Risk Management for REO: it's all about LAYERS of protection

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Eskimos learned a few hundred years ago, that one thick layer was not nearly as effective as several layers of protection. More layers trap heat between those layers.

Eskimos could teach us a few things about REO Risk Management. 'Proactive' LAYERS of protection, are most effective.

How to read this ABA white paper (it is in 3 sections; dig as deep as you wish):

1. **Overview**: provides the background needed and frames the issues.
2. Discussion of **EIGHT Layers of Potection**; known and in use.
3. **Detailed Case Law**, and actual examples of how EACH layer may, or may not, be effective**.**

OVERVIEW

Plaintiff lawyers have thrived in construction defect litigation. It is an inviting area for them. A home is an emotional investment; and for many, their largest investment. If a home is not well built, and suffers from construction defects, consumers will demand justice, repairs and compensation for their loss. Armed with counsel, they will demand more than that. Pitting the 'innocent consumer' against the bigger builder/developer was a good scenario for the plaintiff's bar (for a lot of reasons). Now, imagine this case (parties with unequal bargaining powers) with the BANK being the villain? Even more of a deep pocket! This is even more likely, with the recent visibility of BankAtlantic and Countrywide in 2010. [see the March 2011 ABA white paper on this; available at jleach@isgins.com]. Countrywide settled in May 2010 for $624 million the charges related to activities surrounding their Real Estate mortgage business (various misrepresentations and misleading statements were alleged). This was the second largest securities settlement in 2010. Six months later (November), a jury found against BankAtlantic in a case with similar allegations related to its troubled real estate loan portfolio. This was the first securities class action case to go to a jury verdict, as a result of the current real estate financial crisis. While BankAtlantic has indicated it will appeal, our point is not related to those allegations and the fact these were rare 'securities class action' cases. The point here is simply the **enhanced visibility related to the current 'real estate crisis,'** and the large dollars.

Add to these facts the **Implied Warranty Laws**. Implied Warranty Laws are creatures of the courts, and have been around for decades, and almost all states have their own version. Generally, the Implied Warranty Laws require that the party placing (new) real estate into the stream of commerce, warrant that the property is habitable and free from construction defects. Why is this? The home is a very complex structure with over 12,000 parts and features. Courts deemed it simply unfair to the unsuspecting consumer, to have the law be 'caveat emptor' (let the buyer beware). Thus, for new residential construction, it is the opposite: **Caveat Venditor: Latin for 'seller beware'**. This is a tacit warning to sellers that, unless they expressly disclaim any responsibility, they will be held liable if their sold item is defective.

Thus, the deck is stacked against banks in the new world of REO. The banks have customers wanting to buy their properties; and many banks would like more from these customers, including their checking and savings and a long term relationship. Implied warranty laws and plaintiff lawyers, however, lurk to make this area of REO particularly hazardous. How do banks protect their assets in such a situation? Just like Eskimos. NO layers of protection; would be disastrous. ONE layer of protection ("as is" contracts?), in real estate, particularly residential, is simply ineffective. SEVERAL layers of protection are recommended, and available. This is being proactive, before going out in the cold. Let's examine some layers that are time-tested, and that professionals in the field know work.

LAYERS OF PROTECTION

1. Use of an **EXPRESS WRITTEN WARRANTY** to replace the implied warranty laws: Implied warranty laws are nebulous and ambiguous. What does 'free from construction defects' really mean? It may mean, what a court/jury decide, five years later. The Express WRITTEN warranty takes the place of implied warranty laws. It spells out, with great detail, what is a construction defect, and how any dispute will be resolved (preferably, via arbitration, using the Federal Arbitration Act) and not in a court of law. It also can provide peace of mind to the purchaser. Having a written contract is a much better situation, for both parties, than reliance on 'implied warranty laws.'
2. **FEDERAL ARBITRATION ACT**: The use of this dispute resolution mechanism, will keep you out of court. Many contracts contain arbitration provisions; the Federal Arbitration Act is 'a step above'. Court is the friend of the lawyer. Juries are not construction defect experts.

