Caveat Lender: Take A Close Look At The Subdivided Lands Act and Right to Repair Law – They May Impact Sales Of Newly Constructed Homes Acquired Through Foreclosure

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(This is part one of a detailed article on the Subdivided Lands Act and California's Right to Repair Law. The complete article may be viewed on the California Receivers Forum's website -- www.receivers.org. Part II will appear in the next issue of RN)

Lenders face the prospect of foreclosing on residential property developments in various stages of construction as a consequence of the downturn in the California residential real estate market and developer defaults. The developer may have completed all construction and the foreclosing lender may acquire and sell completed homes in some cases. In others, the lender may wish to complete construction before the homes can be sold.

The prudent lender should consider a number of issues peculiar to the residential development industry before it proceeds under either scenario, however. This article highlights two of these issues: the potential applicability of California's Subdivided Lands Act[1]; and the potential applicability of the "Requirements for Actions for Construction Defects" set forth in Sections 895 et seq. of the California Civil Code[2] (commonly known as the "Right to Repair Law").

SUBDIVIDED LANDS ACT.

Any person seeking to sell five or more "undivided interests" in "subdivided lands" (including, without limitation, lots, parcels, or condominiums in a common interest development and lots in standard subdivisions in the unincorporated area of a county) must comply with California's Subdivided Lands Act and submit to the jurisdiction of the California Department of Real Estate ("DRE") (subject to certain exceptions[3]).

The Subdivided Lands Act (the "Act") generally requires any person intending to sell undivided interests in subdivided lands within California to first obtain a final subdivision "public report" from the DRE[4]. This public report is designed to provide prospective purchasers with sufficient information to make an informed purchase decision and to protect buyers from misrepresentation, deceit and fraud[5].

A host of material must be furnished to the DRE obtain a public report. Subdividers usually must submit "governing documents" intended for use in sale of properties. These include a notice of intention and completed questionnaire regarding the subject property, as any covenants, conditions, and restrictions ("CC&Rs") on the land, sample purchase and sale agreements, deeds, and escrow instructions, preliminary title reports, tract maps, condominium plans, and homeowners association ("HOA") budgets, articles of incorporation, and bylaws.[6]

Lenders taking title to five or more undivided interests in subdivided lands through foreclosure are not exempt from these obligations[7]. Nor are

receivers appointed by courts at the request of such lenders for the purpose of marketing and selling such property exempt from these requirements[8].

If a public report for such property already exists (e.g., prepared by the prior owner or developer pre-foreclosure), the lender may be able to use it, pursuant to Section 11010.5 of the California Business & Professions Code, which states:

> "The filing of a second notice of intention to sell and a second report of the commissioner under this article shall not be required when all the following conditions have been met: (a) where there has been a previous subdivision report and the lots are subsequently acquired through any foreclosure action, or by a deed in lieu of foreclosure, by a bank, life insurance company, industrial loan company, credit union, or savings and loan association licensed or operating under the provisions of a state or federal law if the acquired lots, either improved or unimproved, will be sold in conformance with the previously issued subdivision public report; (b) the original public report is given to the first purchasers of the lots in the foreclosed subdivision; and (c) the commissioner is notified of the change of ownership within 30 days of the acquisition of the title to such property.[9]"

A lender wishing to use this statute must notify the DRE that it acquired the property through foreclosure within thirty (30) days after it takes title.[10]

The statute also requires that the property be sold "in conformance with the previously issued subdivision public report."[11] Precisely what this language means is subject to interpretation. Minor changes that do not affect the body of the public report (e.g., name and address changes, etc.) or the governing documents are presumably permissible[12]. But "material" changes reflecting different sales and marketing goals of the lender (such as revising the governing documents to provide that the homes will be sold in their "as-is" condition or to change the DRE phasing or HOA assessments, and the like) may be beyond the scope of permitted modifications.[13]

In the interest of avoiding differing applications of the statute by the DRE, as well as avoiding potential criminal liability,[14] any lender who desires to make ANY changes to the public report or governing documents other than a simple name or address change should strongly consider applying to the DRE for an amended public report[15]. Using this procedure may delay the sale of homes and add to the lender's costs, but the lender can minimize these problems by retaining an experienced DRE processor, budget consultant, and legal counsel well versed in DRE requirements.

