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PERSPECTIVES

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CONSIDERATIONS FOR CONSTRUCTION LENDERS TAKING OVER PROJECTS MIDSTREAM

by Lawrence Teplin and Heather E. Stern

For a lender in today's uncertain environment, the decision of whether and when to foreclose on a commercial loan in default – and then what to do with the property once the foreclosure is completed – is daunting given the diverse and sometimes conflicting factors involved. The decision to foreclose on a loan where the project is still under construction goes far beyond the economic decision. Not only does the construction lender have to consider all of the other factors ordinarily involved in the foreclosure process, but the lender also has to consider stepping outside its comfort zone and into the shoes of the developer/owner, to take over a project with an uncertain future and try to complete construction. Few lenders have (or want) the staff and resources to become a developer/owner. Although each project presents unique challenges, below is an outline of some of the key factors to consider when a construction lender contemplates foreclosure on a loan for a not-yet-completed construction project located in California:

> ***The lender has to consider stepping outside its comfort zone and into the shoes of the developer/owner.***

Understanding the Status of Construction

A lender contemplating foreclosure in order to take title to a partially-completed project must understand the construction contracts already in place and the rights, if any, that the lender will have to either enforce those contracts or walk away from those contracts. A project in trouble could be suffering from poor construction plans, poor design, unclear scopes of work, an incompetent contractor, or all of the above. The lender must also understand what stage of construction the project is in, how much more time and money it will take to bring the project to completion (including how much it will cost for remedial work), and the likely market for the project once it is completed. Also, if the general contractor and/or major subcontractors were required to bond their portion of the work, the lender will need to put the bonding companies on notice.

Construction Defect Liability

By statute, a lender is not liable to third parties for construction defects unless the loss or damage is the result of an act of the lender outside of its lending activities or the lender has been a party to misrepresentations with respect to the property. (Civ. Code § 3434.) However, if a lender forecloses on an unfinished project, takes title, and then undertakes work to complete the project, or even undertakes merely to sell the completed project to a buyer, the lender risks liability for construction defects. For both commercial and residential properties, the lender as an owner / developer may become liable for negligent construction. In addition, for residential property sold to consumers, whether single-family homes or condominiums, the risk increases because the lender may be considered a

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NEGOTIATING STRATEGIES FOR LANDLORD: HANDLING RENT MODIFICATIONS IN THE CURRENT ECONOMIC DOWNTURN

by Anne E. Clinton

An ever-growing number of retail tenants are requesting rent relief as a result of today's challenging economic landscape. While no landlord wants to grant rent concessions, reduced rent from an operating tenant is generally preferable to no rental stream and a dark space. Based on our experience in drafting and negotiating documents that reduce rent while protecting landlord's long-term interests, we offer the following strategies:

Review Tenant's Financial Statements. In considering a request for rent relief (assuming landlord is able to financially absorb the cash flow reduction), landlord's first step should be to request and review proof of the retailer's economic distress. This often takes the form of gross sales reports and/or financial statements, for both the current and past periods. Even if the subject lease does not obligate tenant to provide this information, landlord can request such reports and statements as a prerequisite to rent reduction consideration. After analyzing tenant's gross sales reports and/or financial statements, landlord can better determine the amount and nature of rent relief (if any) that is most appropriate under the given circumstances.

A strongly-worded confidentiality provision can be one of the most important provisions in a rent relief document.

Tenants in Default Are Not Entitled to Rent Relief. Any document granting a rent modification should be expressly conditioned on tenant not being in default. If tenant goes into default, the document should specify that the rent reduction automatically terminates, and that tenant must resume full payment of the original contract rent and immediately repay to landlord the total amount of unpaid rent tenant would have owed if rent relief had not been granted. Reinstatement of the contract rent and acceleration of unpaid but accrued rent at the contract rate is especially important because it provides landlord with an initial remedy to enforce against tenant before landlord turns to the typical remedies for tenant defaults under the original lease.

Include a Confidentiality Provision… With Teeth. As many landlords know, word spreads quickly about rent reductions, making a strongly-worded confidentiality provision one of the most important provisions in a rent relief document. A well-drafted confidentiality provision requires tenant, its employees and agents to keep the terms of the rent relief negotiation and agreement confidential, and sets forth indemnity obligations and a monetary penalty in connection with any violation of this covenant.

