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2011 RESOURCE GUIDE

In this issue:
- Green Banking
- Asset Management
- Human Resources

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LENDING

REO in 2011:

It's the VISIBILITY, Stupid!

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Banks and real estate investors are overwhelmed with unfamiliar real estate challenges due to distressed builders and foreclosed, finished and unfinished residential construction projects. Banks have now stepped into the shoes of the owner/developer and sometimes even general contractor; they are at least a "commercial seller of real estate." Case law recognizes this new role; thus, banks are no longer immune to the construction defect exposures that exist. As a general statement, the party that placed residential property into the stream of commerce has the exposure, even if that party did not build it (see California Civil Code @911; see also, *Lane v. Trenholm Bldg. co, 267 S.C., 1976*).

In spring 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 actual court cases across the country, and discussed a bank and fund'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; examples of actual construction defect (CD) liability claims (seven major losses outlined); strict liability; 'as is', and why that is unlikely to shield the bank; and the "long tail" nature of CD claims (This article available upon request; jleach@isgins.com).

In November 2010, a Miami jury raised the stakes and 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 was originally estimated at $150 million in damages. Although BankAtlantic plans an appeal (the mention of this case is not intended as an indictment of BankAtlantic or its actions; rather, a recognition that the result was significant), it is likely this is just the beginning of the plaintiff's tsunami headed toward banks related to their REO portfolios.

Plaintiff lawyers are very aware not only of the challenges in this REO crisis, but of the deep pocket potential.

What should banks and investors be concerned about with respect to taking over finished or unfinished residential properties?

Do banks' current insurance programs provide comprehensive liability protection for construction defect claims and related litigation?

As a general statement, bank insurance policies cover a bank's activities as a lending organization, and not as a residential contractor or developer. Banks are service organizations, not manufacturers of products. Banks probably have property and premises liability coverages, but likely do not have coverage for the construction defect liability claims that will inevitably happen after the sale of the property. Construction defect liability exposures 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 examples, available upon request at jleach@isgins.com). Banks are now placing properties (products) into the stream of commerce. They need the products liability element of insurance coverage once needed only by manufacturers or distributors.

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Are banks and investors, like builders, exposed to residential implied warranty laws?

Implied warranty laws protect the consumer purchasing a home. These laws are creatures of the courts and generally make the party placing a newly constructed property into the stream of commerce responsible for a well-constructed home — one that is habitable and free of construction defects. Are banks and investors exposed to this tort, just as builders or developers? It may depend on a few other factors. But the probable answer is, yes.

Can a bank sell property "as is" and escape liability exposure?

Generally, no. For routine losses, the "as is" features may deflect claims; however, the *Kirkman v. Parex Case*, from the Supreme Court of South Carolina (2006), is very instructive. This case referenced case law in several other states (it is addressed in the ABA white paper). What did the bank know of potential construction issues, and when did it know it? What's in the bank's file? "As is" is counter to the implied warranty laws, which have been the law of the land for 50 years. Implied warranties establish that homes must be habitable and free of construction defect claims. "As is" attempts to escape that liability. Finally, construction defect claims by their very nature are hidden or behind the walls. For "as is" to be effective, the items noted "as is" must be very specific. Being specific for CD claims, is simply not possible. Courts don't like uncompensated victims; while the deep pocket escapes liability.

Does a bank have a legal duty to maximize the value of real estate owned (REO) for the bank's shareholders and note-holders?

Do you want to be on the witness stand answering that question? It is a rhetorical question. Banks can be tempted to sell assets quickly to cut their losses. What if other options are available that could bring more value, with a little time and effort? What if the bank did not pursue? Have they neglected their fiduciary duties? When the bank officer is on the witness stand explaining the bank is losing.

Can a bank have an exposure from selling pre-owned properties that were previously placed into the stream of commerce by someone else?

Consumer to consumer is legally different than business to consumer. The bank or fund is in the business of selling these properties to consumers. They intend to profit from the commercial effort.

Should a bank have a residential project finished by the low bidder?

A low bid might result in inadequate structures where construction defect claims can result years down the road. A bank can be tempted, for example, to handle workmanship items "on the cheap." Fixing a roof leak today avoids water intrusion and mold claims later. In CD claims, proactive is ultimately much less expensive than reactive.

Are law firms gearing up for real estate?

Plaintiff lawyers are always looking for the next lucrative opportunity. (Note to reader: Lucrative to them is not good for you.) Remember asbestos? tobacco? Class actions for shareholders for diminished shareholder value? And now, BankAtlantic? The next litigation opportunity is expected to be related to the current real estate crisis.

There are numerous risk management techniques to protect banks and property investors: to avoid tort and keep exposures in contract. Strong contracts can be effective. Insurance is available. LLC's and "as is" contracts are also popular. None of these is absolute, and a layered approach is most effective.

Banks and distressed property investors face unique challenges. There are solutions. A "head in the sand" approach is reactive. That is always more expensive and costly than a proactive program.

About the Author

James Leach is a 35-year veteran of the insurance business with a background in several specialty insurance areas including construction, professional, aviation and reinsurance. He is an attorney, CPCU, CLU, and holds a master's degree in insurance, and an MBA in accounting and finance.