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Commentary

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As reluctant recipients of residential and commercial projects, after a foreclosure or a deed in lieu, lenders increasingly find themselves taking on the liability exposures typically confronted by property owners, sellers, developers and landlords. REO (real estate owned) properties can present significant risks stemming from design and construction defects, and from sales and marketing activities. As a result, REO owners must protect themselves by pursuing strategies to avoid, minimize, shift or insure these potentially explosive liabilities.¹

This article offers practical and legal tactics for avoiding, minimizing and shifting construction defect risks and related exposures in REO operations. A future article will assist REO owners structure insurance programs for these exposures.

Lenders are urged to apply a comprehensive and integrated approach to managing their risks. The approach should be *comprehensive* in that it must encompass the entire life cycle of ownership of the asset, from acquisition through disposition and be-

yond. The approach should be *integrated* in that the lender's risk management program — both insurance coverages and non-insurance strategies — must be designed so that each element complements the others.

Liability Avoidance

Lenders may avoid liability for design and construction defects and for marketing-related claims by selling the underlying note to a third party. Alternatively, the lender may cause a receiver to be appointed for the project, with the receiver responsible for completing and disposing of the asset.

However, sale of the note will occur at a discount, and depending upon local market conditions, there may be a limited number of potential buyers. Handling the asset via a receiver may not be appropriate, depending upon the asset type and the stage of development (e.g., raw land). Thus, the lender may conclude that its best opportunity to achieve its business objectives is to complete the project.

Where the lender elects to complete the project, it can improve its odds of avoiding liabilities in the first instance by pursuing a multi-part risk management strategy. Some specific suggestions:

Detailed project evaluation. Careful pre-foreclosure or pre-acquisition due diligence and evaluation can reveal significant future issues requiring disclosure or specially targeted care in completing construction. Additional relevant information will be acquired during the construction process. Examples include environmental issues, adverse geotechnical conditions, potential sources of noise, potential sources of traffic,

and impacts from future construction, both inside and outside the project.

Quality assurance scrutiny during construction. At the same time, potential future trouble areas should be identified for increased scrutiny during construction and for possible special disclosures at the time of sale or leasing. Depending upon the product type, construction components most likely to require special attention include roofs, waterproofing, exterior cladding, windows, plumbing, sound attenuation, structural framing, geotechnical and soils, mechanical and HVAC, and drainage, irrigation and landscaping.

An effective construction quality assurance ("QA") program has three major components. First, real-time observations of construction in progress should be conducted by qualified personnel. Second, a checklist or inventory system must be in place to document correction and closure of each identified construction anomaly. Third, the REO owner or its trusted contractor must establish a sophisticated record retention and retrieval system to allow for ready access to the observation reports and closure documentation when needed.²

For most REO projects, the QA observations will be conducted by a third party consultant. In pre-qualifying the consultant, the REO owner should focus on the QA consultant's experience with the particular product type; training, qualification and supervision of the inspectors; the consultant's re-observation and closure procedures; and the consultant's recommendation regarding scope of the observations, sequencing, and sample size.

Design peer review. Occasionally, completion of the project will involve redesign of certain elements. Use of a design peer review program is essential in such cases.

The peer review concept is well-established in both residential and commercial construction. A forensic architect or team of design professionals should be tasked with a detailed review of the proposed plans and specifications involved in the redesign. The objective is to identify and eliminate "designed in" defects; assure compliance with applicable building codes; and maximize constructability of the plans. The level and timing of the peer review can be ad-

justed for maximum effect, depending upon such factors as the scope of the redesign, and the type and complexity of construction.

Management of project staff. Poor supervision and turnover of project staff are frequent sources of construction deficiencies. As a result, it is critical that the REO owner use care in selecting, retaining and managing the project's professional staff and contractors.

Engaging and managing contractors. Proper selection of the general contractor and the subcontractors is essential. In particular, it is important to prequalify every construction participant. Among the critical questions: Is the contractor bondable? What is its track record regarding warranty work, its ability to maintain insurance coverage, and its claims history? Do its references check out? Does the contractor have a strong QA culture, and the ability and willingness to comply with the REO owner's project QA programs?

Minimizing Liabilities

REO owners can seek to minimize liabilities by improving their contractual protections in project documentation and in disclosures to end users of the property. The possible protective tactics are numerous. There are, of necessity, distinctions between what can be achieved in residential projects vs. in commercial projects.

In the commercial context, the REO owner will have more latitude in negotiating risk minimizing provisions (subject, of course, to market conditions). These may include mandatory alternative dispute resolution ("ADR") provisions, such as binding arbitration;³ shorter, contractual limitations periods for claims;⁴ recitals by which the buyer or tenant acknowledges that it has performed all necessary investigation, due diligence, and the like, and is relying solely thereon; selective use of "as-is" provisions, disclaimers and releases; and thorough, customized disclosures to the buyer or tenant.

