

## **BANK REO in 2011: more visibility, and the inevitable follows**

*-By James Leach, esq.*

Bank real estate portfolios are at all time highs, due to mortgage, as well as construction loan, defaults. The properties foreclosed can be new or old, finished or unfinished, residential or commercial. In some cases, banks have now amalgamated into the role of Owner/Developer and sometimes even General Contractor. Case law recognizes this new role of banks; i.e., they are no longer just banks and immune to the construction defect exposures that exist (this is true, even with 'As Is' contracts; more on this later). Case law supports the proposition that it is the party that placed newly constructed residential property into the stream of commerce that has the exposure to implied warranty laws, even if that party did not build it (see California Civil Code @911; see also, Lane v. Trenholm Bldg.co, 267 S.C., 1976). A bank's REO exposures, however, are not limited to 'new' construction.

### **2010 White Paper on Real Estate Liability**

In the Spring of 2010, the American Bankers Association published the White Paper "Real Estate Liability- the National Landscape is evolving: Banks need to be aware". This article focused on 12 court cases, across the country, and discussed a bank's issues in today's unique market. Many potential liabilities were addressed, including, but not limited to: exposures to complete and incomplete construction; implied warranty laws; seven examples of actual construction defect (CD) liability claims; strict liability; is the Bank considered the builder?; 'As Is', and why that is unlikely to shield the bank; and, the 'long tail' nature of CD claims [this article available upon request at [jleach@isgins.com](mailto:jleach@isgins.com)].

### **Countrywide, and now, BankAtlantic**

In November, 2010, a Miami jury raised the stakes, and they heightened the visibility when they handed down a rare securities fraud class action verdict against BankAtlantic Bancorp Inc., finding that the risks related to its real estate loan portfolio had not been adequately disclosed. This could be \$50 million in damages. BankAtlantic plans an appeal, and the mention of this case is in no way intended to opine on this verdict, or the likelihood of success on appeal; but only to point out that the result itself is significant. This case has the attention of the plaintiff's bar.

BankAtlantic is one of only twelve (12) securities cases that have gone to trial since the Private Securities Litigation Reform Act of 1995. While many of these cases are being appealed, the current scorecard is 6-6; an equal number of wins for plaintiffs and the defense. While this was a rare court case, it will also be a reminder of the litigation settlement against Countrywide Financial Corporation (similar issues: securities law violations alleged regarding Countrywide's activities related to their Real Estate portfolio; same plaintiffs' law firm) earlier in 2010, for \$624 million. This was the second largest securities settlement in 2010.

### **New exposures to banks**

Plaintiff lawyers are well aware of the challenges banks face in this REO crisis; and quite interested in the deep pocket potential. Construction defect liability has been a lucrative area for lawyers for decades.

As a general statement, bank insurance policies cover the bank's activities as a 'lending' organization; and not as a residential contractor or developer; or commercial seller of real estate. Banks are service organizations; and not manufacturers of products. Banks usually have property and premises liability insurance; and they likely do not have coverage for REO issues, after the sale of a property. Construction Defect liability exposures (post sale) last until the expiry of the statute of limitations; 10 years in most states. These can be very large claims (see the ABA White Paper for Seven(7) actual examples; available upon request at [jleach@isgins.com](mailto:jleach@isgins.com)). Banks are now placing properties (products) into the stream of commerce. They need the 'products liability' element of insurance coverage that was once just needed by 'manufacturers or distributors'.

## **Implied warranty laws; and 'business to consumer'**

Construction defect liability exposures arise from the Implied warranty laws, which protect the consumer purchasing a home. These laws are creatures of the Courts (they vary by state); and generally make the party placing a newly constructed property into the stream of commerce responsible for a well constructed property that is habitable and free of construction defects.

Banks can also be liable for damages from 'prior owned' real estate, as a commercial seller of properties. While the older real estate does not trigger the implied warranty laws, the exposures exist nevertheless. Consumer to consumer is legally different from 'business to consumer', where the business (bank) intends to profit from the endeavor.

## **Beware "As Is" as your only Risk Management technique**

Banks have for years relied on 'As Is' contract features to protect them. For routine losses, the 'As Is' features of a contract may deflect claims. However, the Kirkman v. Parex Case, from the Supreme Court of South Carolina (2006) is very instructive. It is a case which referenced case law in several other states (this case is addressed in the ABA White Paper referenced herein). "As Is" [essentially caveat emptor] is 'counter' to the implied warranty laws, which have been the law of the land for 50 years. "As Is" attempts to escape that liability. In addition, Construction Defect claims by their very nature are usually 'hidden' or behind the walls. For "As Is" to be effective, it must be very specific (see Kirkman V. Parex). Being specific with construction defect claims is simply not possible. "As Is" can provide 'some' level of protection in some instances; but such language is not bullet proof. The 'As Is' language is even less likely to be effective if the losses are severe, and include, for example, bodily injury claims.

There are other ways to avoid many court (tort) claims and keep exposures in contract. Many effective Risk Management techniques have been in use in the construction defect liability area for years. Layers of risk management, and insurance, protection, are most effective.

## **2011, and beyond**

Remember 'asbestos' and 'tobacco'? Or Class Actions for shareholders related to diminished shareholder value? The visibility of BankAtlantic and Countrywide have raised the bar related to bank owned real estate. Plaintiff lawyers are always looking for the next lucrative opportunity (note to reader: lucrative to them, may be a problem for you). Many believe the next legal tsunami will be related to the current real estate crisis. It is not difficult to see why.

Banks face unique challenges related to their REO portfolios. There are solutions. A reactive approach to construction defect liabilities, is more expensive, ultimately, and risky. Proactive measures exist to cover and deflect claims. Courts don't like uncompensated victims. And they don't like the guy whose last name is BANK, getting off the hook; while the consumer suffers.

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