Think Short Term. Rent reductions should be viewed as a temporary concession to tenant, so rent modifications should only apply for a relatively short time. We suggest limiting the term of reduced rent to twenty-four months or less. Rent modification documents should provide that at the end of the reduced rent term, rates either re-set to the rents in the original lease, or that rent will be re-negotiated by landlord and tenant based on then-current market rates.

Review the Current Lease for Concessions from Tenant. A thorough review of the existing lease and any amendments is an important step in any rent modification process. For example, landlords can request eliminating or modifying exclusive use, prohibited use and co-tenancy provisions. Landlords can also consider imposing a requirement that tenants submit regular gross sales reports—even for a non-percentage rent tenant—for use as a management tool to permit regular monitoring of a particular tenant's business. Additionally, if tenant secured its rental obligations with a letter of credit, Landlord should determine the strength of the issuing bank. As the FDIC has signaled that it may not honor letters of credit issued by banks that are in receivership, landlord should attempt to modify the existing letter of credit provision if landlord has concerns about the viability of the issuing bank.

Add Estoppel and Release Language to Head Off Future Disputes. It is advisable to include estoppel and release language in rent relief documents in order to limit landlord's exposure to inchoate claims. Ideally, the language would be similar to the provisions of a typical estoppel certificate and would include a release of

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LENDERS BEWARE - THE PERILS AND PITFALLS OF STOP NOTICE CLAIMS

by Robert G. Campbell

In light of the economy, more and more lenders are encountering issues with construction projects on which the lenders made loans in recent years. One issue that is becoming quite common is claims by contractors that the contractors were not paid as required by their construction contracts with the property owner. Some of these claims by contractors result in a stop notice being issued. A stop notice is defined as a written notice by the contractor to the lender to withhold loan funds to pay the contractor. Such stop notice creates a claim or "lien" on undisbursed construction funds held by lender for the benefit of the contractor. Put simply, it allows contractors, subcontractors and materialmen to reach undisbursed construction loan proceeds as security against the owner's failure to pay such contractor, subcontractor or materialmen. Like mechanic's liens, stop notices are not a creature of contract and do not require prior judicial approval. Furthermore, lien and stop notice rights may not be waived by contract, reflecting a strong public policy favoring payment of improvers of property.

> ***Lenders may face demands to disgorge earned fees and interest to bonded stop notice claimants.***

A form of stop notice that lenders are facing is known as the "bonded stop notice". A *bonded* stop notice is a stop notice given to a construction lender accompanied by a bond in a penal sum equal to 1.25 times the amount of the claim. This bonded stop notice requires the lender to withhold from undisbursed loan proceeds an amount that is sufficient to pay the amounts set forth in the bonded stop notice. The amount retained by the lender in response to a bonded stop notice should not be used to pay down the principal amount of the loan or to pay interest, fees or other costs owed to lender. A lender who fails to properly withhold undisbursed loan proceeds following a bonded stop notice is personally liable for the amount due to the lien claimant. However, it should be noted that the lender will not be liable for more than the amount of undisbursed loan proceeds at the time the bonded stop notice was served.

As both stop notices and mechanic's liens arise due to the failure by a property owner to pay the contractor, there are some similarities between stop notices and mechanic's liens that should be enumerated. For example, the same classes of claimants which may record a mechanic's lien may serve a stop notice. In addition, a 20-day preliminary notice is required under both mechanic's liens and stop notices unless the claimant has a direct contract with the owner of the property. Lastly, mechanic's liens must be recorded and stop notices must be served by the same deadline.

While there are some similarities between stop notices and mechanic's liens, there are also a few differences. First of all, stop notices attach to the funds of the owner of the property, or the construction loan proceeds from a lender, rather than to the real property being improved like mechanic's liens. As a result, a stop notice survives a foreclosure of the property and claimants serving stop notices do not have issues concerning priority over the construction lender's deed of trust which exist with mechanic's liens. Another significant distinction between a mechanic's lien foreclosure action and a stop notice enforcement action is the right of a bonded stop notice claimant to recover its attorneys' fees if determined to be the prevailing party. Lastly, a stop notice claimant need not wait until his or her work is complete to serve a stop notice, while a mechanic's lien claimant must wait until its work or the overall work of improvement is complete.

