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## **CONSTRUCTION LOANS IN THE SHADOW OF COVID-19**

**John L. Hosack, Esq., Jason E. Goldstein, Esq.,  
Michael Flynn, Esq. and Mr. Joffrey Long**

**Buchalter  
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Los Angeles, California 90017**

## INTRODUCTION

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The impacts of the COVID-19 pandemic severely affect construction loans and the construction industry. This is especially true in places which have severe “Shelter-In-Place” decrees which may stop all construction with a few exceptions.

## LOCATION OF THE CONSTRUCTION PROJECT

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Some places have very severe “Shelter-In-Place” or “Stay-At-Home” rules which may prohibit all construction with a few exceptions. Accordingly, the first thing you should do is to determine the local requirements applicable to the property and the loan.

## TYPE OF CONSTRUCTION

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Depending on the type of loan, with a few exceptions (i.e., affordable housing, sewage treatment plants, etc.), much construction has been stopped by governmental emergency decrees.

## STAGE OF CONSTRUCTION

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Assuming that you are able and willing to work on the project, a major issue will be the stage of construction (i.e., is it just started [foundation poured]? Is it nearly complete [installation of carpet]? Or is it in the middle?

## INSPECTIONS

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A major factor in deciding whether to attempt to continue construction is whether required inspections can be performed.

A. Governmental Inspections

Will the Building Department approve your electrical installation?

B. Private Inspections

Can you obtain an inspection for a draw request?

## **PARTIES WITH WHOM YOU SHALL NEED TO COMMUNICATE** (1 OF 2)

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- A. Borrower
- B. Guarantors
- C. Loan Participants
- D. Take Out Lenders
- E. General Contractors
- F. Subcontractors
- G. Material Suppliers
- H. Escrow Agent
- I. Title Insurer
- J. Holders of Junior Liens



## **PARTIES WITH WHOM YOU SHALL NEED TO COMMUNICATE (2 OF 2)**

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- K. Regulators
- L. News Media
- M. Loan Participants
- N. Loan Servicers

# OBTAIN A PROTOCOL ("PRE-WORKOUT") AGREEMENT

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## A. Parties

1. Borrower
2. Guarantors
3. General Contractor
4. Architect
5. Subcontractors
6. Suppliers

## B. Terms

1. Judicial reference or arbitration
2. Release

## DETERMINING WHETHER THE PROJECT HAS LOST VALUE

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- A. Type of Property (i.e., Shopping Mall vs. Apartment Building)
- B. Is the appraisal post COVID-19?
- C. Did the appraisal specifically consider the potential adverse impact of COVID-19 on the value of the property?

## OPTIONAL VS. OBLIGATORY ADVANCES

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Is the loan in a condition of default and are all further disbursements optional such that the disbursement will lose priority to any subordinate lien on the property?

# INSURANCE COVERAGE FOR COVID-19

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## *INSURANCE SOLUTIONS*

- Insurance could be part of the solution for some kinds of losses faced by this pandemic – mandatory closures, event cancellations, loss of use of business property, service disruptions, supply chain disruptions, sanitation and clean-up, income loss, and urgent need for additional or increased operating expenses, among many other impacts.
- Potential “first party” insurance for financial losses that may be available.
  - **Property insurance, business interruption, business income**
    - Broadly covers loss from “all perils” that cause “physical damage” to property like fire, storms, hurricane, earthquake, flood (e.g., COVID-19 contamination of business premises results in exposure or injury to patrons or employees; landlords, hospitality and food service operations requiring extraordinary measure to decontaminate may be covered).

## INSURANCE COVERAGE FOR COVID-19

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- Standard business policies typically exclude loss caused by contagious virus/disease
- Civil authority – if involuntary closure is ordered by State, what is the “cause”?
- Several states, New Jersey, Massachusetts, Rhode Island (CA soon?) are considering legislation to limit disease and similar exclusions, suspend “physical loss” conditions.
- Federal relief for small businesses (<500 employees) – handled like BI? ...by insurers?
- **Event Cancellation** (again – closely check coverage perils, conditions, exclusions)
- Potential “third party” insurance for damages claim against business owners
  - **Commercial General** liability, **Directors & Officers** liability, etc.