THE RIGHT TO REPAIR LAW.

The Right to Repair Law (the "RRL") imposes numerous obligations on each "builder" of original construction intended to be sold as an individual dwelling unit[16]" and actually sold on or after January 1, 2003[17]. Both "builder" and "unit" are defined terms under the RRL.

The RRL requires each builder to meet construction standards enumerated in the statute.[18] Any builder whose homes fail these standards may be liable for damages for the reasonable value of repairing the violation and/or the reasonable cost of : repairing any damages caused by the repair efforts; damages resulting from the failure of the home to meet the standards; rectifying any damages resulting from the failure of the home to meet the standards; removing and replacing any improper repair by the builder. Reasonable relocation and storage expenses, lost business income if the home was used as a principal place of a business licensed to be operated from the home, reasonable investigative costs for each established violation, are also recoverable, as are all other costs or fees recoverable by contract or statute.[19]

Even if homes do meet the RRL construction standards, the builder may still be liable for (1) claims arising out of a function or component of a structure which cause damage to something other than the component itself[20]; (2) claims to enforce a contract or express contractual provision (such as express warranties); (3) claims for fraud; (4) claims for personal injury; and (5) claims for violations of other statutes[21]. The RRL does appear to eliminate claims based on implied warranties or strict liability beyond what is expressly set forth in the statute, however.[22]

The RRL also requires the builder to undertake and provide a variety of tasks and materials, including (but not limited to) a one-year fir and finish warranty for cabinets, mirrors, flooring, interior and exterior walls, countertops,

paint finishes, and trim in the home[23] , copies of maintenance materials , warranty information, etc..

WHEN IS A LENDER A "BUILDER" ?

The RRL defines the term "builder" as "any entity or individual, including, but not limited to a builder, developer, general contractor, contractor, or original seller, who, at the time of sale, was also in the business of selling residential units to the public for the property that is the subject of the homeowner's claim or was in the business of building, developing, or constructing residential units for public purchase for the property that is the subject of the homeowner's claim.[24]"

There is no express exclusion for a lender that takes title to a builder's interest in a residential real estate project through foreclosure[25]. Nor does the RRL contain any express provisions shielding construction lenders who take title to property through foreclosure from liability for construction defects[26].

Another California statute, Civil Code Section 3434, provides that a lender is not liable for construction defects on newly constructed property financed by the lender unless the lender engages in activities outside the scope of the activities of a lender or the lender has been a party to misrepresentations with respect to such property[27]. The qualifier "activities outside the scope of a lender" is key. California Civil Code Section 3434 states:

> "A lender who makes a loan of money, the proceeds of which are used or may be used by the borrower to finance the design, manufacture, construction, repair, modification or improvement of

> real or personal property for sale or lease to others, shall not be held liable to third persons for any loss or damage occasioned by any defect in the real or personal property so designed, manufactured, constructed, repaired, modified or improved or for any loss or damage resulting from the failure of the borrower to use due care in the design, manufacture, construction, repair, modification or improvement of such real or personal property, unless such loss or damage is a result of an act of the lender outside the scope of the activities of a lender of money or unless the lender has been a party to misrepresentations with respect to such real or personal property." [emphasis added.]

Since it is not "outside the scope of the activities of a lender of money" for a secured lender to take title to real property through foreclosure and then sell the property to a member of the general public, the statute appears to protect the lender from liability for construction defects in the property. It should be noted, however, that because Civil Code Section 3434 uses the term "lender," it is possible that the statute could be construed to apply only while the lender remains a *lender* (i.e., the holder of a note secured by the property) and may not protect the lender from any liability arising out of the lender's status as the *owner* of the property[28].

