The Use of the Health and Safety Code Receivership Remedy for Substandard Residential Buildings

Promises and Pitfalls

*By Robert C. Pearman, Jr., Esq.**

Recent amendments to Health and Safety Code §17980.7(c)[1][2] serve as a reminder of this seldom used but potentially powerful receivership remedy available to cities and counties, against owners of substandard buildings.

To begin, the condition precedent to invoke the receivership remedy is found in §17980.6.[3] It provides in relevant part:

> "If any building is maintained in a manner that violates any provisions of this part, the building standards published in the State Building Standards Code relating to the provisions of this part, any other rule or regulation adopted pursuant to the provisions of this part, or any provision in a local ordinance that is similar to a provision in this part, and the violations are so extensive and of such a nature that the health and safety of residents or the public is substantially endangered, the enforcement agency[4] may issue an order or notice to repair or abate pursuant to this part. ..."

This requires more than the merest of nuisances (See Civil Code §§ 3479, 3480), and is akin to the substandard building definition in Health and Safety Code § 17920.3.

§ 17980.7 (c) is attractive to advocates of decent and affordable housing, in part because it synthesizes in a favorable context these elements: a receiver can be appointed to manage such substandard buildings, the receiver may borrow money secured by a lien on that property, and extends this right to petition for such a receiver to tenants and tenant organizations. Further, recent amendments make it clear that non-profit organizations and community development corporations eligible, potential receivers in such cases.

The real promise and attraction of this statute come not only from its express language, but from the common law of receiverships. It has been established that a court, when allowing a receiver to borrow money with a lien on the estate property as security, can grant priority status to that lien. The leading California case is Title Ins. & Trust Co. v. California Development Co. 171 Cal. 227, 231 (1915): "there can be no question of the right of the court to give priority to certificates issued to enable the receiver to carry out the primary object of his appointment, viz., the care and preservation of the property."

Thus, an optimistic scenario of how this statute might work is as follows. If an owner has failed and refused to respond to notices and orders to repair a substandard building, one reason may be the simple lack of equity in the property. He or she cannot afford to utilize the property value to further improve it, and may not have independent funds to do so. By having a receiver appointed, who can then borrow money and lien the property, the rehabilitation work might take place. However, lenders will not come forth if no equity exists and their new loan would be junior to many existing debts. If the court grants the new lender priority over some existing indebtedness, the theory goes, then the rehabilitation project might "pencil out" and be attractive to a lender.

The key elements of § 17980.7 (c)[5] include the following:

"§17980.7. If the owner fails to comply within a reasonable time with the terms of the order or notice pursuant to Section 17980.6, the following provisions shall apply:...

'(c) The enforcement agency, tenant, or tenant association or organization may seek and the court may order, the appointment of a receiver for the substandard building pursuant to this subdivision. In its petition to the court, the enforcement agency, tenant, or tenant association or organization shall include proof that notice of the petition was served not less than three days prior to filing the petition, pursuant to Article 3 (commencing with Section 415.10) of Chapter 4 of Title 5 of Part 2 of the Code of Civil Procedure, to all persons with a recorded interest in the real property upon which the substandard building exists."

(c)(2) "The court shall not appoint any person as a receiver unless the person has demonstrated to the court his or her capacity and expertise to develop and supervise a viable financial and construction plan for the satisfactory rehabilitation of the building."

A recent amendment to §17980.76 included, among other changes, the addition of two more sentences to subsection (c)(2). It provides that:

> "a court may appoint as a receiver a nonprofit organization or community development corporation. In addition to the duties and powers that may be granted pursuant to this section, the nonprofit organization or community development corporation may also apply for grants to assist in the rehabilitation of the building."

The legislative author of these amendments argued that since substandard buildings are likely to lack equity or sufficient rental cash flow, using non-profits as receivers can create value because they have the ability to apply for and utilize grants to rehabilitate deteriorated properties.[7] I surmise also that non profits, from a financial standpoint, don't necessarily look like traditional property managers, etc. who often act as receivers in typical rents and profits cases. Perhaps some

judges were loathe to appoint them as receivers under § 17980.7. The fact that they often depend upon grants for funding might make their balance sheets look weaker than judges are used to seeing in property receivers. The amendments make it easier for an interested non profit to act as a receiver where it can show, not only by its own assets but by grants available to non profits, that it could carry out its duties as a receiver.

Subsection(c)(4) states the receiver "shall have all of the following powers and duties in the order of priority listed in this paragraph" They include:

> "(A) To take full and complete control of the substandard property."
>
> "(E) To collect all rents and income from the substandard building."

The key power is in subsection (4)(G):

> "To borrow funds to pay for repairs necessary to correct the conditions cited in the notice of violation and to borrow funds to pay for any relocation benefits authorized by paragraph (6) and, with court approval, secure that debt and any moneys owed to the receiver for services performed pursuant to this section with a lien on the real property upon which the substandard building is located. The lien shall be recorded in the county recorder's office in the county within which the building is located."

