

The Tipping

Know the liability issues for brokers and lenders in private construction lending

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We all know construction projects don't always go as planned. But if you think that lending institutions and brokers aren't liable when such projects go awry, think again.

Avoid surprises by knowing the potential liabilities that can surface for private construction lenders and by extension, for you.

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By nature, making a loan to a borrower is risky business. Private construction lenders face even greater risks than typical lenders.

Besides having the more difficult mathematical and social equation of figuring out what the property will be valued if it is constructed as planned, these lenders take on the risk of additional liability on construction loans that don't pan out.

This reality goes against the common belief that lenders shouldn't be liable for merely lending money to construct property. And generally speaking, if they provide only project financing to borrowers, they probably will not be liable. Indeed, many states have statutes protecting lenders from lawsuits in these cases.

But what happens when lenders foreclose on a half-constructed project and have to finish the property in order to sell it? Most lenders are in a Catch-22 position at this point. They cannot sell for the value of the original loan because that was the as-constructed price, and the property is nowhere near that value. If they finish the construction, however, they could be liable for defects in the property construction.

Brokers and borrowers must be aware of the liability that private construction lenders can face. The threat of this liability can impact these lenders' decisions to make loans. At times, brokers also can be placed on the book for potential loan violations.

Two of the most-common ways unsuspecting construction lenders can create third-party liability are:

- When the lenders take over as the general contractor and finish the project; and
- When the lenders act as a joint-venturer with the project developer.

Lender as general contractor

Many lenders decide to take over a construction project after they have foreclosed on the property. Other times, they work out a buyout of the development tract — not because they want to, but generally out of necessity.

In this case, they take over as the general contractor and hire subcontractors to finish the job started by the original developer. This



situation exposes lenders to liability, especially in terms of construction defects.

Some lenders have tried to create solutions before having to foreclose on the property, thereby attempting to avoid liability for any resulting construction defects. For instance, one construction lender created a corporation to market and sell its borrower's housing units as an alternative to foreclosure. The plan backfired.

In previous inspections, the lender noticed that the roofing the borrower put on the units was defective, and the lender hired companies

to repair the defective roofs — even after the roofers recommended replacing them.

Homeowners sued the lender. But the lender said it wasn't liable because it only lent money to the borrower.

The court ruled that even though the lender only provided financing, it also directed companies to repair the roofs. Although the lender had no liability with the original roofs, it did have liability with those it had repaired. It owed due care to the homeowners to repair the defective roofs effectively.

This would probably play out the same way in most states. For instance, one California statute protects lenders "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." Acting like a general contractor would be outside a lender's scope of activities in lending money.

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Lender as joint-venturer

For the purposes of this article, the construction lender is considered a joint-venturer when it acts as a working partner with the borrower rather than merely as the lender. This type of business relationship also can expose lenders to liability.

Generally, four elements are necessary for a lender to be considered a joint-venturer.

1. **Intent to create a joint venture**
2. **Community of interest** (usually defined in terms of a common business purpose or undertaking)
3. **Mutual right of control of the business**
4. **Sharing of profits and losses**

Legally, it generally is hard to prove that a lender is sharing profits and losses. But when the construction lender takes total control of the project, takes stock as security and eventually forecloses on it, the court might view the lender as a joint-venturer.

Lenders and developers also may be seen as sharing their profits and losses when the lender requires a shared equity arrangement from the proceeds. In other words, the lender agrees to make the loan for a low or no interest rate in exchange for a percentage of the proceeds from the sale of the developed land.

It can be hard for the court to prove that a lender is part of a joint venture, but it's not impossible. As such, lenders must pay attention to this risk because of the ways many subtle nuances could come back to haunt them.

Protect yourself

Brokers who place loans with private construction investors can protect themselves from liability. Two ways to do this are to ensure that lenders are not acting outside the scope of a lender and to make sure to draft complete, well-written loan documents.

First and foremost, brokers' lenders should think twice about taking over a project because of foreclosure or as a bailout remedy. Although they may take a loss on the subsequent sale of the unfinished property, it may be better than facing the liability.

Of course, this option may not always be feasible. Lenders might have no choice but to finish the project to get paid. If that is the case, they should enter into a specific agreement with the contractor hired to finish the work. They should include an agreement indemnifying them for any damage caused by their work on the project.

Complete and well-written loan documents



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also can mean the difference between making or losing money. Your loan documents should include a hefty indemnification agreement from the developer and possibly a personal guaranty and indemnification. This ensures the lender has some assets outside of the development company and constructed property.



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Brokers owe a fiduciary duty to their private investors. Because of this, the investors will place the broker on the hook for the loan's violations.

You should consult with your attorney before deciding whether to partner with a developer or finish an unfinished construction project. Prudent underwriting and contract drafting will help to protect you against any additional liability that you may be facing. 

Disclaimer: This article is intended for educational and informational purposes only and should not be interpreted as legal advice. Consult an attorney to determine appropriate legal matters in your specific situation.