It is also questionable whether Civil Code Section 3434 protects a lender who causes construction activities to be conducted at the property from liability as a "builder" under the RRL. The California Supreme Court case which led to the

enactment of Civil Code Section 3434, Connor v. Great Western Sav. & Loan Ass'n[29], concluded that a lender could be held liable to homebuyers for construction defects because the lender exceeded its traditional role as lender by actively participating in the construction and sale of homes. Although Civil Code Section 3434 limits the effect of the Connor case, the statute does not establish a bright line test for determining when a lender has acted "outside the scope of the activities of a lender of money." Moreover, court cases decided under the laws of other states have recognized that, in some circumstances, lenders who perform construction activities on new homes acquired through foreclosure may be liable as "developers" for defects in the homes.[30] Accordingly, any lender whose security includes partially constructed residential homes should strongly consider using a court-appointed receiver to complete the construction of the homes prior to taking title to the homes through foreclosure[31].

Due to the uncertain meaning of the term *lender* in Civil Code Section 3434 noted above, it is also unclear whether that statute insulates from liability as a "builder" under the RRL a lender who does not perform any construction activities on the homes after taking title. If the lender does not perform any construction activity on the homes, it seems unlikely that a court would classify the lender as a "builder," "developer," "general contractor," or "contractor" within the meaning of the RRL.[32] However, it is more difficult to predict whether the courts would construe a lender as an "original seller, who, at the time of sale, was also in the business of selling residential units for public purchase."[33]

Presumably, a lender would argue, among other things, that it is not an "original seller" within the meaning of the RRL because it did not develop and manage the construction of the homes, is not the first entity to sell the homes (i.e., the first sale of the homes occurred when the homes were sold to the lender at the foreclosure sale), and is engaged in the business of lending (which includes liquidating collateral for loans upon which borrowers have defaulted), rather than in the business of selling residential units for public purchase. In contrast, a homeowner in a construction defect case might argue that the lender is an "original seller" within the meaning of the RRL because the lender is the first seller of the homes to members of the general public and, if it chooses to sell the homes to members of the general public (e.g., as opposed to selling them to another developer), is in the business of selling residential units for public purchase.

Which of these arguments will prevail is not evident from the statute or the legislative history of the statute[34]. Moreover, to date, there do not appear to be any reported court cases directly on point. However, California case law existing at the time of the enactment of the RRL does appear to provide guidance as to what the legislature intended.

Under such cases, an original seller of a newly constructed home (as well as the builder) was deemed to warrant impliedly to the initial purchaser of the home that the builder of the home "used reasonable skill and judgment in constructing" the home[35]. In addition, an original seller of mass-produced homes was deemed to warrant impliedly to its initial and subsequent purchasers that the

homes were "reasonably fit for their intended purpose" and was strictly liable for defects in products which failed to meet this standard[36].

The primary rationale for imposing liability on the original seller given by the courts was that the original seller has greater knowledge than the buyer about the construction of the home and the buyer relies on that knowledge:

> "In the setting of the marketplace, the builder or seller of new construction – not unlike the manufacturer or merchandiser of personalty – makes implied representations, ordinarily indispensable to the sale, that the builder has used reasonable skill and judgment in constructing the building. On the other hand, the purchaser does not usually possess the knowledge of the builder and is unable to fully examine a completed house and its components without disturbing the finished product. Further, unlike the purchaser of an older building, he has no opportunity to observe how the building has withstood the passage of time. Thus, he generally relies on those in a position to know the quality of the work to be sold, and his reliance is surely evident to the construction industry.[37]"

Where the original seller was not in a position to know the quality of the builder's work, some courts refused to impose liability on the seller. For example, in Siders v. Schloo[38], the court concluded that the implied warranty doctrine did not apply to an individual who retained a contractor to construct a home because the individual was not in the business of commercial development

and, the court suggested, did not have the expertise to examine and evaluate the contractor's work during construction. Similarly, in East Hilton Drive Homeowners' Assn. v. Western Real Estate Exchange, Inc.[39], the court concluded that a company which had purchased newly constructed condominiums at a foreclosure sale and then rehabilitated and sold them to their first occupants four years later was not subject to the implied warranty doctrine because it did not have the ability to examine the homes during construction:

> "The Pollard case extended implied warranty liability to sellers of new construction only. The homes here, although not occupied before the sale to respondents, were built some four years before appellant acquired them. If they could be considered new construction when appellant acquired them, then the Pollard case would impose an implied warranty on that sale. But appellant who had no part in building or financing the building of these homes, cannot be considered a seller of new construction whether it occupied the homes or not. The Pollard case did not say a warranty would be implied for first occupants of buildings. It said the warranty would be implied for sellers and builders of new construction. Appellant Western had no better way of knowing of any defects in construction than did respondents. Appellant is not a builder ... Pollard extended the warranty because builders and sellers of new

> construction are in a better position than buyers of new construction to know of defects. There is no reason to extend this warranty to appellant simply because the homes had lain vacant for a number of years."