## TITLE INSURANCE AND RECORDATION

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- A. Is your Title Insurer open and operating?
- B. Is the County Recorder's Office open and operating?

## RESPONDING TO THE BORROWER'S REQUEST FOR A LOAN MODIFICATION AGREEMENT (1 OF 2)

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- A. Obtain a Protocol Agreement from all relevant parties.
- B. Obtain current financial statements from the Borrower and all Guarantors.
- C. Conduct a litigation search on the Borrower, and all the Guarantors.
- D. Have your attorney obtain a current appraisal on the Property.



## RESPONDING TO THE BORROWER'S REQUEST FOR A LOAN MODIFICATION AGREEMENT (2 OF 2)

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- E. Determine if the request for the Loan Modification was caused by COVID-19.
- F. Review the other projects and assets of the Borrower and all Guarantors.
- G. Determine what disaster relief programs, etc., which the Borrower and the Guarantors may qualify for.

# LENDER ALTERNATIVES IN THE EVENT OF DEFAULT

1. Events of default, e.g., recordation of mechanic's lien, stop payment notice, etc.
2. Immediately notify borrower and guarantor – *in writing* – of default and request that they cure.
3. Depending on nature of default, immediately inform in writing the title insurer, escrow agent and/or surety.
4. Determine if the borrower(s)/guarantor(s) can increase their equity contribution to the project.
5. Determine whether borrower can obtain additional financing.
6. Determine whether borrower can obtain additional investors.
7. Determine whether borrower can reduce the scope of the construction project.
8. Determine whether the borrower can sell the property in its “as-is” incomplete current condition.
9. Determine if the construction loan can be sold at an acceptable discount.
10. Multi-beneficiary loan issues.

## SHOULD THE LENDER RECORD A NOTICE OF DEFAULT WHILE IN NEGOTIATIONS WITH THE BORROWER OVER A POSSIBLE LOAN MODIFICATION OR FORBEARANCE AGREEMENT?

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- A. Introduction.
- B. Frequently, a modification agreement is considered as a result of a default by a borrower which would entitle the lender to record a notice of default.
- C. Frequently, the borrower will request that the lender not record a notice of default during the period of time that the borrower and the lender are discussing a possible forbearance agreement
- D. In the event that the borrower files for bankruptcy, the lender will not be able to record a notice of default until it first obtains relief from the automatic stay.
- E. The recordation of a notice of default by the lender will avoid the risk to the lender that the borrower, during the negotiations over the forbearance agreement, will file for bankruptcy and prevent the lender from recording a notice of default until after relief from the automatic stay is obtained.

THE MODIFICATION AGREEMENT SHOULD EXPRESSLY PROVIDE THAT EXCEPT AS EXPRESSLY MODIFIED ALL OTHER OBLIGATIONS REMAIN IN FULL FORCE AND EFFECT AND ARE REAFFIRMED BY THE BORROWER AND ALL GUARANTORS

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- A. Introduction.
- B. A modification agreement is an agreement by the parties to an existing contract to alter their obligations without deleting any of the elements essential to the validity of the original contract. *Carlson Collins, Gordon & Bold v. Banducci* (1967) 257 Cal.App.2d 212.
- C. A modification of the details of a contract which leaves its general purpose undisturbed is a modification rather than a rescission. *Travelers Ins. Co. v. Workmens Comp. App. Bd.* (1967) 68 Cal.2d 7, 17.

## STANDARD PROVISIONS TO BE CONSIDERED IN DRAFTING A MODIFICATION AGREEMENT

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- A. Introduction.
- B. Alternative dispute resolution.
- C. Choice of venue.
- D. Statute of limitations.
- E. Limits on recoverable damages.
- F. Releases.
- G. Borrower's admissions of defaults.
- H. Borrower's lack of defenses to the obligation.
- I. State loan balance is unquestionably owed.
- J. Consider interest rate adjustment commensurate with increased risk.