When served with a bonded stop notice, in addition to understanding the basic rules governing bonded stop notices, a lender must consider the following:

(1) Stop notice priority extends to all loan funds available for disbursement, even funds which the property owner is not entitled to receive because disbursement conditions have not been satisfied or if the property owner is in default. As a consequence, a lender may not properly defeat a stop notice by insisting that no "undisbursed funds" exist because the borrower is in default. Therefore, the loan documents between lender and property owner may not serve as a defense to a stop notice claim.

(2) There is case law which is not favorable to lenders titled *Familian Corp. v. Imperial Bank* (1989) 213 Cal.App.3d 681 which might impact how lenders respond to stop notices. In *Familian,* a construction lender received stop notices which far exceeded the undisbursed loan balance. Meanwhile, the lender had paid itself interest and fees from a reserve account specifically set up to pay interest on the loan and other fees owed to lender as such amounts accrued. The claimant contested the right of the lender to pay itself from such reserve account *before* the stop notice was served. According to this decision, the practice of

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> payment from an interest reserve constitutes a statutorily prohibited assignment. The court held that the lender may not pay itself fees and interest in preference to stop notice claimants. To do otherwise would permit the lender a "double recovery" by allowing it to capture fees and interest *and* the enhanced value of its property created by the construction work performed by the claimants. The effect of the *Familian* decision is huge in that a lender may be required to disgorge amounts it has paid itself in *earned* interest and expenses.

The rationale of the *Familian* case has been questioned and many consider it a bad decision. In fact, in a case entitled *Steiny v. Real Estate, Inc.* (1999) 85 Cal.Rptr.2d 38, another court disagreed with the *Familian* court's reasoning. It ruled that a lender was entitled to keep payments made to itself from the loan fund to the extent those amounts were *earned* prior to service of the stop notice. However, the *Steiny* case was later decertified from publication, meaning that it may not be cited as law. *Familian*, warts and all, remains existing law and must be considered by lenders.

So, all this being said, how does a lender defend against a stop notice claim? Initially, the lender should evaluate whether the prerequisites for a stop notice have been met, such as verifying that a proper bond was obtained by the claimant, a proper 20-day preliminary notice was given and in a timely fashion, the stop notice was timely served, the claimant is among the categories of claimants which possess stop notice rights, and, if the claimant was required to hold a license, it is properly licensed. The lender should also work with the property owner to determine the merits of the stop notice claim and attempt to compel the property owner to resolve the dispute with the claimant. The lender should consider demanding that the property owner secure a stop notice release bond if a legitimate dispute exists. Ultimately, the property owner and the lender share a strong incentive to keep stop notices from interfering with timely project completion. An incomplete and delayed project undermines the value of the lender's security. In addition, if a lawsuit is filed to enforce the stop notice and is accompanied by a mechanic's lien foreclosure action, the lender should consider whether to tender the lawsuit to the title insurer. Finally, the lender may need to consider whether to file an interpleader action, in which it may be entitled to recover its attorneys' fees. Given everything set forth herein, it is clear that a lender should never ignore a stop notice claim.

NEGOTIATING STRATEGIES FOR LANDLORD, cont'd

landlord from any claims up to the date the rent modification document is executed.

Include a Landlord Recapture Right. Another important concession to gain from tenants in a rent relief negotiation may be the inclusion of a right for landlord to recapture the space from tenant for any reason during the rent reduction period, which, if exercised, can only be nullified by tenant's agreement to revert to payment of full rent under the original lease. While some tenants may initially find such a recapture right to be overly-aggressive, it actually represents a fair compromise between landlord's long-term interests and tenant's short-term needs. Since it is unlikely that a landlord would exercise its recapture right against a performing tenant now when times are difficult, tenant is protected from an unexpected lease termination in the near future. If rental rates during the period of rent reduction rebound, landlord retains the flexibility to re-lease the space to a tenant who can pay the then-current market rate. If the original tenant can afford such higher rates, it can nullify the recapture notice by agreeing to pay the higher rent. If the original tenant can not afford the higher rates, the lease terminates.

Defer Rent, Don't Abate. Landlords should consider avoiding rent waivers or abatements. Instead, landlords may prefer to structure rent relief as a deferral. As discussed above, the amount of deferred rent can be used as an incentive against non-performance, so that if tenant violates any of the provisions of the lease, the portion of rent that is deferred accelerates and becomes immediately due. Landlords may also consider structuring deferred rent as a non-interest loan that is payable at the end of the lease term or at some other date in the future.

