruns,  
Construction Defects and Faulty Designs***

**12:00 Noon**

**June 21, 2016**

**Buchalter Nemer - Webinar**

**John L. Hosack, Esq., Jason E. Goldstein, Esq.,  
Mr. Rick Rodriguez and Mr. Matt Becica**

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