The foregoing cases suggest that, under California case law existing at the time of enactment of the RRL, a lender selling completed homes acquired through foreclosure would not have been subject to the implied warranty doctrine because, unlike the original builder and seller of the homes, the lender was not in a better position than the buyers of the homes to know of any construction defects[40]. Moreover, under the East Hilton Drive Homeowners' Assn. case, even a lender who performed repair work on the homes before selling them might have been exempt from implied warranty liability, although that conclusion is less certain[41].

In light of such cases, as well as the lack of any evidence of legislative intent to the contrary, it seems plausible that the legislature did not intend for the phrase "original seller, who, at the time of sale, was also in the business of selling residential units for public purchase" to encompass a lender who acquires fully completed newly constructed homes through foreclosure and does not perform any construction activities on the homes. Moreover, that interpretation is certainly consistent with Civil Code Section 3434, which, even if it is not strictly applicable to lenders who have taken title to real property through foreclosure, clearly evinces a public policy not to hold lenders liable for construction defects as long as they do not overstep their traditional role of financiers and have not made any misrepresentations to buyers.

Nevertheless, any lender contemplating taking title to newly constructed homes needs to realize that there is uncertainty concerning whether the lender may have potential liability for construction defects in the homes (even if the lender did not perform any construction) and should take appropriate steps to preserve its arguments under Civil Code Section 3434 and the RRL in the event of litigation. It is important to remember that, even if Civil Code Section 3434 applies, it does not shield a lender from liability "if the lender has been a party to misrepresentations with respect to such real or personal property."[42] Therefore, among other things, the lender should make sure that it is giving appropriate disclosures concerning the homes to prospective purchasers.

In addition, that portion of the definition of "builder" in the RRL referring to an "original seller" requires that the original seller be "in the business of selling residential units for public purchase."[43] Accordingly, the lender should take appropriate measures to make clear to prospective purchasers that the lender is not the builder or developer of the homes and has acquired, and is selling the homes, as part of the process of collecting on the collateral for loans.

Lenders should evaluate each situation on a case-by-case basis. However, among other things, a lender may want to consider some of the following issues:

- Whether the public report and governing documents (if applicable), lender's disclosures, and advertising media adequately disclose that the lender is not the builder or developer of the homes, that the lender has no information or only limited information about the construction of the homes and the financial

condition and insurance of the builder or developer, and that the prospective purchaser will not be able to look to the lender in the event any construction defects in the homes are subsequently discovered;

- Whether the broker retained by the lender to sell the homes is experienced and knowledgeable about the documents used by the lender and properly supervises its sales staff to disclose to prospective purchasers that the lender is not the builder or developer of the homes (as well as the other items referenced herein);
- Whether the lender will sell the homes on an "as-is" basis and require a release from prospective purchasers (as noted above, if so, the governing documents approved by the DRE may need to be modified to reflect this condition) and whether the sales documents make clear that the buyer has the responsibility to investigate the property and the purchase price has been negotiated and reflects the "as-is" nature of the sale;
- Whether the lender will offer prospective purchasers the opportunity to have any optional items installed at the homes and, if so, how that should be structured to minimize any potential liability to the lender;
- Whether the lender will offer any form of third party warranty in connection with the sale of the homes[44];

- Whether the lender has made all disclosures required by law and, assuming the lender is providing prospective purchasers with disclosures prepared by the builder and/or developer, whether the lender has made appropriate disclaimers regarding the information contained in the builder's and/or developer's disclosures; and
- Whether the lender's purchase and sale documents should address the notice, pre-litigation options, and other requirements imposed on builders at the time of sale by the RRL, subject to the caveat that they shall apply only if the RRL is ultimately determined to apply to the lender.