Tenants Must Be Open and Operating Continuously. To the extent the original lease does not include an operating covenant, rent relief should be conditioned on tenant's continuous operation. This provision is especially important (if not necessary) if rent relief takes the form of a percentage of gross sales in lieu of fixed rent.

Include a Right for Landlord to Show the Space. During any period of rent relief, landlord should be allowed to show the premises to other potential tenants. While the existing tenant may object, it seems fair to give landlord the ability to market the space to a prospective tenant who can pay full rent during the period in which tenant is enjoying a gratuitous rent reduction.

FIDUCIARY DUTIES: THE HIDDEN OBLIGATIONS IN JOINT VENTURES

by Kevin J. Crabtree

As we move into more contentious times, people are dusting off their old agreements with increasing frequency to determine their rights and obligations. However, sometimes these rights and obligations are hidden. In the joint venture context, this is particularly true with respect to fiduciary duties. Fiduciary duties are commonly imposed upon anyone exercising control over a joint venture. Even though these duties are often not detailed or even mentioned in joint venture agreements, they can nevertheless impose substantial constraints upon the parties to joint ventures. These fiduciary duties can be broken down into two primary duties – the duty of loyalty and the duty of due care. Given the common use of Delaware limited liability companies in real estate joint ventures, this article focuses specifically on fiduciary duties imposed in connection with limited liability companies formed in Delaware.

The Duty of Loyalty.

The duty of loyalty requires the manager and other fiduciaries of a limited liability company to be motivated only by the best interests of the company and its members.

This duty often arises in connection with transactions and agreements entered into between a limited liability company or its members, on the one hand, and its manager or the manager's affiliates, on the other hand. In these transactions, the duty of loyalty is generally interpreted to require the manager to prove that the transaction was entirely fair to the limited liability company and its members. Entire fairness, in turn, has two components: fair dealing (relating to issues such as the timing of the transaction and how it was initiated, structured and negotiated) and fair price (relating to the ultimate consideration paid). Needless to say, it can be very difficult to prove that a transaction was entirely fair. As such, even though a limited liability company agreement may grant broad management discretion to a manager and not prohibit or otherwise restrict the manager or its affiliates from lending money to, borrowing money from, selling assets to, buying assets from, merging with or otherwise entering into transactions with, the company, the imposition of the duty of loyalty can severely limit a manager's ability to enter into these transactions.

> ***Delaware law grants the parties to limited liability company agreements broad authority to modify fiduciary duties.***

The duty of loyalty can also arise in a variety of other contexts, including instances in which a manager or other fiduciary is competing with its limited liability company, is taking a business opportunity that it learned about through the limited liability company or even when it is simply exercising its management rights under the limited liability company agreement. For instance, even when a limited liability company agreement provides that a manager may make a decision in its sole discretion, its discretion may not be unfettered. Rather, a manager may be found to have breached its fiduciary duties in the event that it makes a decision in bad faith.

The Duty of Due Care.

The duty of due care requires the manager and other fiduciaries of a limited liability company to act without gross negligence. For instance, the manager cannot be recklessly uninformed in connection with performing its duties or act outside of the bounds of reason. As such, even if a limited liability company agreement does not require the manager to adhere to a specific standard of care, the manager will nevertheless be required to act without gross negligence.

Modification of Fiduciary Duties.

The imposition of these general fiduciary duties can create a great deal of uncertainty and result in the creation of limitations which the parties never intended to create. Fortunately, limited liability company agreements can be drafted so as to eliminate, limit or expand the fiduciary duties which would otherwise be imposed. However, if such modifications are not drafted in a clear and unambiguous manner, there is a substantial risk that a court will nevertheless impose standard fiduciary duties.

For example, in the event that a transaction between the manager and its limited liability company has been specifically provided for in a limited liability company agreement, the manager will generally not be required to prove the entire fairness of the transaction so long as it complies with

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the requirements of the limited liability company agreement. In other words, to the extent that related party transactions are specifically contemplated by a company's limited liability company agreement, the courts will generally respect the terms of the limited liability company agreement and not impose any additional fiduciary duties.