While subsection (c) is the focus of receivership appointment, other elements of § 17980.7 are of interest. Subsection (d) provides:

> "(d) If the court finds that a building is in a condition which substantially endangers the health and safety of residents pursuant to Section 17980.6, upon the entry of any order or judgment, the court shall do all of the following:
>
> (1) Order the owner to pay all reasonable and actual costs of the enforcement agency including, but not limited to, inspection costs, investigation costs, enforcement costs, attorney fees or costs, and all costs of prosecution."

Perhaps a city could use this subsection in conjunction with an ongoing receivership matter and obtain an order for all such costs to be assessed against the owner. If funds are in the receivership estate, it can immediately present that "bill" to the receiver for payment.

§17980.7(g) provides that the remedies of the statute "shall be in addition to those provided by any other law". This serves as a reminder that, at least as to governmental agencies, the powers granted by subsection (c) are not necessarily unique nor exclusive. Having a receiver appointed for a substandard building by using the general receivership authority of CCP § 564 may be possible. For instance, if a city has obtained a contempt order against an owner, it can use CCP §564(b)(3) to have a receiver appointed after the judgment to enforce it. And it seems that the general equity receivership, CCP §564(b)(8), would also be available for a building repeatedly and seriously violating the housing code.

In my experience several pitfalls can occur in practice when attempting to employ §17980.7(c).

1. Property may have too much debt, too many potential claimants and interested holders such that it complicates the efforts to use this remedy. Additionally, while the court can allow supra-priority to the lien securing the new loan to finance the receiver's rehabilitation work, it's doubtful that it can override the lien status of existing tax deficiencies at the federal, state and county level. So if those tax liens are present, the rehabilitation still may not pencil out.
2. The novel nature of this remedy may make it difficult to entice institutional lenders to work with an enforcement agency to fund rehabilitation. The expected sequence of events is that the receiver borrows money to perform the rehabilitation, issues a certificate (which is like a promissory note), grants the lender a secured lien on the building as collateral which the court allows to be first priority, the certificate has a short time period for the receiver to pay it - presumably the receiver lacks sufficient funds from the rental income to do so - thus leading the lender to start foreclosure. If the lender becomes the successful credit bidder at the foreclosure sale (hopefully after the necessary rehabilitation has been completed), then it would take title to the property. While that is good in theory, are notoriously conservative institutional lenders comfortable in that situation?
3. The city will also have to devote staff time. Relying solely on the receiver to accomplish the objectives of the statute and the receivership would be dangerous. As plaintiff, the city could face liability if something goes amiss. Some construction expertise, accounting knowledge to monitor the receiver's accounting and expenses, city attorney skills, and perhaps marketing ability to help find interested lenders or developers are roles that the city should play.
4. Lastly, the city may turn out either to be a partial funder of the rehabilitation, or becomes the requested lender of last resort to step in and fund the rehabilitation.

I am aware of instances where this remedy has been used with some degree of success. Some jurisdictions dedicate a specific pot of money to fund the rehabilitation, not relying on the private market to fill the gap. Or they use it only for properties with a large amount of equity, thus being attractive to private lenders.

CONCLUSIONS

If a city wants to use this §17980.7(c) receivership remedy, the following are steps that should be taken:

(a) Make sure that the "substandard building" definition of § 17980.6 is met.
(b) Make sure that all the due process elements are satisfied, with all lenders, interest holders and potential owners being notified in advance and given reasonable opportunity to abate the substandard conditions.
(c) Petition for the appointment of a capable receiver, one who is used to dealing with substandard buildings and the tenant issues and potential relocation payments, etc. that such an assignment might entail.
(d) Develop a substantive, well thought out rehabilitation program with all attendant cost elements.
(e) Get prospective lenders on board up front, before you even petition for the receiver, so as plaintiff you are confident one will step in and be the lender.
(f) Be prepared to invest some city funds, at a minimum for interim financing to allow the receiver to fully develop the rehabilitation plan.
(g) Avoid complex-multi-liened properties, and properties with significant tax debt attached to them.
(h) Be prepared to dedicate some city staff time to monitor the project; don't rely solely on the receiver.

In short, the promise of a risk-free device, fully funded by the lending community and wholly managed by an active receiver seems unrealistic. However, with the city willingness to commit some staff time and funds, this

remedy can be successful in the right situations.

Endnotes

1 Div. 13 Housing, Part 1.5 Regulation of Buildings Used for Human Habitation, Ch.5, Art. 3.

2 There is only one reported case that even mentions the statute (City and County of San Francisco v. Daley, 16 Cal.App.4th 734 (1993)) but simply in a footnote stating the section's applicability was not considered.

3 All statutory references herein refer to the California Health & Safety Code, unless otherwise indicated.

4 Building departments of cities and counties are enforcement agencies. See § 17960 et seq. For convenience, in this article the term "city" is generally used.

5 Subsection (c) was patterned after New York State legislation. Chicago, Illinois has used a similar receivership remedy program. San Francisco and Los Angeles have used this California law.

6 Stats. 2001, c. 594, AB 1467

7 Assembly Floor Analysis 08/09/01, AB 1467 (Kehoe)

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