


MINIMIZING POST-FORECLOSURE REO DISPUTES

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Both attorneys and lenders know that it is essential to prepare for, and thoroughly assess, potential issues before they mature into problems. Because lenders have not historically managed vast amounts of property, and because foreclosed properties (often called "real estate owned" or "REOs") may have a host of unknown pre-existing problems, lenders are often unprepared for the challenges and liabilities associated with owning unoccupied property. Lenders who have foreclosed on and taken title to property may find themselves stuck in situations they neither created nor could have prepared for. When these situations arise, the lenders then call their attorneys. While most post-foreclosure situations are unique in one way or another, thankfully, there are a few common types of problems, and knowing about these types of problems will help attorneys prepare lenders for potential disputes.

GENERAL PROPERTY MAINTENANCE ISSUES

There are certain property maintenance issues that all owners must perform, and a lender who has taken title at foreclosure is no exception. Typically, these issues involve yard work, weatherization, garbage issues, or hazardous conditions. The definition of general maintenance for each piece of property depends on several different factors, and the failure to perform required general maintenance can lead to liens and fines. These liens and fines can ultimately cost a lender hundreds, if not thousands, of dollars in fees, interest and costs.

During foreclosure, lenders need to assess each property to determine if there are any ongoing maintenance issues that are not being addressed. Often liability for these issues will pass to future owners, including the lender. Where there are expensive or numerous unresolved maintenance issues, a lender should consider whether it really wishes to purchase and market a property. After taking title, the best way for a lender to avoid maintenance fines or liens is to have a good local property manager who understands the property's maintenance needs and alerts the lender of any remedial action to be taken.

Yards

Almost all urban and suburban properties have grass restrictions. Though it seems obvious that lender-owners should cut the grass on a regular basis, grass height issues are all too common. Grass lawns located in incorporated areas are typically governed by local ordinances, and lawns located in a planned development are governed by restrictions contained in the community's declarations. When one's lawn reaches a certain height it becomes a safety violation, and the town or association is entitled to cut the grass and charge the owner for the lawn work provided. Where declarations so provide, community associations may also enforce grass restrictions by performing required yard work and charging the homeowner.

In both instances, most lawn restrictions require that there be notice before the government or association resorts to self help. This notice is typically placed on the property. Without an agent periodically checking on a property, a lender might never know of its alleged yard infraction. While the cost to cut the grass is often low, the daily interest on that amount can quickly add up. A lender should make certain that all required yard work is performed and that any fines are immediately paid. Otherwise, the daily interest on a $50 bill can soon cost the lender thousands in interest and late fees.

Less common than grass height violations are plant requirements. Typically, these arise in planned developments. Developments may have declarations requiring that all flower beds be weed-free and that dead plants be removed. As with grass height restrictions, the failure to maintain plant beds and plants can quickly lead to thousands in interest, costs, and late fees. Similarly, and even more rare, are violations under state and local laws governing invasive, exotic, or preferred plants. An agent's attempt to add curb value to a property might actually bring about lender liability where newly planted items are considered noxious species.

Ultimately, attorneys should familiarize themselves with local and associational lawn and plant requirements so that lenders are prepared to immediately take over these duties. Because of the speed at which grass and weeds grow and plants die, these are not issues that can wait.

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Weatherization

Lender-owners must typically weatherize properties in colder climates. Though this requirement might seem like second nature to a lender located in a colder state, it is all too unfamiliar to lenders located in warmer parts of the country. A REO property might be located in Massachusetts but it could be owned by a lender whose REO manager lives in the Florida panhandle where the only "weatherization" that is needed is to occasionally throw old sheets over winter flowering bushes. Local foreclosure and property management attorneys should, therefore, explain any local weatherization requirements to the owner and manager of an REO property so that the lender-owner can avoid city-imposed weatherization liens.