3. **CONTRACTS:** Lawyers learn in their first year in law school: with a **civil dispute, you are either in tort, or contract**. Tort, means court, and who knows the damages? Or the costs? Or the time involved? CONTRACTS are preferred. Several coordinated contracts help in the world of Real Estate. The warranty contract is mentioned above; but also the sales and purchase agreement (and be sure there are not conflicts in those documents, such as in 'dispute resolution') and in any subcontractor or service agreements. Keeping exposures IN CONTRACT; is possible to a significant extent, with real estate; and wise, to avoid protracted and expensive litigation.
4. **'AS IS' LANGUAGE** in your sales agreement: If this is your ONLY layer of protection, you may end up freezing. See Kirkman v Parez (South Carolina Supreme Court case, which referenced case law in several other states; discussed in an April 2010 ABA White Paper and available at jleach@isgins.com; also discussed herein, below). AS IS, is essentially Caveat Emptor. The implied warranty laws are Caveat Venditor. See the conflict here? Courts do not like uncompensated victims. In addition, the law on 'AS IS' requires that one must be very specific about it. Selling a complex structure like a home, "AS IS?" No; the downstairs crack in the tile, might be 'as is.' It is not really possible to be specific about most construction defect claims; they are insidious by nature; and behind the walls or beneath the floor. 'AS IS' might help with a more routine claim; but consider the risks of relying on "AS IS" only, with these deficiencies, and with a $30 million damages claim. It seems likely, that this language, alone, would be challenged as ineffective.
5. **USE OF LLC's:** Many banks and developers use this vehicle to ring fence exposures. Is it possible to pierce an LLC? When a court might view the effort as an effort by the selling entity to dodge claims, and defraud unsuspecting creditors? When you are on the witness stand explaining this; you are probably losing this argument.
6. **RECIEVERS**: Generally, this technique is used considerably. But, who controls all the actions of the receiver? To the extent that these actions make the receiver a 'puppet' of the bank; it's possible this could be attacked. Successfully? Who is to say? It may depend on facts and circumstances.
7. **INSPECTIONS**: A quality inspection, by a third party, provides a 'line in the sand'. The bank then really KNOWS what they have, and can make informed decisions. They have the documents, from expert third parties; to protect themselves. By not having an inspection, a bank may be guessing too much on property conditions. In addition, an 'inspection' enables the last layer of protection: Insurance. Insurance for construction defects is available; even though the bank may not have built the property.
8. **INSURANCE** protection **is** available: Most banks do not have the coverage, however. Why? Banks were historically 'financial service' organizations. Banks are now commercial sellers of real estate. They may effectively be builders and developers. Thus, banks need 'products liability' insurance protection, usually only needed by distributors and manufacturers of products (in real estate, this is **construction defect liability**). Construction defect liability is a specialized area of insurance that should only be handled by experts in the field. Not purchasing this coverage could not only expose the bank's assets, but could expose the bank's officers and directors. Gaps in coverage for insurance that was readily available and not purchased, are found in many D&O policies (see below).

Eskimos are proactive before they go outside. They use layers of protection. In the REO world, LAYERS of protection are available; and can prevent frostbite.

CASE LAW, and ACTUAL LOSS EXAMPLES, for each LAYER of Protection

According to many of our large clients, it is the possibility of an uncovered loss that causes lack of sleep: something 'falling through the cracks.' This section is a look at several court cases, and actual losses that could cause such a nightmare.

1. Use of an **Express Written Warranty to replace the implied warranty laws**: A warranty contract specifically defines, in great detail, what is, and what is not, a workmanship claim or a structural defect claim; while the implied warranty laws are very unspecific in this regard. Perhaps surprisingly, a warranty contract could also encompass, in some cases, a bodily injury matter. **In Mercedes Homes, Inc. v. Rosario, 920 So.2d 1254 (Fla.App.2 Dist.2006**), the Florida Court of Appeal reversed the trial court and ordered the homebuyers and their minor child to arbitrate all of their claims against their builder for construction defects, toxic mold, and bodily injuries from toxic mold. The court concluded that the arbitration agreement conferred jurisdiction upon the arbitrator to decide which claims he was empowered to arbitrate and that it was immaterial whether those claims were covered under the warranty or not. In reaching this conclusion, the court relied on **First Options of Chicago, Inc. v. Kaplan, 514 U.S.938, 115 S.Ct. 1920 (1995).**
2. Use of the **Federal Arbitration Act**. **In Lopez v. Homebuyers Warranty Corp. 628 So.2d 361 (1993), reversed and remanded, 513 U.S. 1123 (1995), 670 So.2d 35 (1995), the U.S. Supreme Court** reversed and remanded the decision of the Alabama Supreme Court invalidating the contract's arbitration agreement, holding that the arbitration agreement is governed by the Federal Arbitration Act, which invalidates and preempts the Alabama statute prohibiting pre-dispute arbitration agreements. On remand, the Alabama Supreme Court ordered the plaintiff to arbitrate his claim, based on **the Federal Arbitration Act. The Federal Arbitration Act was initially established in 1925**; and has been upheld by the U.S. Supreme Court in several cases over the last 86 years.

