

## **Foreclosing on Subdivisions – Know Your Subdivision Agreement**

(Article 2 of 2)

Our earlier memorandum on Set Aside Letters made the point that a lender is never in a better position to gain the assistance and support of a Borrower than before the loan records or when a Notice of Default is imminent. Assuming the loan you are managing is already on the books, before you declare an event of default, record the NOD and move toward foreclosure, you need to evaluate several critical documents. One such document is the Subdivision Agreement.

You need to understand that every Subdivision Agreement (sometimes known as the Site Improvement Agreement) is unique in its scope and requirements. Even Agreements issued by the same City or County can vary widely from project to project. There is no way to avoid the sad fact that you are going to have to read this document from cover to cover to understand your position as Lender.

The Subdivision Agreement typically outlines the timing and scope of the site improvements for a proposed subdivision. Most of the Agreements are very detailed and include budgets for bonded work, required public right-of-way improvements, reimbursements, utility requirements, and improvement phasing. The document provides for penalties and consequences for violations of the document as well as procedures for amending the document. The Subdivision Agreement sets out the rules and the scope of the development of the site.

What the Subdivision Agreement does not usually address, however, is the financing of the development. It is not a tri-party agreement that includes the Lender in the terms and conditions. The Subdivision Agreement is strictly between the Subdivider (who is typically identified by name in the document) and the City or County. It is up to the Lender to ensure that they are able to insert themselves into the provisions of the document by obtaining an assignment of the Subdivision Agreement.

Most Construction Loan Agreements contain a general assignment of “all project documents.” Occasionally, the Loan Agreements will enumerate those documents and even mention the Subdivision Agreement by name. However, many cities and counties have very specific requirements for assignment of the Subdivision Agreement, which are written into the Agreement itself and they do not recognize general assignments. It is not uncommon for a city or county to require written consent of any assignment of the document before such assignment is considered valid. Third parties, such as Lenders, are unable to take advantage of “reimbursables” or, upon the foreclosure and subsequent sale of the OREO, the further assigning such reimbursables and fee credits to the new owners if the Lender has not perfected their assignment of the Subdivision Agreement.

In one recent case, a Lender foreclosed on a 100+ lot subdivision with the site work about 75% complete. The widening of an adjacent street, center median construction and landscaping, perimeter landscaping and irrigation, and street lighting all remained to be completed. The Lender was notified by the Bonding Company that the City was calling the Performance Bonds and that the Lender was to remit the remainder of the Set Aside funds. The Lender had the remaining work estimated by a GC and the total cost to complete was less than the remaining

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Set Aside balance. The Bonding Company allowed the Lender to contract for the work and the site was completed.

Upon Tract Acceptance by the City, the Lender applied for the reimbursables as provided for in the Subdivision Agreement. These reimbursables included fee credits that the Lender wanted to pass along to a future buyer of the OREO and cash payments for public benefit improvements that the Lender had paid for after the bonds were called. The City refused to remit the funds to the Lender, maintaining that the Lender had no rights to the funds as the Lender had not obtained the City's written consent to their assignment of the Subdivision Agreement. And while letters were flying back and forth between the City Attorney and the Bank's counsel, the original Borrower made claim to the funds under the terms of the Subdivision Agreement. The Lender had to file a motion in court prohibiting the City from remitting the funds to the Subdivider (the original Borrower). If this case goes to court, it is possible that the court will interpret the document strictly as written and will award the funds to the Subdivider, maintaining that the City provided a means for the Lender to perfect an assignment in the Subdivision Agreement, but the Lender failed to do so.

It is true that under some circumstances, it may not be to the Lender's benefit to step into the Subdivider's shoes. Counsel should be retained to draft the Assignment document. It is critical that the Lender be allowed to replace the Subdivider under the terms of the Subdivision Agreement, but not required to do so. This gives the Lender maximum flexibility to act in its own best interest.

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