Hazardous Conditions

There are numerous hazardous conditions that a lender might inherit with a property. For example, pools, old wells, or sink holes can cause injuries to those on the property, and a lender might find itself liable for those conditions. A holder of REO properties should keep in mind that claims for nuisance, trespass, negligence, and even strict liability for abnormally dangerous activities may provide a basis for a claim against it as the property owner. As an attorney for a lender, one should familiarize oneself with the various common law and statutory requirements that govern the extent to which a lender must try to identify property hazards. Attorneys should then work with lenders, and their agents, to identify and secure obvious hazards, For example, an attorney should determine local ordinance requirements for securing pools, then work with the lender to make certain that the pool is maintained and fenced accordingly. There is no limit to the types of hazardous conditions that a lender might face, but a simple and careful inspection and evaluation of each property will circumvent these types of problems.

LIEN PROBLEMS

Pre- and post-foreclosure lien issues are all too common. Though some liens will be wiped out in foreclosure, there are numerous liens that survive foreclosure. Because these disputes are expensive and affect the marketability of a property, lenders must be prepared to address them.

Immediately upon taking title, lenders should order title searches of a property to determine if there are any government liens recorded against a property. Typical liens include weatherization liens, lawn maintenance liens, water bill liens, tax liens, and criminal forfeiture liens. Because of the nature of these liens, lenders are often assumed liable for the lien even if the lender did not cause the lien. Despite assumed liability, municipalities often have procedures wherein a lender can seek to have the lien reduced on the basis that the lender's activities did not cause the lien and that the lender has fixed the problem that caused the lien. These liens often have hefty interest and daily fines – sometimes as much as $1,000 per day – which have been known to reach over $100,000 before the lender even learns of the lien. Therefore, immediately upon learning about a government's lien, attorneys should contact the government and determine whether the lien can be reduced or disputed. Attorneys should then begin the process of reducing or paying the lien, as necessary.

In addition to government liens, there may be community association liens. States approach these liens in three general ways. In a majority of states, a lender-owner is not liable for an association's lien if the mortgage arose prior to the association's lien. Because a mortgage is rarely given where there is a recorded association lien, the lender will not typically be liable for pre-foreclosure assessment liens in these states. On the other end of the spectrum, in a small handful of states, these liens have super priority over mortgages and, therefore, survive foreclosure. Finally, about one-fourth of states have hybrid systems entitling community associations to statutorily predetermined amounts. Where lenders fail to pay community association dues, the association can bring a foreclosure action and can seek interest, reasonable attorneys' fees, late fees, and costs from the lender. Attorneys, therefore, need to advise lenders of each state's requirement to pay dues and make sure that those dues are promptly paid.

ENVIRONMENTAL CONCERNS

Many lenders are familiar with secured creditor exemptions under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and the Resource Conservation and Recovery Act (RCRA), but these exemptions are not absolute, and may require the foreclosing lender to refrain from taking certain actions or, in some cases, to follow a particular course of action. Other environmental laws do not contain exemptions for secured creditors pre- or post-foreclosure. Environmental concerns will also vary depending on the nature of the property – industrial, commercial, or residential and whether the property is

developed, undeveloped, or mid-construction. Additionally, while the most well-known environmental laws are federal, states and local governments administer many environmental programs and have their own environmental laws and programs, which may vary or impose additional requirements. There also may be common law claims for nuisance, trespass, negligence, and even strict liability that may provide a basis for a claim against the owner-lender even when environmental laws do not. Because of unfamiliarity with the intricacies of various environmental laws, lenders may not be aware of their exposure to a range of potential environmental liabilities until after foreclosure.

While there is no replacement for pre-foreclosure environmental due diligence, this section is intended to provide holders of REO properties with a non-exhaustive list of potential environmental issues that can come to light post-foreclosure, and if not addressed quickly, can lead to significant financial liability. Lenders, where appropriate, should consult an environmental attorney to assess the extent of potential liability under the following statutes and determine what, if any, action should be taken.