In the residential context, the range of possible strategies is best illustrated by an example. Assume that the REO owner plans to complete the construction of a condominium project, governed by a homeowners association ("HOA"). As many wary developers can attest, condominium projects have the highest incidence of design and construction defect claims of

any real estate product type. What can be done at the front end to minimize these liabilities?

Sophisticated REO owners should work with their risk management counsel and with their construction professionals to identify in advance the most likely areas of risk, then create responsive documentation and procedures. Some key examples:

Maintenance and the adequacy of the HOA budget. Frequently, alleged construction defects are caused entirely or partially by lack of maintenance on the part of the HOA or the homeowners. But when confronted with their failure to maintain, the HOA and the homeowners typically argue that the developer did not provide for adequate funding in the HOA budget.⁵

As a result, preparation of the initial HOA budget requires special attention. Compliance with the applicable Department of Real Estate manual or guidelines may not be a safe harbor. This is particularly true with regard to two elements: recommended reserve figures, and the anticipated useful life and maintenance cycle of project components. The REO owner must review the project components as they actually are designed and built, then anticipate real maintenance costs over time. Input on the adequacy of the budget should be obtained from contractors, design professionals, and consultants, such as an experienced HOA management company.

Imposition of mandatory inspection and maintenance obligations on the part of the homeowners and the HOA. When confronted with their failure to maintain, the HOA and the homeowners generally make another argument: that the developer did not provide any guidelines as to the required frequency or scope of maintenance. Commercial developers have long addressed this issue by providing end users with formal written operations and maintenance ("O&M") manuals. Likewise, sophisticated residential developers have made it a best practice to adopt a similar model. Mandatory inspection and maintenance obligations accordingly should be included in the consumer sales agreements and in the covenants, conditions and restrictions ("CC&Rs") for common interest subdivisions such as condominium projects.

Professionally-prepared homeowner and HOA maintenance manuals are essential because they specify the

frequency and scope of the required inspections and maintenance. The project documentation should afford the REO owner the right (but not the obligation) to participate in the inspections and to observe the required maintenance as it is being performed. In addition, the REO owner may wish to secure a contractual right to obtain copies of the inspection and maintenance logs and reports.

The REO owner should obtain input in drafting inspection and maintenance provisions from vendors, contractors, design professionals, and consultants. As noted above, the HOA budget must provide funding for these obligations. On-site training sessions, supplemented by video presentations, may be advisable to assure that the HOA has been sufficiently educated about its inspection and maintenance obligations.

These maintenance obligations now have a legal impact, as well as a practical one. For example, California's construction defect right to repair law, commonly known as SB 800, now explicitly recognizes lack of maintenance as a defense to construction defect claims. Thus, failure by the homeowner or by the HOA to follow reasonable maintenance obligations, schedules and commonly accepted maintenance practices may subject the claimant to an affirmative defense of lack of maintenance.⁶

Presence at the project. Litigation experience teaches that one of the major drivers for construction defect litigation is lack of a developer presence at the project. REO owners accordingly should consider maintaining a visible presence at the project and on the board of directors of the HOA, even after the project is turned over to an independent board comprised of homeowners. Consider specifying in the CC&Rs that the REO owner is entitled to notice of HOA and board meetings; the right to attend meetings; and the right to receive all information provided to homeowners, such as meeting minutes, reserve studies, future budgets, inspection and maintenance reports, and notices of special assessments.

Some sophisticated condominium developers go a step further. They designate one of their executives as the HOA liaison for the project. This individual attends HOA and board meetings with the objective of maintaining positive relations with the homeowners and the HOA. These developers also invest in formal

training programs for homeowner board members on their duties as fiduciaries; on the HOA's inspection and maintenance obligations; on how to read financial statements; and on other HOA operational issues. While most REO owners will not perform these functions, they can engage consultants to do so. The investment will be worthwhile.

Customer service. In the author's experience, one of the top causes of litigation on residential and mixed use projects is lack of effective customer service. Conversely, an aggressive customer service program serves a number of positive purposes for the REO owner. It assists in maintaining a visible presence at the project. It serves as an early warning system for problems and concerns of the homeowners and the HOA. Finally, if properly executed, it conditions the homeowners and the HOA to call the customer service provider *first*, rather than calling a plaintiff lawyer.

As with the HOA liaison function, the REO owner will not handle the customer service function directly. Rather, outsource warranty and customer service providers may be engaged for this purpose.

Common area turnover procedures. At the time of turnover of the project to the HOA, the REO owner should perform a detailed review of project conditions and maintenance. Frequently, the construction QA consultant will be engaged to handle this review and to assist in conducting the observations and walkthrough of the common area, including common mechanical systems and other equipment, amenities and landscaping. The QA consultant should be accompanied by an independent consultant engaged by the HOA, as well as by one or two board members. The observations provide an opportunity to take photographs, videos, and detailed job walk notes in order to document the REO owner's record that the common area was turned over to the HOA in a well-maintained condition. The turnover procedures should be formally described in the CC&Rs. The HOA should accept the common area by a board resolution.

The turnover procedure also offers an opportunity for further education of the homeowners and the board members as to their inspection and maintenance responsibilities. Further disclosures, if needed, also can be made at this time.