Implied Covenant of Good Faith and Fair Dealing.

In general terms, the implied covenant of good faith and fair dealing provides that a party to a contract cannot engage in arbitrary or unreasonable conduct which prevents the other party from receiving the benefits of the contract. While fiduciary duties may be modified or eliminated, it is important to note that, under Delaware law, the implied covenant of good faith and fair dealing can never be waived. As such, parties to Delaware limited liability company agreements will always, at a minimum, be bound to adhere to the implied covenant of good faith and fair dealing.

Delaware law grants the parties to limited liability company agreements broad authority to modify the default fiduciary duties which would otherwise be imposed by law. As such, when drafting a limited liability company agreement, careful consideration should always be given to any desired modification of these duties. A limited liability company agreement which has been carefully drafted to specify the extent to which fiduciary duties will be applied will generally yield few surprises. However, the impact of fiduciary duties, whether arising under the law or the terms of a limited liability company agreement, should always be carefully analyzed before taking any action in which fiduciary duties may be implicated. This is particularly the case in instances involving related party transactions. Otherwise, one runs the risk of unknowingly breaching a fiduciary duty.

CONSIDERATIONS FOR CONSTRUCTION LENDERS, cont'd

"builder" under California's Right to Repair Law (SB 800) (the "Right to Repair Law") and, therefore, subject to construction defect liability under that statute.

One potential way for a lender to minimize its potential liability for construction defects is for the lender to use a single purpose entity ("SPE") as the foreclosure entity and obtain adequate insurance (see discussion below), including completed operations coverage, for that foreclosure entity. Like any SPE, to avoid alter ego liability, the entity will need to be adequately capitalized and, among other things, the lender will need to keep segregated funds, maintain legal formalities like corporate minutes, and have enough separate officers and directors such that the SPE can effectively make its own separate business decisions independently of the lender.

Additionally, for any residential project, the SPE will need to be staffed and prepared to handle the "builder's" responsibilities under the Right to Repair Law. Among other things, the Right to Repair Law establishes specific liability standards for construction defects in residential projects and establishes dispute resolution procedures homeowners must follow prior to filing a construction defect lawsuit (assuming the developer "opted-in" to this process during the sales process). As part of these procedures, the SPE may have a right to inspect and attempt to repair the defect prior to litigation. However, the lender will have to make sure that the homeowners know how to contact the SPE and that the SPE has the staffing and expertise needed to handle calls from homebuyers pursuant to the Right to Repair Law.

One potential way for a lender to minimize its potential liability for construction defects is for the lender to use a single purpose entity as the foreclosure entity.

For a lender that lacks the necessary staffing and expertise, one possible alternative is for the SPE to enter into a joint venture with an experienced developer. Another alternative is for the SPE to contract with a developer to act as the construction manager, customer service representative, and sales representative.

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CONSIDERATIONS FOR CONSTRUCTION LENDERS, cont'd

Insurance

Insurance and risk management are key components to a developer's strategy for a successful project, and likewise for a lender once a lender takes over a project. The lender must perform a comprehensive evaluation of the coverage that is in place and what, if any, benefits that coverage will provide to the lender upon the lender's takeover of the project. No matter what insurance the loan documents required and regardless of how many certificates of insurance are in the lender's file, the lender should assume that when it forecloses there will be insurance deficiencies which range from under-insurance, to a lack of insurance for important exposures, to no insurance at all.

The lender needs to locate the actual insurance policies (and not just the certificates, which are not binding on the insurer), including the additional insured endorsements, evidence of property insurance, and loss payee endorsements, in order to fully evaluate existing coverage. An example of coverage that the lender will want to ensure is in place is a "tail" policy covering construction defects for at least 10 years from completion of construction, given the 10 year statute of repose which generally governs construction defect claims. Finally, if the lender forecloses and its newly-formed SPE takes title, the SPE will either have to arrange to be added as a named insured on existing policies or buy new coverage under its own name.

