

# Commentary

## Foreclosed Condominium Projects – Traps for the Unwary Lender

by L. David Cole

Foreclosure of a troubled condominium project leaves the foreclosing lender with the customary REO problems to resolve. In addition, however, the structure of a condominium project and related statutory and regulatory requirements result in a number of additional problems, particularly if the condominium development is partially constructed and sales are under way, of which a foreclosing lender should be aware and which should be considered in evaluating the lender's security and in anticipating its exit strategy from the foreclosed property. Those problems include the following:

- California Department of Real Estate (DRE). If sales are under way, the builder's sales of finished condominiums units were regulated by DRE, which had approved a Final Subdivision Public Report (generally referred to as a White Report) before any sales by the builder could be finalized. Following foreclosure, the builder identified in the White Report is no longer the owner of the project. Most institutional lenders, following foreclosure, may continue to sell in conformance with the builder's then-current White Report, provided that notice is given to DRE within 30 days of foreclosure. However, in a troubled project the builder may not have kept the information in its White Report current, and often budgets and other information are out of date. Moreover, the foreclosing lender may wish to amend the builder's White Report, for example to disclose that such lender did not build the project and to add "as-is" disclaimers. The foreclosing lender may also wish to amend the builder's sales or other documents which have been approved by DRE, for comparable purposes. A bulk sale of the entire property by the foreclosing lender following foreclosure is usually exempt from DRE requirements; however, if such a bulk sale is being considered the availability of an exemption should be confirmed.
- Declarant Rights. Ownership and operation of a condominium project is typically governed by a Declaration of Covenants, Conditions and Restrictions (CC&Rs), which is prepared by the builder and recorded in the County where the property is located. If any sales have closed at the project, amendment of the CC&Rs is difficult, and often impossible. Most CC&Rs designate the builder-developer as "Declarant" and provide for a number of rights and exemptions for Declarant from restrictions imposed on other owners, including, for example, commercial use of the condominium units (for example, as a sales office), architectural review and approval, signage, hours when work may occur, etc. In addition CC&Rs typically provide for a limited period within which Declarant controls the Homeowners' Association. CC&Rs often, but not always, include provisions anticipating a successor Declarant, - for example following assignment by the existing Declarant or automatically upon foreclosure. Whatever the procedure to designate a successor, the foreclosing lender should assure that it succeeds to Declarant's rights and that, if the project is to be sold to another builder or developer, Declarant's rights can be transferred concurrently with such conveyance. (Although it's too late to address when the foreclosure occurs, the lender's loan documentation should include Declarant's rights in its security, and the lender's approval of the project CC&Rs and related subordination of its loan security to the CC&Rs, a DRE requirement, should not be given if there is not a clear procedure for the transfer of Declarant's rights.)
- Improvements, Improvement Agreements and Security. Many condominium developments include amenities (pool, health club, playground, etc.) which are promised to purchasers but may not be completed when sales commence. Often the completion of those improvements will be the subject of an improvement agreement, with the Homeowners' Association, DRE and/or the local government, for the performance of which the builder may have delivered improvement bonds, letters of credit or other improvement security. Such improvement agreements should be carefully reviewed (preferably as generated and agreed while the project is proceeding rather than at

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foreclosure), to identify and address any liabilities and obligations to which the foreclosing lender may succeed and responsibility for any related improvement security. Even if the foreclosing lender does not succeed to any such obligations and is not responsible for any improvement security, it should at least consider the effect on the value of the project following foreclosure if the improvements are not completed.

- Construction Defects. California law contains extensive provisions regarding responsibility for construction defects and related repair rights and obligations. Generally speaking foreclosing lenders are exempt from construction defect liability. However, if the foreclosing lender improves the property - for example by completing units under construction, it may lose that exemption.
- Pending Sales. If at the time of foreclosure there are pending unclosed sales, the foreclosing lender must consider whether it intends to complete such sales. If so, that consideration should include the status of completion of the units to be sold, of the buyers' deposits (often but not always held in an independent escrow) and of the current White Report and other DRE documentation, which must at a minimum be amended to identify the foreclosing lender as seller.
- Homeowners' Association Dues and Assessments. At the time of foreclosure, the borrower was probably delinquent in obligations for payment of dues and assessments to the Homeowners' Association. That liability will probably be extinguished by foreclosure of the lender's security, but the resulting relief may be more apparent than real. If the delinquency was significant the Homeowners' Association may lack sufficient funds to satisfy its agreed responsibilities (maintenance, landscaping, etc.), with the result that the project's appearance and condition are degraded, at a time when the foreclosing lender is anxious to sell the foreclosed property. In addition, dues and assessments will probably have to be increased, and if so the Homeowners' Association budget (and related DRE disclosures) will have to be revised. There may be improvement agreements and security (see above) which relate to the Homeowners' Association which, although not a direct obligation of the foreclosing lender, would adversely affect the value of such lender's interest if not performed or satisfied. Hence the foreclosing lender may find that, as a practical matter, it must pay or otherwise satisfy obligations to or for the benefit of the Homeowners' Association.

The foregoing list is not exclusive. Other matters which a foreclosing lender should consider include title insurance, liability insurance (both borrower's insurance, on which hopefully the foreclosing lender has been named as an additional insured, and lender's insurance), subdivision compliance (possible expiration of the borrower's tentative map if the borrower has not recorded final maps and/or condominium plans for the entire property) and others.

Foreclosing lenders should carefully address and review all of the foregoing matters, ideally as their loan is being agreed and documented but in any case thoroughly before, during and following foreclosure.

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