CERCLA

CERCLA contains a secured creditor exemption from owner/operator liability, provided that the secured creditor does not participate in the management of the facility. This safe harbor may continue to insulate the lender from liability after foreclosure, allowing the lender to sell, re-lease, or liquidate; maintain business activities; wind up operations; undertake a response action; or take other measures to preserve, protect, or prepare the site for sale. Although a lender that has foreclosed on property may take these actions and retain the secured creditor exemption, these actions must be conducted "at the earliest practicable, commercially reasonable time, on commercially reasonable terms," taking into account market conditions and legal and regulatory requirements. Additionally, some state equivalents to CERCLA, e.g., New Jersey's, impose additional requirements on secured lenders to qualify for this exemption. A lender that has foreclosed on property potentially subject to CERCLA will want to have environmental guidelines in place to ensure that its actions do not take the lender outside the scope of the safe harbor.

RCRA

RCRA regulates the handling, storage, treatment, transportation, and disposal of hazardous and non-hazardous waste, including petroleum-related material. While most of RCRA's regulations will not likely apply to those holding REO properties unless they continue operations, there are two particular sources of RCRA liability to be particularly aware of – Underground Storage Tanks (USTs) and Citizen Suits.

Holders of REO properties, especially commercial and industrial properties, should determine whether there are USTs on the property. A common example is property that was once a gas station. While RCRA contains a secured creditor exemption for liability related to petroleum-USTs, several conditions must be met to ensure that this protection is not lost.

There are several areas of concern under RCRA when the foreclosure process results in the lender taking title to property where USTs are located. First, to ensure application of the safe harbor, the foreclosing lender must satisfy post-foreclosure conditions, including emptying USTs, reporting all releases, and diligently attempting to sell or divest the property. Secondly, even if USTs on the property are no longer active, in some situations, the holder of REO property may be exposed to liability related to releases from old, abandoned USTs. Even if USTs have been removed and are no longer present on the property, the holder of REO property will want to ensure that the property was not contaminated as a result of UST or their removal.

Variations in state laws regarding unregulated USTs can provide significant challenges for holders of REO properties and variations in state laws should not be overlooked. Additionally, when a lender forecloses on residential property, particularly in the Northeast, unique environmental issues related to leaking home heating oil USTs can arise. As previously noted, the UST secured creditor safe harbor only applies to petroleum UST systems and will not protect a lender from liability under other RCRA provisions such as treatment, storage, and disposal facilities.

Another potential source of RCRA liability is a citizen suit that may be brought to address contamination that "may present an imminent and substantial endangerment to the health or environment." RCRA does not contain a secured creditor exemption from citizen suits. Thus, any person may bring a RCRA citizen suit "against any person . . . who has contributed to or is contributing to the past or present handling, storage, treatment, transportation or disposal" of solid waste. Liability for citizen suits is based on regulatory compliance, and RCRA facilities located on foreclosed

property may not have maintained appropriate standards, which may often result in a threat of contamination. Often, the best defense to citizen suit liability a holder of REO property can assert is that he or she has or is not "contributing to" the contamination, as required by the statute; however, this language is often broadly interpreted. Holders of REO property must determine whether solid or hazardous waste has been generated or stored on the property and ensure that they do not "contribute to" any violations, including through complacency.

Clean Water Act and Clean Air Act

The Clean Water Act (CWA) and the Clean Air Act (CAA) do not contain secured creditor exemptions from liability. The absence of a secured creditor exemption under these and other environmental laws potentially exposes holders of REO properties to a variety of risks. Although every piece of property has the potential to raise its own environmental issues, the remainder of this section is intended to highlight specific environmental situations of which holders of REO properties should be particularly aware.