Many, if not all, of the foregoing issues should also be considered by a receiver who has been appointed by a court at the request of a secured lender and is contemplating selling newly constructed homes in residential real estate development. The definition of "builder" in the RRL does not expressly exclude court-appointed receivers[45]. Thus, like a lender who forecloses on newly constructed homes, a court-appointed receiver also runs a risk of being characterized as an "original seller, who, at the time of sale, was also in the business of selling residential units for public purchase." However, this risk would appear to be minimal as long as the receiver does not exceed his authority under the court's orders in selling the homes, since the receiver is the agent of the court and, as such, is clearly not in the "business" of selling homes[46].

Nevertheless, to avoid potential disputes with disgruntled homeowners over the scope of the receiver's agency, a receiver should take appropriate

measures to ensure that prospective purchasers clearly understand the receiver's role. At a minimum, the receiver's purchase and sale documents should emphasize that the receiver is an agent of the court and is selling the homes pursuant to the directives and orders of the court. Other issues, such as those discussed above with respect to foreclosing lenders should also be considered (e.g., disclosures and advertising, training of sales staff, use of "as-is" provisions, availability of optional items, third-party warranties, disclaimers relating to builder's and developer's documents, notice, pre-litigation, options, and other requirements imposed by the RRL on builders).

IV. CONCLUSION

Any lender (or receiver appointed at the request of the lender) who is contemplating selling newly constructed homes in a California residential development should give considerable thought to the potential applicability of the Subdivided Lands Act and the RRL before commencing the selling process. The failure to do so could result in unexpected consequences, including potential civil and criminal liability under the Subdivided Lands Act and potential liability for construction defects under the RRL. However, with advance planning and assistance from the proper real estate consultants, a lender (or receiver) may be able to reduce one or more of those risks.

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[1] Cal. Bus. & Prof. Code Section §11000 et seq.

[2] Cal. Civ. Code §§ 43.99 and 895 et seq.

[3] Exceptions are set forth in various sections of Chapter 1 of Part 2 of Division 4 of the California Business & Professions Code, including, without limitation, Cal. Bus. & Prof. Code §§ 11000, 11000.1, 11003.4, and 11004.5.

[4] Cal. Bus. & Prof. Code §11010, 11010.5.

[5] Cal. Bus. & Prof. Code §11018; DRE Subdivision Public Report Application Guide ("SPRAG Manual"), p. 1.

[6] Cal. Bus. & Prof. Code §11010; Cal. Code Reg., tit. 10, §§ 2792, 2792.1.

[7] Cal. Code Reg., tit. 10, § 2801.5; People v. Byers (1979) 90 Cal.App.3d 140, 149.

[8] Id.

[9] Cal. Bus. & Prof. Code §11010.5.

[10] Id.

[11] Id.

[12] A lender may submit an Exemption Request to the DRE, utilizing DRE form RE 637, to obtain an advisory opinion from the DRE about whether the exemption under Business & Professions Code Section 11010.5 applies.

[13] 8 Cal. Bus. & Prof. Code §11010.5, 11012, 11018(b), 11018.7, 11020; 10 Cal. Code of Regs. §2800.

[14]See California Business & Professions Code Sections 11020, 11022, and 11023.

[15] The procedure for filing an amended public report is set forth in the SPRAG manual, which is accessible from the DRE's website at www.dre.ca.gov.

[16] Cal. Civ. Code § 896.

[17] Cal. Civ. Code §937.

[18] Cal. Civ. Code §896. The standards are sometimes referred to as the functionality standards.

[19] Id; Cal. Civ. Code §944.

[20] Cal. Civ. Code §897. This exception preserves the economic damages rule enunciated in Aas v. Superior Court (2000) 34 Cal.4th 627, 632, and other cases.

[21] Cal. Civ. Code §§897, 943.

[22] Cal. Civ. Code §§896, 943; see Greystone Homes, Inc. v. Midtec, Inc. (2008) 168 Cal.App.4th 1194, 1210-1216.

