HOLDING PROPERTY ACQUIRED AT FORECLOSURE: PREMISES LIABILITY, ENVIRONMENTAL COSTS AND OTHER ISSUES

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Some foreclosing creditors seek at all costs to avoid the liabilities associated with holding the collateral as an owner, while at the same time trying to secure as many of the benefits of ownership as possible. These benefits include cash flow, management discretion, control over marketing and the right to direct disposition. A creditor may try to accomplish this goal by entering into a foreclosure settlement with the borrower in the form of a holding agreement, marketing or listing agreement, or asset management agreement; or, as part of the settlement, may enter into contracts in similar form with its own affiliated *transferee from* the borrower. The trade-off for not taking title directly is that such agreements may not accomplish all the objectives imagined by the parties and/or may provide less in terms of finality and bankruptcy protection. *See generally* § XIII (G), *supra*[i]1 (deed-over transactions).

At the other extreme, many a foreclosing creditor has leapt into whole ownership of collateral, where a careful and realistic analysis would have encouraged some alternative course. Quantifying those economic benefits of ownership that are *realizable by the creditor* in comparison with the *accurate analysis* of prospective ownership liability is the key to making the holding decision that is best calculated to preserve asset value.

1. In Some Circumstances the Liabilities Associated With Holding Foreclosure Property May Arise Without Taking Title

a. As a Property Manager or Mortgagee in Possession Before the Sale

A mortgagee in possession before the sale (*see* § I(E), *supra*) will have responsibility for management and preservation of all the collateral in its custody. *See, e.g., McCorristin v. Salmon Signs*, 244 N.J. Super. 503, 582 A.2d 1271 (1990); *Comfed Sav. v. Newton Commons Plaza Assoc.*, 719 F. Supp. 367 (E.D. Pa. 1989) (rights and duties); *Fox v. Bohemian Sav. & Loan Ass'n*, 671 S.W.2d 412 (Mo. App. 1984); *Johns v.*

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Moore, 168 Cal. App. 2d 709, 336 P.2d 579 (1959) (mortgagee in possession charged with duties of "prudent owner"); Kratovil, *Mortgages--Problems in Possession, Rents and Mortgagee Liability*, 11 DePaul L. Rev. 1 (1961). The more reliable view is that *actual physical possession* by the lender or its agent is required in order for mortgagee-in-possession liability to arise. *But cf.* J. Hetland, *California Real Estate Secured Transactions* §§ 2.10--2.12 at 14--18 (1970) (discussing whether lesser steps might give rise to liability); *Johns v. Moore*, *supra*, 168 Cal. App. 2d 709.

(1) **Is There a Limit on the Mortgagee in Possession's Liability for Maintenance?** The traditional rule, that a mortgagee in possession "is not bound to dig into his own pocket and so need not expend [on necessary repairs] more than the rents and profits he receives" (G. Osborne, *Mortgages* § 168 at 291 (2d ed. 1970)), may not be consistent with the modern scope of liability imposed on those who control or possess potentially dangerous premises.

(2) **Very Difficult Foreclosure Property May Better Be Left to the Management of a Court Receiver, Despite the Costs**. Where serious negative social conditions or other dangers including environmental contamination are present, yet the property generates sufficient current income to warrant concern, lenders seeking possession prior to foreclosure often prefer the appointment of a mortgage foreclosure (rents and profits) receiver to taking possession by private agent.

b. **"Lender Liability" for the Secured Creditor as a Controlling Party**

Other creditors of the borrower or parties injured at the collateral may try to characterize the secured creditor as a "controlling party" under the lender-liability line of cases so as to impose liability for damages. *See, e.g., Credit Managers Ass'n v. Superior Court*, 51 Cal. App. 3d 352, 124 Cal. Rptr. 242 (1975); B. Dunaway, *The Law of Distressed Real Estate, Lender Liability* § 4B.01 et seq. (1994); Lundgren, *Liability of a Creditor in a Control Relationship With Its Debtor*, 67 Marq. L. Rev. 523 (1984); *Restatement (Second) of Agency*, § 14-0, Comment a (liability of security holders).