## ADDRESS THE RISK OF FUTURE EVENTS OF DEFAULT BY THE BORROWER

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- A. Provision which states that the granting of a loan modification is not a guarantee of further modifications of the loan.
- B. Expressly reserve the right to deny any request for a further modification of the loan.

**THE BORROWER SHOULD PROVIDE DETAILED AFFIRMATIONS  
TO THE LENDER ABOUT THE LOAN, INCLUDING THE ADMISSIONS OF ANY DEFAULTS**

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- A. Introduction.
- B. Frequently, a modification agreement is considered because the borrower and the lender have some issues with respect to the terms of the loan.
- C. To eliminate any disputes between the borrower and the lender with respect to the terms of the loan, the borrower should provide detailed affirmations to the lender about the loan (*i.e.*, the principal amount owed, the current interest rate, *etc.*), that there are no defenses to the loan, no breaches by the lender, nothing which affects title (lien priority), had the opportunity to consult with counsel and had sufficient time to make a decision on the modification.

## FEES, CHARGES AND A DEPOSIT FOR A MODIFICATION

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- A. Introduction.
- B. Original loan documents should provide that a reasonable deposit might be required as part of consideration for a modification.
- C. Time and expense to negotiate and document the modification.
- D. Risks to the lender for having agreed to a loan modification.
- E. The lender should impose fees and charges which are adequate to compensate it for: (1) the time and expense to negotiate and document the modification; and (2) the increased risk to the lender for having agreed to a loan modification.
- F. Whether a fee, charge or deposit should be required during COVID-19 should be seriously considered.



## SPECIFIC ISSUES RELATED TO CONSTRUCTION LOANS DURING THE COVID-19 PANDEMIC

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- A. No inspectors (“moth balling” projects).
- B. Breach of the Construction Loan Agreement.
- C. Breach of the Implied Covenant of Good Faith and Fair Dealing.
- D. Lender Activities beyond the Scope of a Traditional Lender of Money and the Potential to Create Fiduciary Duty.
- E. The Lender’s Active Participation in the Construction as Opposed to Normal Activities.
- F. Improper Disbursement of Loan Funds.
- G. Termination of Loan Disbursement
  - 1. Conditions for disbursement not satisfied by the Borrower.
  - 2. Borrower’s breach of loan agreement.
- H. Failure to Extend the Date of Completion.
- I. Failure to Modify the Loan Terms
- J. Lender Taking Control of the Borrower.

## DOES COVID:19 EXCUSE PERFORMANCE UNDER A CONSTRUCTION LOAN? (1 of 3)

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- A. Introduction
- B. Whose Performance Might Be Excused
  - 1. Lender
  - 2. Take out Lender
  - 3. Borrower
  - 4. Guarantor
  - 5. General Contractor
  - 6. Sub-Contractor
  - 7. Material Supplier
  - 8. Buyer
  - 9. Seller
  - 10. Tenant(s)

## DOES COVID:19 EXCUSE PERFORMANCE UNDER A CONSTRUCTION LOAN? (2 of 3)

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### C. Impact of Covid: 19 On Construction

1. Construction Not Started
2. Start of Construction Delayed
3. Pace of Construction is Slowed Down
4. Cost of Construction is Increased
5. Construction is Stopped
6. Value of Completed Project is Decreased
7. Need to Preserve the Value of The Improvements Which Have Already Been Constructed
8. Need to Maintain Insurance Coverage on Project

## DOES COVID:19 EXCUSE PERFORMANCE UNDER A CONSTRUCTION LOAN? (3 of 3)

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- D. Grounds For Non-Performance
  - 1. Force Majeure
  - 2. Material Adverse Change (“MAC”)
  - 3. Impossibility
  - 4. Emergency Orders
  - 5. Decline in Value of the Project
  - 6. Failure to Perform on Time
- E. The Lender’s Response to Borrower’s Non-Performance
  - 1. Loan Modification
  - 2. Forbearance Agreement
  - 3. Other Alternatives
- F. Reputational Injury Based on the Lender’s Response