[23] Cal. Civ. Code §§900, 912(b)-(g), 914(a).

[24] Cal. Civ. Code §911.

[25] Cal. Civ. Code § 911.

[26] Cal. Civ. Code § 895 et seq.

[27] Cal. Civ. Code § 3434; Kinner v. World Sav. & Loan Assn. (1976) 57 Cal.App.3d 724.

[28] Civil Code Section 3434.

[29] Connor v. Great Western Sav. & Loan Ass'n. (1968) 69 Cal.2d 850.

[30] Chotka v. Fidelco Growth Investors, 383 So.2d 1169 (Fla.App. 2 Dist. 1980); Port Sewall Harbor and Tennis Club Owners Association, Inc., 463 So.2d 530 (Fla.App. 4 Dist. 1985) (Lender may be held liable for performance of express representations made to the buyer, for patent construction defects in the entire project, and for breach of any applicable warranties due to defects in the portions of the project completed by the lender); Roundtree Villas Ass'n. v. 4701 Kings Corp., 321 S.E.2d 46 (S.C. 1984)(Lender may be held liable for damages proximately caused by allegedly negligent repairs made at the lender's request and funded by the lender after the builder deeded title to the property to a corporation created by the lender, but not for any original damages proximately caused by the negligence of the builder); see also McKnight v. Board of Directors, 512 N.E.2d 316 (Ohio 1987)(A case which does not involve construction defects, but discusses various factors the courts should consider in

determining whether a lender who takes title to property through foreclosure or a deed in lieu of foreclosure should be considered a developer).

[31] McFarland and Crispin, "A Primer for Lenders: Legal Aspects of Practical Solutions for Defaulted Residential Development Projects and Loans" published in Issue 29 of Receivership News (Summer 2008).

[32] Cal. Civ. Code §§ 911, 3434.

[33] Cal. Civ. Code § 911.

[34] Cal. Civ. Code §895 et seq.; Senate Judiciary Committee Analysis of SB 800, Martha M. Escutia, Chair 2001-2002, Regular Session; Senate Judiciary Committee Analysis of AB 903, Martha M. Escutia, Chair 2003-2004, Regular Session; Assembly Committee on Judiciary Analysis of AB 903, Ellen M. Corbitt, Chair, 2003.

[35] Pollard v. Saxe & Yolles Dev. Co. (1974) 12 Cal.3d 374.

[36] Kriegler v. Eichler Homes, Inc (1969) 269 Cal.App.2d 224; see also Avner v. Longridge Estates (1969) 272 Cal.App.2d 607.

[37] Pollard v. Saxe, supra at 379; see also Becker v. IRM Corp. (1985) 38 Cal.3d 454; Kriegler v. Eichler Homes, Inc (1969) 269 Cal.App.2d 224 (recognizing that the original seller's ability to obtain insurance coverage was another public policy reason for imposing liability on the original seller).

[38] Siders v. Schloo (1987) 188 Cal.App.3d 1217.

[39] East Hilton Drive Homeowners' Assn. v. Western Real Estate Exchange, Inc. (1982) 136 Cal.App.3d 630, 632-33.

[40] The court's language in the East Hilton Drive Homeowners' Assn. case suggesting that a lender who plays "a part in …financing the building" of the homes may be subject to implied warranty liability appears to be no more than an acknowledgment of the established rule that a lender who oversteps its traditional role of financier may be liable for construction defects under Civil Code Section 3434 and associated case law.

[41] East Hilton Drive Homeowners' Assn., supra.

[42] Cal. Civ. Code §3434.

[43] Cal. Civ. Code §911.

[44] A third party limited warranty may bolster the enforceability of the "as-is" provision and lender's disclaimer of warranties. See Hicks v. Superior Court (Kaufman and Broad Home Corp.) (2004) 115 Cal.App.4th 77. Ideally, the third party limited warranty should satisfy the "fit and finish" warranty requirements set forth in Civil Code Section 900 just in case the lender is ultimately determined to be a "builder" under the Right to Repair Law.

[45] Cal. Civ. Code §911.

[46] Id.