Particular attention should be paid to issues that may arise under the CWA when a lender has foreclosed on an unfinished construction site. Stormwater runoff from unfinished construction sites can give rise to both civil and, in some instances, criminal liability. While this is an issue that should be addressed pre-foreclosure, if it arises after foreclosure it must be given immediate attention. In many instances developers faced with foreclosure will not take the necessary measures to comply with their construction stormwater permit. Once the foreclosure has taken place, the holder of the REO property has often become the owner of property that is in violation of the CWA. Some states have specifically addressed this situation in their applicable permits or by issuing guidance for lenders. While the majority of states do not have a formal policy, environmental regulators in many states are willing to work with holders of REO property that find themselves in this situation if timely and appropriate action is taken.

Wetlands are protected under the CWA and should also be of particular concern for lenders managing properties. If REO properties are located on wetlands, the holder must determine whether the defaulting borrower took the necessary steps to protect the wetlands on the property. Similar issues arise under the Endangered Species Act, when there are endangered or threatened species or habitats located on the property.

Unlike the CWA, the CAA is not likely to be implicated in the case of REO properties, especially when operations have ceased at facilities on the property. Despite this generality, there are specific situations in which the CAA imposes obligations on a property owner, including a secured creditor that has taken title to the property post-foreclosure. For example, certain industrial facilities may be subject to permit requirements under the CAA, and as owner, a lender that has foreclosed on the property may be required to bring the site into compliance with applicable laws and regulations.

As with RCRA, lenders that have foreclosed on property in violation of the CWA or CAA do not fall within an exemption. Thus, they are subject to citizen suits for any existing violations and should analyze properties taken at a foreclosure sale for possible CWA and CAA issues.

Other Environmental Concerns

Often times, an REO property is not subject to liability under a clear and widely used federal statute. Instead, liability may simply arise because of a potentially dangerous and commonly used building material or because of preexisting permitting issues.

When buildings are present on the property, the lender may want to determine whether those buildings contain asbestos-containing materials ("ACMs"). If ACMs are present, the lender will want to ensure that they are maintained and in good condition. An operations and maintenance plan is ordinarily used to make this determination. If the lender does not have any information on ACMs and the structure was built before 1980, the lender should consider undertaking a limited ACM survey to determine whether ACMs are present.

Particularly in the case of residential property, individual states may have other disclosure requirements, such as a requirement that a Chinese drywall disclosure be provided to potential purchasers. In addition to required disclosures, selling residential property with environmental conditions may expose the holder of REO property to a variety of claims.

Lead-Based Paint ("LBP") may also raise environmental concerns, especially in residential property or property occupied by children. A lender that has foreclosed on residential property built before 1978 may be required to provide a LBP disclosure to purchasers.

In addition to specific issues arising under the various environmental laws and statutes, it is imperative

that holders of REO property determine whether there are any ongoing enforcement matters concerning the property, environmental permits issued for operations on the property, ongoing environmental monitoring or remediation requirements, or any reportable environmental issues. If there are ongoing enforcement matters concerning the property, the lender should determine whether it is now responsible for resolving such matters. If it is determined that permits have been issued for operations on the property, the holder of REO property may be subject to notice and compliance obligations. Additionally, the lender may be obligated to continue monitoring and remediation post-foreclosure, for which costs can be significant. There may also be requirements to report certain issues to government authorities, such as releases on the property. In some instances it may be a positive step for the lender to meet with the regulatory agency when such issues arise. In any of these instances it is imperative that holder of REO properties identify and assess any environmental issue as soon as possible and consult counsel that has experience in dealing with the specific environmental matters.

CONCLUSION

A lender cannot always know what types of property problems it is inheriting when it takes a property at foreclosure. Yet, knowing the types of problems that can arise will help an attorney advise a lender on how to quickly identify and assess potential problems. Quick action will help lenders address REO property management problems before they escalate into difficult and expensive disputes, and ultimately – once a property's maintenance, lien, and environmental problems are solved – the lender will be able to market the property and recoup some of its foreclosure losses. ⚖

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