## OBTAIN THE WRITTEN CONSENTS OF ALL INTERESTED PERSONS, INCLUDING BORROWER AND GUARANTORS

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- A. Introduction.
- B. Obtain the participation of all borrowers and all guarantors in any discussions with respect to a potential modification.
- C. Obtain the signatures of all borrowers, servicers and all guarantors to a protocol agreement before negotiations are commenced.
- D. Obtain the participation of all borrowers and all guarantors to any proposed modification agreement before it is effective.
- E. The failure to obtain the written consent of all borrowers and all guarantors can materially or adversely affect the loan modification.

**HAVE ALL GUARANTORS REAFFIRM THEIR GUARANTEES AND EXPRESSLY CONSENT TO ALL OF THE CHANGES IN THE LOAN TERMS WHICH ARE PROVIDED FOR IN THE MODIFICATION AGREEMENT**

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- A. Introduction.
- B. When the issue of a potential modification agreement is first raised, the lender should make it clear that as a condition to any modification agreement all guarantors must expressly consent to all of the changes in the loan terms which are provided for in the modification agreement, and reaffirm their obligations under the loan as modified.
- C. The guarantors should be required to participate in any negotiations with the borrower relative to a potential modification agreement.

## DETERMINE THE STATUS OF TITLE TO THE PROPERTY BEFORE ENTERING INTO NEGOTIATIONS AND BEFORE EXECUTING THE MODIFICATION AGREEMENT

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- A. Introduction.
- B. It is difficult in many states (including California) to determine the status of title to the property.
- C. There are a variety of ways that the status of the property could have been altered since the initial loan was made.
- D. The lender should make it clear to the borrower and all guarantors that the status of the title to the property must be as good, if not better, as it was when the original loan was made.

## AVOIDING THE LOSS OF PRIORITY OF THE CURRENT MORTGAGE

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- A. Introduction.
- B. The modification of the current mortgage loan may result in a loss of priority.
  - 1. The loss of priority could be a complete loss of priority to any junior lien.
  - 2. The loss of priority could be a loss only to the extent that a junior lien was prejudiced by the modification.
- C. How do you know who has a junior lien interest in the secured property?
- D. Inaction by a secured lender may, under certain circumstances, lead to a loss of lien priority.



**BEST PRACTICE: OBTAIN TITLE INSURANCE COVERAGE FOR  
THE MODIFIED MORTGAGE**

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- A. Introduction.
- B. There is a substantial risk that the title insurer will take the position that the title insurance coverage terminated if there is a modification of the insured mortgage.
- C. There is a material risk that the title insurer will take the position that the loan policy of title insurance does not extend to the modified mortgage.
- D. Obtain title insurance coverage for the modified mortgage, whether by an endorsement to the original policy or by the re-issuance of the policy.
- E. Beware of title company affidavits which make you liable.
- F. Determine the availability of “gap” coverage.

**BEST PRACTICE: HAVE THE TITLE COMPANY  
RECORD A NOTICE OF THE MODIFICATIONS**

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- A. Introduction.
- B. The lender should cause to be prepared a written memorandum relative to the modification of the loan agreement.
- C. The lender should request the title company to record the notice of the modification of the loan agreement.

## ALTERNATIVES TO A LOAN MODIFICATION AGREEMENT OR A FORBEARANCE AGREEMENT

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1. **Additional Loan Guaranty**
2. **Security from the Borrower and/or Guarantors**
3. **A “mini-perm” by the construction lender.**
4. **Sale of the project.**
5. **Bridge financing.**
6. **Participating mortgage.**
7. **Litigation.**
8. **Bankruptcy.**

# STOP PAYMENT NOTICES AND MECHANICS LIENS

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- A. What caused the problem?
- B. Immediate demand upon borrower, guarantors, escrow agent and title insurer.
- C. Who is responsible?
- D. How does the construction get completed?
- E. The roll of tolling agreements.
- F. The lender's obligation to withhold funds upon receipt of a Bonded Stop Notice.