(1) **Where the Creditor Directs the Borrower's Management of the Collateral Without Regard to the Borrower's Wishes**. Even absent an acceptance of deeded title, the secured creditor who exercises pervasive management domination and control over the collateral is most likely to fit the description of a "controlling party." It is hard to imagine, however, that in such a case the lender would not also have liability as a mortgagee in possession. *See* Hetland, *supra*.

(2) **Where the Creditor Directs Management of an Affiliated Transferee**. Where the borrower has transferred title to a different entity controlled by the lender (or *lenders*, as the use of such entities at foreclosure is common in the participation setting), liability for an (unanticipated) uninsured loss often flows upward to

the controlling parties anyway. Lender liability, alter-ego and other theories may be applied. *See* § (K)(1), *infra* (use of affiliates and environmental liability). For a discussion of the liability of the affiliated secured lender, *see Talley*, § XIII(A)(3), *supra*.

2. **Some of the Reasons Why Lenders Perform Audits and Inspections Before Taking Over Foreclosure Property**

a. **Searching Title to Confirm Carrying Costs, Including Senior Liens, Assessments and Taxes**

These costs include not only amounts necessary to cure, carry or pay-off senior liens, but also amounts necessary to satisfy delinquent taxes, to carry homeowner fees, to pay street improvement bonds and community facility district assessments, and to cover a variety of possible development and mediation expenses where subdivided lands are involved.

b. **Inspecting the Site and Improvements for Unsafe Conditions**

Liability may arise from conditions the lender has no personal knowledge of. These could include, among other dangers, hidden defective wiring (*Fann v. Brailey*, 841 S.W.2d 833 (Tenn. App. 1992)), a concealed condition such as an untempered shower door (*Becker v. IRM Corp.*, 38 Cal. 3d 454, 213 Cal. Rptr. 213, 698 P.2d 116 (1985) (strict liability for latent defects in apartment)), a seemingly minor condition such as a chipped faucet handle (*Rowland v. Christian*, 69 Cal. 2d 108, 443 P.2d 561, 70 Cal. Rptr. 97 (1968)), or conditions such as an unsafe stairway (*Jones v. Bierek*, 306 Or. 42, 755 P.2d 698 (1988)), a poorly maintained fence (*McDaniel v. Sunset Manor Co.*, 220 Cal. App. 3d 1, 269 Cal. Rptr. 196 (1990)), or an incorrectly sloped wheelchair ramp (*Barnes v. Innis-Tennebaum Architects*, Inc., 221 Cal. App. 3d 1314, 271 Cal. Rptr. 92 (1990) (ordered unpublished, not to be officially cited, Cal. Rule of Ct. 977(a))).

c. **Conducting the Environmental Audit**

The many recent articles and newsletters written with the foreclosing creditor's concerns in mind emphasize the need to conduct due diligence before entering into a loan transaction. *See, e.g.,* Brody, *Minimizing Environmental Liability When Taking a Deed in Lieu of Foreclosure*, 9 Cal. Real Prop. J. 25 (1991); Becker, Butler & Jatlow, *The Role of Environmental Assessments in Real Estate Transactions*, 18 Real Est. L.J. 379 (1990) (the "phase I assessment"); Ribblett & Turschmid, *Advice From Environmental Consultants: How to Achieve Competent, Comprehensive and Understandable Results From Environmental Audits*, 41 S.C. L. Rev. 887 (1990).

(1) **Pre-Foreclosure Testing**. Even "intrusive" environmental testing (such as the drilling of test bores pursuant to a "phase two" investigation) may be allowed

before foreclosure, over the borrower's objection, pursuant to boilerplate language in the mortgage permitting the lender to "protect or enhance the security." *First Capital Life Ins. Co. v. Schneider, Inc.*, 608 A.2d 1082, 1085-86 (Pa. Super. 1992). However, the *cost* of a preforeclosure environmental assessment may not be recoverable as part of the lender's demand at the foreclosure sale. *See Norwest Bank Indiana, N.A. v. Friedline*, 591 N.E.2d 599 (Ind. App. 1992).

(2) **Careful Drafting in Loan Documents**. An environmental contamination of or by the collateral should be carefully anticipated in the loan documents. *See, e.g.,* Gershonowitz, *What Should be in Environmental Indemnity Clauses*, 5 Prac. Real Est. Law. 55 (1989); