The Real REO Costs

-By James Leach, esq.

REO costs. What are they? What to do with them? We hear this common theme from banks: "Our Real Estate costs are overwhelming us". This white paper will review those costs, followed by suggestions to reduce them, and thus, protect the bank's capital base. What ARE the REO costs?

1. DIRECT COSTS (in time, and out of pocket expenses) of holding Real Estate. Banks are very familiar with: Repair costs; property management; utilities; payment to real estate brokers, etc. The length of TIME that banks own REO is not a good thing. Unlike Wine, REO does not get better with age.

2. LITIGATION/LEGAL costs. At a Webcast for 40 bank association in May, a prominent bank lawyer lamented the heavy and increasing costs of outside attorneys. For litigation or for the administration of REO/foreclosures/ receivers, these legal costs add up. Thus, cost saving alternatives are all the more attractive (and we will discuss later; they are available).

3. INSURANCE COSTS AND CLAIMS, while you own REO. This is often referred to as 'Force Placed' or REO insurance coverage. It usually covers premises liability coverage, in addition to the property or 'hazard' insurance. This is fine, as far as it goes. But what comes later? Post sale?

4. MANAGEMENT DIVERSION. This is a well known soft cost to banks. Much of bank's efforts today are associated with managing the costs of REO; and not on 'banking'. Banks know, the sooner they are out of the real estate business, and back in the banking business, the better.

5. REPUTATION AND CLIENT RELATIONSHIP risks. Many banks sell REO to their current or potential bank clients. Do banks want an adversarial relationship with customers associated with REO they formerly owned? Do banks want the workmanship or construction defect issues that will be around for years? [Rhetorical questions]

6. ADMINISTRATION positioning costs: forming LLC's? The costs of Receivers? The 'HOW TO' dispose of, issues. How do we avoid taking title?

7. CAPITAL costs. Many of these areas are a direct hit to bank capital. See #9 and #10: they could be a 'large', unexpected hit to capital.

8. POST sale construction defect claims: frequency. Did you know that ONE IN FOUR homes built during the boom will have a serious construction defect claim? The report, and the data, are discussed below (Criterium Engineers report, December 2006).

9. POST sale construction defect claims: severity. Construction Defect claims can be SEVERE losses. Losses in excess of $30 million, or more, are not common; but they do happen. An example is the home in Calhoun, Georgia which exploded in April 2010. This home damaged all 60 homes in the subdivision and rendered 18 families homeless. It was a gas leak. While there was no bodily injury in this case (during the day; kids at school and others at work), just imagine the loss here with deaths and injuries. Construction Defect losses are always surprising. We don't know where they will come from. A home; is a complex product.

10. Costs to DIRECTORS OR OFFICERS, or to the bank….from NO insurance coverage. This could be a hit to capital; or personally to D's and O's. Banks typically have no insurance coverage in the area of post sale, construction defects.

It is possible to: control and reduce costs; prevent uncovered REO claims; expedite getting REO off the books; avoid hits to capital and D's and O's; cut down on legal and litigation costs. This paper will evaluate and discuss, how.

CONTRACTS (versus, TORTS)

Contracts are important in Real Estate. Getting the language right, to protect banks/sellers, is good common sense business. In addition, new Real Estate comes with implied warranty laws (creatures of the courts; around for decades). Implied warranties (requiring, generally, the seller of new real estate to assure properties are free of construction defects; this is caveat Venditor, seller beware) place the seller of real estate into TORT, and into the cross hairs of seasoned plaintiff lawyers. Avoiding TORT, avoids legal fees and litigation costs, and addresses many of the issues outlined above. Let's delve into this seemingly simple distinction a bit more. It isn't quite as easy as it looks.

Contracts deal with bargained expectations of parties. When there is an issue, and the parties are 'in contract', the remedy is spelled out in that document, which may also state the forum (arbitration, for example, versus a court of law). Torts (commonly referred to as 'negligence') are legally imposed duties. These are both first year law school subjects and are essentially your two options for civil dispute resolution. Contracts are preferred by businesses, and are more efficient and less costly. Tort is the friend of lawyers; it generally means a lot of attorney time, and depositions and court. The simple example of tort is driving. The law imposes duties upon us to exercise reasonable care, and if we do not, and are guilty of negligence, which leads to an accident, then the resulting claim would be in tort. Having made the distinction, the differences have been eroded in some states, and the lines can blur.

The ECONOMIC LOSS DOCTRINE

For example, the economic loss doctrine (an important concept in construction claims), in its current formulation, is a test for determining whether contract law or tort law govern a claim. As a general rule, contract law governs claims against builders (banks?) arising from defects in construction absent an occurrence causing property damage or bodily injury. So the economic loss rule provides that where a party sues for purely economic losses, the party that is suing needs to have a contract with the defendant. This question of where an economic loss begins and where it ends, will depend on your state, and it might appear to be 'legal mumbo jumbo', but understanding this concept and its application, is important.