3. **CONTRACTS**: In #1 and #2 above, the parties (homebuyer, and seller) were **IN CONTRACT** with each other. Thus, the contract prevailed, and arbitration was enforced as the dispute resolution mechanism. There is another contract that is between the same two parties (the sales and purchase agreement). Imagine a scenario where that Sales contract calls for resolution by a court of law? In the case of such an ambiguity, the parties may be forced into court. The consistent coordination of contracts is important. Many "motions to compel arbitration' have been sought, and granted; based on consistent contract provisions. Contracts with subcontractors and service providers are also important in establishing the liability of parties.
4. **'AS IS':** Many banks use a form of 'as is'; **essentially caveat emptor**. **The law of Implied Warranties, however, is Caveat Venditor**. This issue came to a head in the case of **Kirkman v. Parex, Inc. 632 S.E.2d 854 (S.C. 2006**). The Kirkmans purchased a home from a builder who was going out of business. First Union foreclosed on the property; and then spent money to complete the home. However, it was undisputed that First Union did not install the artificial stucco which the Kirkmans claim was defective and rendered the house uninhabitable. First Union also disclaimed the warranty of habitability by selling the home **as is**. The trial court and the court of appeals agreed that First Union was a mere lender as a matter of law and therefore the 'as is' language was effective to disclaim the implied warranty of habitability. The South Carolina Supreme Court disagreed. As to the two main issues to be resolved (was First Union a 'mere lender'; and the effectiveness of the 'as is' language), the court found in favor of the Kirkmans, and against the bank, in both cases. Under Caveat Venditor, the seller of a new house impliedly warrants the habitability of the house; and **the determining factor is not whether the defendant actually builds the defective house, but that he places it, by the initial sale, into the "stream of commerce"** (**Lane v. Trenholm Bldg. Co., 267 S.C. 497 S.E. 2d (1976); Arvai v. Shaw, 289 S.C. 161 S.E. 2d (1986).** The Court went on to cite cases in Alabama, and Washington and established a **test for the 'as is' disclaimer: it must be conspicuous, known to the buyer, and specifically bargained for**. In the case of construction defect liability, this test is not possible to be met. Construction defect claims are, by their very nature, hidden behind walls and below the floor. Specificity is not available; and a general 'as is' on a home was deemed by the court to be "unduly paternalistic."
5. **USE OF AN LLC**: Two recent Connecticut cases are instructive on how to attack or pierce an LLC. **Breen v. Judge, 124 Conn.App 147 (Sept 28, 2010), and Sturm v Harb Dev., LLC 298 Conn. 124 (Aug 31, 2010).** An LLC is treated as a separate legal entity and its debts are separate from the debts of its members or managers. Piercing the veil is an exception; but it is possible under the 'instrumentality test' or the 'identity test' [those tests are outlined in great detail in Breen]. The Breen case is a roadmap for how not to fall into the trap. In the Sturm case, the plaintiffs raised tort claims against an LLC member. The short answer? While an LLC can be effective; one can expect attacks on the LLC to get to the real party at interest. Some courts will be persuaded that a 'victim' should not be defrauded of relief by the smart use of a legal entity designed to shield the true target.
6. **RECEIVERS:** Many are used; and in theory, this is an effective layer. However, here is another actual example. Our firm had a bank client in 2009 who took over several undeveloped properties from one of our former builder clients. The bank hired a receiver, who we recommended, to handle the matters. However, the bank officer would routinely copy us (and other parties) with instructions to the receiver, to keep us all 'in the loop.' We ultimately pointed out, it was clear the bank was directing traffic, and the attorney client protection had been effectively, waived. A plaintiff firm will attempt to prove that the bank is really the party in control. What other evidence could they find to support this proposition?
7. **INSPECTIONS:** An important layer, is the use of an independent, professional inspection firm. A Bank needs to know 'what they have'. A head in the sand approach is problematic for many reasons. A quality inspection provides an 'as of this time' report on the property; and if it passes, enables construction defect liability insurance coverage. If it does not pass, the bank knows what options are available to repair the property. Importantly, construction defect issues do not get better with time. Water intrusion, for example, ultimately causes mold, rotting and collapse. Repair of water leaks early prevents such future larger claims. "Proactive" is ultimately less expensive; and the inspection provides the road map needed.
8. **INSURANCE:** Does a bank need it? Consider this actual event in Calhoun Georgia on April 16, 2010. A **newly-purchased home exploded** because of a gas leak. **All 60 homes in the neighborhood were damaged and 18 families were rendered homeless**. It is remarkable that this was during the day, and there was no bodily injury. With bodily injury, the liability damages are a potentially huge number. Consider a second example. Our firm is currently involved in a series of multi-family construction defect claims, where faulty siding, and thus water intrusion, is the culprit. There are 6 multi-family projects involved, and 780 individual townhomes affected. The cumulative damages alleged exceed $20 million. 'Multi-home' cases are especially hazardous and expensive in construction defect liability. Finally, consider this **exclusion that is contained in many D&O policies**: **Failure to Effect or Maintain Insurance**. Does your D&O policy have this endorsement? Or, any similar language somewhere in the document? Knowing about a coverage available, and not purchasing insurance, can lead to a confrontational conversation with your D&O carrier; and the real possibility of NO coverage for Directors and Officers. Insurance coverage is available to protect from all these exposures.

What keeps YOU up at night? Will any of the above cases or losses do it? Layers of protection are available.

More information is available at jleach@isgins.com (more white papers; and answers to inquiries).

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