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Mark W. Vyvyan

Real Estate Considerations for Managing the OREO on Your Books

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By Mark W. Vyvyan

Following the "Great Recession" of 2008 and 2009, banks were forced to foreclose on a number of mortgages granted to defaulting borrowers. As a result, banks' portfolios of "other real estate owned" grew significantly. Although the economy is recovering, these OREO properties continue to demand significant attention. While there are many regulatory issues related to OREO properties, this article will focus on some of the real estate related considerations for managing your OREO.

HOW DID THE PROPERTY BECOME OREO?

Typically, a bank will acquire title to an OREO property through foreclosure. There are two main types of foreclosures in Minnesota: (1) non-judicial foreclosure, commonly known in Minnesota as "foreclosure by advertisement," and (2) judicial foreclosure, often referred to as "foreclosure by action." Minnesota banks often favor foreclosure by advertisement because it is generally faster and less expensive than foreclosure by action. Foreclosure by action is often used when there are outstanding title issues or other concerns that require the approval of a court. A bank's selection of a foreclosure method can impact its rights to pursue a deficiency judgment and may also impact other rights. In addition, foreclosure procedures in different states vary.

Often, a defaulting borrower is willing to cooperate with a foreclosing bank. In these circumstances, the parties may wish to pursue a "voluntary foreclosure." Minnesota Statutes allow the parties to execute an agreement for a foreclosure process with shorter timelines (including a shortened time for redemption). In exchange for the shortened time periods in a voluntary foreclosure, the bank waives its right to a deficiency judgment against the borrower. A defaulting borrower may also be willing to simply deed the mortgaged property to the bank. When acquiring a property by a "deed in lieu," banks should be careful to include "anti-merger" language to ensure that the lien of the mortgage does not "merge" with the bank's ownership interest under the deed. The use of anti-merger language will allow any title or priority issues to be resolved through a later foreclosure if necessary.

WHEN YOU HAVE THE PROPERTY BACK

Once the foreclosure process is complete, a bank needs to focus on managing and disposing of the property. One of the first issues a bank must deal with is gaining physical control of the property. If the foreclosed-upon property is still occupied by a tenant or the former owner, the bank should consider bringing an eviction action. Under Minnesota law, an eviction action to remove a former owner will likely take approximately three weeks. Foreclosing banks should also keep in mind that "bona fide" tenants of a foreclosed-upon property may be able to remain in possession of the premises for the remainder of their lease term.

Banks also need to be strategic about who will manage the property prior to its sale to a third party. In many foreclosures, a receiver has been appointed by the court to manage the property and collect rents from any tenants. Typically, the receiver is discharged at the completion of foreclosure proceedings. If so, the bank may wish to retain the receiver as a property manager until the property can be sold. Otherwise, banks should consider retaining a professional property manager.

MANAGING RISK

Although many banks are anxious to sell the property quickly, managing risk until a foreclosed property is sold is important. One of the initial risk management considerations is how title to the property will be held. Depending on regulatory concerns, a bank may transfer title to the property to its bank holding company or to a separate subsidiary created for that purpose. The primary benefit of title being held in the bank holding company is that the property is removed from the bank's books and its Call Report. Benefits of holding the property in a subsidiary include limiting liability and facilitating situations where the underlying mortgage loan was subject to a participation agreement. In addition to satisfying regulatory considerations, a bank may also need to seek the approval of its board and comply with other legal requirements before transferring an OREO property into a separate subsidiary. A transfer into a separate subsidiary likely does not circumvent regulatory holding periods for OREO property.

Another obvious concern for any OREO property is making sure that the title-holding entity (whether it be the bank itself, a holding company, or separate subsidiary) has the proper insurance coverage in place on the property.

SPECIAL CONSIDERATION FOR CONDOMINIUMS AND TOWNHOMES

In the years before the Great Recession, developers built many townhomes and condominium units on a speculative basis. Unfortunately, the townhome and condominium markets softened considerably and many units in these common interest communities have been acquired by banks through foreclosure or deed in lieu of foreclosure. A bank should be mindful of some special considerations

whenever taking title to a condominium or townhome unit. In Minnesota, common interest communities created after June 1, 1994 are generally governed by the Minnesota Common Interest Ownership Act (MCIOA). Two of the more common issues raised by MCIOA for banks are the obligation to pay homeowners' association assessments and whether a foreclosing bank steps into the shoes of the developer and acquires the developer's rights over the project (and some liabilities).

Generally, if a first mortgage bank forecloses on a townhome or condominium unit, that bank will be liable only for (i) unpaid assessments that come due during the six month period that precedes the end of the owner's redemption period, and (ii) assessments that come due thereafter. A bank is generally not liable for assessments that were due prior to the foreclosure process. Many banks would prefer to wait to pay any assessments until they have resold the unit to a third party purchaser. Absent an agreement with the homeowners' association to that effect, a bank is obligated to pay the assessments described above without delay. Failure to do so may result in the homeowners' association beginning proceedings to foreclose its own assessment lien, and may subject a bank to claims for interest, late fees and attorneys' fees.

When a bank is acquiring title to units owned by the common interest community's developer (referred to in MCIOA as the Declarant), the bank needs to be mindful of whether it wishes to acquire certain special rights belonging to the Declarant. These "Special Declarant Rights" include, but are not limited to, the rights to: (i) complete improvements in the common interest community, (ii) add real estate to the community, (iii) maintain sales offices in the community, and (iv) control the homeowners' association. The general rule is that a foreclosing bank taking title from a Declarant also succeeds to the Special Declarant Rights. This may impose liability on the bank for obligations originally imposed upon the Declarant in the declaration creating the community or by MCIOA. However, Minnesota law includes provisions that allow a bank to limit its liability in this situation. Accordingly, before taking title to condominium or townhome units, a bank should weigh the advantages of taking on the Special Declarant Rights against the disadvantage of potential liability.

Takeaway

No bank looks forward to foreclosing mortgages and bringing properties into its OREO portfolio. Managing OREO properties and ultimately liquidating them raises a host of concerns and potential pitfalls. Banks should consider their options carefully in connection with disposition of their OREO assets.