In Determan v. Johnson, 613 N.W. 2d 259, 262 (Iowa 2000), for example, "the line between tort and contract must be drawn by analyzing interrelated factors such as the nature of the defect, the type of risk, and the manner in which the injury arose. These factors bear directly on whether the safety-insurance policy of tort law or the expectation-bargain protection policy of warranty law is most applicable to a particular claim".

THE UNITED STATES SUPREME COURT; on CONTRACTS

While this can be confusing, even to lawyers, the US Supreme Court declared that rumors of the death of 'contract law' were premature: "Products liability [editors note: in the case of real estate, this is 'construction defect liability'] grew out of a public policy judgment that people need more protection from dangerous products than is afforded by the law of warranty. It is clear, however, that if this development were allowed to progress too far, contract law would drown in a sea of tort". E.River S.S. Corp. v. Transamerica Delaval, 476 U.S. 858, 866 (U.S. 1986). [Ed note; how poetic that the Supreme Court would use the 'drown in a Sea of Tort' analogy in an admiralty case!].

Simply stated, Contract law is premised on a voluntary allocation of risks. Tort law, relies upon a court or jury assigning risks. "The court should not ask tort law to perform a job that contract law might perform better". Saratoga Fishing Co. V. J.M. Martinac & Co, 520 U.S. 875, 879-890 (1997) (quoting East River, 476 U.S. at 872-73). Thus, while it can become muddled and complicated, a business or bank wants to use contracts to settle losses; and avoid tort claims, to the extent possible. And here is the key point: even the United States Supreme Court supports the use of contracts, versus having everything 'drown in a sea of tort', as would be preferred by many lawyers.

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REAL ESTATE, and CONTRACTS

The use of contracts is possible to a large degree, with real estate. First of all, it is important to address the implied warranty laws. How? Replace them with a written warranty contract. This can also address other costs (above), including the direct costs of holding real estate (in that providing a warranty on property can avoid the taint of 'distressed' real estate and aid the sales cycle, thus increasing value and lowering the holding costs). However, while the warranty is a contract between buyer and seller, so is the sales contract. If the warranty calls for dispute resolution by (as we recommend) the Federal Arbitration Act (supported by the U.S. Supreme Court since it was authorized 86 years ago, in 1925; and in April 2011, the U.S. Supreme Court upheld the use of arbitration to curtail class actions, in ATT Mobility vs. Concepcion), and the sales agreement's dispute resolution is via a court of law, then there is a conflict, and the dispute my have to go to court/tort. Thus, contracts, and the coordination of those real estate contracts, is vital to controlling ultimate costs.

The proper use of contracts, while costing 'some' legal fees up front, will cut down on legal costs later. Tort dispute resolution is far more expensive than contract drafting and administration. Trust me on this; I, am a lawyer.

COST BENEFITS OF PROACTIVE

Dealing with Real Estate proactively is much more cost effective than a 'head in the sand' (we'll deal with that later) approach. For example, the Criterium Engineers report from December 2006 analyzes Residential Real Estate claims that can be expected, with great specificity. The report (available upon request), in summary, points out that 17% of the homes built during the boom will have at least TWO significant construction defects. The report goes on to evaluate each area where the defect would likely come from (for example: Roof installation: 23%; Siding: 19%; Framing: 24%: Foundation: 16%), with the overall conclusion of at least ONE significant defect in one of four homes. TWENTY FIVE PERCENT! There were 10 million units built during the boom, and we are very early in the cycle of when those claims will appear. As a general rule, whoever places that property into the stream of commerce (even if it is the bank, or the bank's LLC), will have that exposure up until expiration of the statute of limitations or statute repose (10 years, in many states). Dealing with these exposures up front (for example, with quality inspections and express written warranties, to delineate what are and what are NOT, claims), ultimately saves costs, by avoiding tort claims.

THE COSTS OF NO COVERAGE

Finally, of much concern, are the severe losses (post sale of REO), which at the moment, are generally NOT covered by banks' insurance policies. And, as coverage is available and known, if not addressed, these losses could leave gaps in the bank's D&O coverage. Very large, uninsured losses (direct hits to capital), and resulting exposure to directors and officers, are possible.

SUMMARY

There are many costs associated with REO. Many direct costs; many indirect costs; many costs 'today'; and many coming 'tomorrow'. Layers of risk management protection are available to control these costs (see our last white paper on this subject, available upon request at jleach@isgins.com). We will also provide, upon request, the DVD of the May 2011 National Webcast, supported by over 40 state banking associations.

Being proactive, controls costs; lowers legal expenses; cuts down on uninsured exposures; protects D's and O's; reduces REO time on the books; avoids future disputes with bank customers; gets banks back to being 'bankers'.

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