A related issue is the release of development bonds (for common area improvements, maintenance assessments and the like). In the author's experience, failure of the developer to obtain prompt release of its bonds leaves them hostage to the HOA. The longer the bonds remain in place after completion and turnover, the more likely it is that HOA will find "defects" that delay or preclude release of the bonds. Local jurisdictions handle bond release in differing ways, so there is no easy solution to the problem except to carefully monitor the status and completion of the bonded work and move aggressively to obtain bond exoneration.

Protective provisions in CC&Rs and consumer sales documentation. There is considerable room for creativity in adding protective provisions to CC&Rs and to consumer sales documentation. REO owners are cautioned that the decision actually to include such provisions must be balanced by consideration of the marketing impact and the mandates of state law and regulatory guidelines.⁷ Among the possible provisions for consideration:

- *Provide the REO owner with access and repair rights.* The REO owner may wish to retain rights of access to perform inspections and invasive testing, and to repair or correct unsatisfactory conditions (for example, in order to satisfy a local jurisdiction and obtain bond release). Such contractual access and repair rights must be coordinated with the rights and obligations to which the REO owner may be subject under California's right to repair statute.⁸
- *Standing to enforce inspection and maintenance obligations.* Consider providing such standing to the REO owner.⁹
- *Limit the incentive and ability of the HOA to sue the REO owner.* This is a rapidly evolving area, with numerous alternatives available. At one end of the continuum are provisions that simply require notice and a reasonable opportunity to cure before the HOA can sue. The HOA also might be required to engage in mediation or arbitration prior to instituting a suit. Related provisions might create an obligation of mandatory disclosure by the board to the individual homeowners of such items as the impact of litigation on the

HOA budget, an estimate of litigation costs, an explanation of contingency fee litigation, and the impact of a construction defect lawsuit on the marketability and financeability of residences.

- *Project expansion and contraction rights.* In multi-phase projects, where construction and sales may span several years, there may be a business need to expand or contract the project, reconfigure it, eliminate or add amenities, or pursue other strategies not originally contemplated when construction commenced. REO owners can provide for these important rights in the project documentation¹⁰. At the same time, they should disclose the fact that such decisions may affect home values, assessments, availability of amenities, and the like.
- *Other protective provisions in residential project documentation.* In detached housing projects, it is equally critical to educate the homeowners about their maintenance obligations. Depending upon the type of improvements and the site conditions, the REO owner may wish to provide customized inspection and maintenance protocols as part of the homeowner maintenance manuals, together with specific warnings about the possible effect of such things as improper alterations of grading, improperly engineered construction additions, and lack of required maintenance.

Other protective provisions can include a repurchase option (where permissible under state law and regulatory guidelines); strengthened anti-fraud provisions, supported by an addendum separately signed by the buyers acknowledging that no other representations have been made other than those set forth in the sales agreement; specifically tailored "as-is" provisions, where appropriate; and an express written limited warranty which disclaims any other warranties, including implied warranties. Finally, deletion of the attorneys' fee provision from the consumer sales agreements may help deter claimants and plaintiff lawyers.

Disclosures. Disclosures are a powerful liability minimization tool, particularly when combined with advanced CC&Rs and consumer sales agreements. Project configuration, site conditions, and location will often dictate appropriate disclosures, but litigation

experience teaches that a wide range of issues must be considered for disclosure. These include seismic conditions; geotechnical conditions; noise; views; environmental issues; assessments, fees and charges; boundaries and physical features (i.e., proximity of common area, proximity of third party property, slopes, berms, monuments, and other sources of potential disputes); future construction (both inside and outside the project); and potential changes in pricing, sales concessions, and terms and conditions.

Shifting Liabilities By Contract

Risk-shifting provisions are an essential part of construction documentation. They have even greater importance in today's litigious environment. While a detailed discussion of contractual risk transfer provisions is beyond the scope of this article, some significant issues arise when engaging contractors, which deserve further comment.

Scope of work. Does the contract contain the correct scope of work for the contractor? Reuse of old boilerplate forms typically is inadequate to afford the REO owner the protection it needs.

Performance standards. What performance standards will apply? Frequently, this is an overlooked provision, but its significance should not be underestimated. If there are objective standards for the contractor's work, such as building industry, trade group or institute standards, these can be included. The contract also should include representations by the contractor regarding its expertise, knowledge of and adherence to applicable codes, knowledge of site conditions and acceptance of same, and the like.

Warranty, indemnification and insurance requirements. Are the warranty, indemnification and insurance provisions in the contract adequate? Once again, the significance of these provisions sometimes is overlooked in favor of other business points or is relegated to boilerplate. This is a mistake, because even a modest scope of work can result in large liability exposures for the REO owner. The warranty should be specifically tailored to the risks created. As discussed below, the indemnification provisions must be drafted carefully to assure compliance with applicable state law and must be broad enough to provide true protection to the REO owner for the potential liabilities involved. Finally, appropriate insurance requirements must be imposed.