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

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- 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.4th 199.

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

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- 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.

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

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- 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.

# CONSENSUAL WORKOUT OF A DEFAULTED LOAN

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



# LOAN DEFAULT AND DISPUTE RESOLUTION

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- Jury waivers Grafton Partners v. Sup. Ct. (2005) 36 Cal.4th 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

## IS A DEED IN LIEU OF FORECLOSURE PREFERABLE TO A FORBEARANCE AGREEMENT?

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- A. Introduction.
- B. The “true” deed in lieu of foreclosure.
- C. The “modified” deed in lieu of foreclosure where the loan survives.

# FORECLOSURE OF A CONSTRUCTION LOAN DEED OF TRUST

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- 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.

## John L. Hosack—*Presenter*

John L. Hosack is a Shareholder in the firm's Litigation Practice Group in Los Angeles and a member of the firm's Mortgage Banking Group. Mr. Hosack represents mortgage brokers, secured lenders and property owners at trial and on appeal in real property disputes including, broker liability, lender liability, fraud, breaches of contract, mechanic's liens, stop notices, judicial foreclosures, receiverships, escrow claims and title insurance claims. His transactional practice includes commercial real property loan documentation, loan workouts, REO sales and foreclosures. He is an Affiliate Member of the California Mortgage Association and a member of the Los Angeles Mortgage Association, a Fellow of the American College of Real Estate Lawyers and a Fellow of the American College of Mortgage Attorneys. He is the author of "California Title Insurance Practice (First Ed., Calif. Cont. Ed. Bar), the first book on title insurance, and is a past Chair of the ABA's Title Insurance Litigation Committee.



**John L. Hosack**  
Shareholder  
Buchalter Los Angeles Office

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## Jason E. Goldstein—*Presenter*

Jason E. Goldstein is a Shareholder and Co-Chair of Buchalter's Mortgage Banking Group. Mr. Goldstein specializes in "private money," real property related litigation, title, escrow, trade secrets and business litigation. Mr. Goldstein has an extensive legal background which includes defending lenders, brokers and servicers in court (negligence, fraud, TILA, RESPA, HBOR, wrongful foreclosure, lender/servicer liability defense, etc.), prosecuting escrow and title insurance litigation (on behalf of the insured), insurance coverage (Title, CGL, E&O, etc.), litigating misappropriation of trade secret claims, defending and prosecuting claims on behalf of general contractors and prosecuting receiverships. Mr. Goldstein is a fellow of the American College of Mortgage Attorneys ("ACMA") and a member of the ACMA Title Insurance Committee.



**Jason E. Goldstein**  
Shareholder  
Buchalter Irvine Office

## Michael Flynn—*Presenter*

Michael Flynn is a member of the Firm's Corporate Practice Group and Co-Chair of Buchalter's Mortgage Banking Group in the Los Angeles office. Mr. Flynn applies his unique background as the former Acting General Counsel of HUD, and the former General Counsel of PNC Mortgage and Flagstar Bank, to counsel clients on a variety of regulatory, mortgage, consumer financial services, FinTech and real estate matters.



**Michael Flynn**  
Of Counsel,  
Buchalter  
Los Angeles Office

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## Joffrey Long—*Presenter*

Active in making, arranging and loan servicing of both hard money ("private money") and institutional real estate loans, and in arranging and servicing trust deed investments since 1979. President of mortgage company, past president and education chair and current director and member of the education committee of the California Mortgage Association. Extensive teaching and training experience as an instructor for loan originator and loan servicer continuing education classes, including those required under the Nationwide Mortgage Licensing System, (NMLS) seminars on mortgage industry practices, and as a contract instructor for Park University Enterprises. Author of numerous courses and seminars regarding loan origination, loan servicing and the sale of loans to investors.



**Joffrey Long**  
Southwest Mortgage