

B&B REVIEW

Environmental and Natural Resources

Financial Services and Transactions

BANKS MUST MANAGE THE ENVIRONMENTAL RISKS IN “ORE”

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INTRODUCTION

In our August 2008 *B&B Review*, “Community Banks Offered a Refresher on How to Hold “Other Real Estate”, we described how the FDIC had provided guidance to banks on the prudent way to manage real estate acquired from foreclosures (usually called “other real estate” or “ORE”). We described the FDIC’s guidance in three areas: (1) valuing ORE (2) maintaining ORE and (3) accounting for ORE.

We noted that some banks have never had to service ORE over a long period of time, and that as a result many bankers have never had to concern themselves with property management issues such as maintaining property in accordance with homeowner association rules and paying real estate taxes and other amounts owing.

Another significant risk arising from ORE property management arises from laws which are designed to protect the environment. In particular, many states have laws requiring that property owners protect against soil erosion, and will impose significant fines for violations of these laws. Such laws would be of particular importance to banks holding partially constructed properties as ORE.

APPLICABLE ENVIRONMENTAL LAW

Stormwater runoff from construction activities can have a significant impact on water quality and has been identified as one of EPA’s primary issues for 2009. The federal Clean Water Act, 33 U.S.C. § 1251 *et seq.* (1972), requires construction site operators to manage stormwater discharges from those sites under the National Pollutant Discharge Elimination System (NPDES) permitting program. Most states are

authorized to implement and carryout the stormwater NPDES permitting program for construction sites in their states. See e.g., ALA. ADMIN. CODE Ch. 335-6-12; Miss. WPC-1, Ch. 1; GA. COMP. R. & REGS. r. 391-3-7. Under this program, builders and developers are required to obtain an NPDES stormwater permit and comply with various best management practices in controlling and reducing the impact of stormwater runoff from construction sites. Normally, the regulatory agency would visit the site, note any violations, and issue a notice of violation or order to the builder or developer to correct the problem and pay a fine. However, when the developer or builder becomes insolvent and the property is foreclosed, the usual responsible party is no longer there to monitor erosion control and ensure compliance at the site. In addition, it is difficult in many cases for the respective regulatory agency to determine who the responsible party is during the foreclosure process. As a consequence, in many cases, the property and its related fines or cost of compliance become the bank’s responsibility once it is foreclosed.

BANK RESPONSIBILITY

Historically, banks that have foreclosed on partially constructed properties have not had to be concerned with environmental compliance issues because of the quick turn around in discharging their ownership of these properties. However, because of the current market downturn, many banks are finding themselves owners of a large number of these properties for a significant duration of time. In such cases, lenders have not factored in compliance with these environmental laws when they initiated the loans. Because these financial issues were never budgeted when the lenders initiated the loans, payment for these costs can only come out of the bank earnings. In addition,



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banks are either unaware of the environmental issues at foreclosed properties, or view the cost of correcting violations as optional when they are already burdened with declining real estate values and rising costs. As a result, as banks take back these properties by the hundreds, compliance is lapsing and erosion control and other environmental issues on these properties are becoming a large cost for banks. For example, one foreclosed subdivision in Georgia has accumulated millions of dollars in county fines for not complying with erosion control rules.

STATES' RESPONSE

Because of the growing problem of maintaining environmental compliance on foreclosed properties, states are starting to take specific action against such violations. For instance, the California legislature recently passed a statewide law that allows local governments to assess a fine of up to \$1,000 a day on the owners of foreclosed properties who do not adequately maintain stormwater controls on those properties. S.B. 1137, 2007-2008 Sess. (Cal. 2008). In addition, California cities have adopted ordinances requiring lenders to register foreclosed properties allowing the cities to keep track of who is responsible for the property's upkeep. For example, Cathedral City, California requires owners of foreclosed properties to register the property with the city and pay a \$70 annual registration fee to cover maintenance of the property. Likewise, Selma, California recently passed an ordinance requiring banks to register and pay \$200 annually for each property they own through foreclosure.

California is not alone.¹ In an effort to increase mortgage lender accountability, Boston, Massachusetts recently passed an ordinance requiring property owners to register foreclosed properties and to designate a property management company to maintain the property. Failure to register the property or identify a company to maintain the property is punishable by a \$300 fine, and failure to maintain the property is punishable by a \$300 per week fine. See Boston, Mass., Ordinance Regulating the Maintenance of Vacant, Foreclosing Residential Properties (March 3, 2008).

¹ In January, the State of Rhode Island passed the Rhode Island Foreclosed Property Upkeep Act which requires any financial institution that purchases a foreclosed property to post a bond with the municipality for 25 percent of the property's assessed value. However, that state's governor subsequently vetoed the legislation.

This trend appears to be gaining ground in the Southeast as well. Forsyth County, Georgia recently started requiring developers to secure an erosion control bond up to \$3,000 per disturbed acre before construction begins. This ordinance provides a means of assuring environmental compliance should the developer become insolvent and can no longer adequately maintain environmental controls on the foreclosed properties. See Forsyth County, Ga., Code § 34-72(f)(2) (2008). Also, in July, the city of Margate, Florida started requiring registration of foreclosed property and payment of a \$50 annual registration fee and other maintenance and security requirements. See Margate, Fla. Code App. A, Art. XXIII, § 23.16.

OBTAINING COMPLIANCE

Banks are typically not accustomed to dealing with environmental issues and permits. These issues require both legal advice and technical assistance. As compliance with construction storm water regulations continues to be a growing issue for financial institutions assuming foreclosed properties, banks should take a proactive team approach. First, to minimize any liability, banks should inventory their foreclosed properties and identify which properties were under construction at the time of foreclosure. Once identified, the bank should hire an environmental consultant to assess and determine whether those properties are currently in compliance. For those properties determined to be out of compliance, stormwater runoff, erosion and sedimentation control plans should be developed for those sites. Second, banks should consider hiring attorneys to develop solutions for existing violations and work out an agreement with the applicable regulatory agency until the bank can sell or auction off the violating property. Third, banks, in consultation with their attorneys, should review and update their environmental risk management policies to ensure these issues are adequately addressed.

CONCLUSION

As the downturn in the economy continues to worsen, issues related to maintaining environmental compliance at foreclosed properties will only increase. While, historically, banks have not had to be familiar with implementing and abiding by these guidelines, institutions which take a proactive approach in ensuring that their foreclosed properties are compliant will be able to address these issues at substantially less cost and decrease the risk of the implementation of state and/or federal regulatory programs to ensure compliance.