> ***The advantage of a receivership is that absent conspiracy or inappropriate control over the receiver, California law provides that the lender is not liable for the receiver's conduct and is insulated from third party claims.***

Appointing a Receiver

In order to protect its real property collateral, a lender will often want a receiver to be appointed to take over management of the collateral during the pendency of the foreclosure proceedings. A receiver is an agent of the court, charged with considering and protecting the rights of all interested parties, and is not an agent of the lender. A deed of trust typically contains provisions allowing for the appointment of a receiver to take possession of and operate the real property collateral upon the borrower's default under the loan. The receiver has only the powers given to him by the court order appointing the receiver. Typically, the court may authorize the receiver to take control of, manage, and care for the lender's collateral, to take control of the borrower's books and records pertaining to the property, and to do all acts necessary to protect the property, its proceeds and products and to preserve the lender's rights in the property, where the lender can show that the property is in danger of being lost, removed, or materially injured. (Code Civ. Proc. § 564, *et seq.*) In some instances, the court may authorize the receiver to complete construction of the project.

The advantage of a receivership is that absent conspiracy or inappropriate control over the receiver, California law provides that the lender is not liable for the receiver's conduct and is insulated from third party claims. The disadvantage is that the lender does not have direct control over the project, and the receiver's fees and expenses (which can be considerable) are paid out of and reduce any eventual proceeds from the project. If the proceeds are not sufficient to pay the receiver's fees and expenses, the lender likely will be liable for paying them. Also, the appointment of the receiver generally only lasts through the completion of a sale or foreclosure.

Stop Notices and Mechanics Liens

A borrower in default under a construction loan midstream through the construction will undoubtedly leave in its wake a string of unpaid contractors, subcontractors and materialmen with the ability to file mechanic's liens on the project. A lender's deed of trust is senior to any mechanic's liens, so long as the deed of trust was recorded before any work commenced on the project. (Civ. Code § 3134.) Thus, a senior lender's foreclosure on the property can wipe out mechanics liens as well as any other junior interests.

Recognizing that its mechanic's lien may not result in payment, a contractor, subcontractor or materialman can also issue a stop notice to the construction lender. A stop notice is a written notice to the lender to withhold loan funds to pay the contractor. One form of commonly used stop notice is known as the "bonded stop notice." A bonded stop notice creates a claim or "lien" on undisbursed construction funds held by a lender for the benefit of the contractor, as security against the owner's failure to pay the contractor. A bonded stop notice has additional penalties and recoveries associated with it if the

CONSIDERATIONS FOR CONSTRUCTION LENDERS, cont'd

lender fails to properly withhold undisbursed loan proceeds following receipt of the bonded stop notice.

A bonded stop notice not only liens undisbursed construction fund proceeds, but it may even require the lender to pay back previously earned fees and interest into the construction fund. Because stop notices attach to the funds of the owner of the property or the construction loan proceeds from a lender, rather than to the real property being improved like mechanic's liens, they survive a foreclosure of the property. (Please see the article entitled "Private Works Stop Notices Create Risks For Lenders" for a further discussion on stop notices.)

Affirmative Claims for Construction Defects

Leaving aside a construction lender's rights and remedies against the borrower and/or guarantors, a construction lender also may want to consider potential claims against third parties. A lender has standing to sue third persons such as contractors and design professionals for intentional or negligent impairment of the lender's security interest, even if the lender does not first judicially foreclose and obtain a deficiency judgment. (*See, e.g., United States Fin. v. Sullivan* (1974) 37 Cal.App.3d 5.) However, if a lender makes a full credit bid at a foreclosure sale, then the lender will have no further recourse against third parties (or the debtor) since the debt will be found to be extinguished.

Liability for the Condition of the Property

A lender that takes title to the property, whether through a bid at a foreclosure sale or through a deed in lieu of foreclosure, can be held liable for the condition of the property just like any other property owner. This can include liability for nuisance, dangerous conditions, encroachments and boundary disputes, and environmental hazards.

A construction lender contemplating foreclosure on a construction loan in the middle of a construction project rarely faces any good options. However, if the construction lender considers all of the issues and does its due diligence prior to deciding on a course of action, the construction lender can minimize some of the risks while it acts to maintain or even enhance its security.

LOS ANGELES
2049 Century Park East, 28th Floor
Los Angeles, California 90067-3284
P 310.277.4222 F 310.277.7889

ORANGE COUNTY
19800 MacArthur Blvd., Suite 500
Irvine, California 92612-2435
P 949.476.2111 F 949.476.0256

SAN FRANCISCO
555 California Street, 10th Floor
San Francisco, California 94104
P 415.392.4200 F 415.392.4250

www.coxcastle.com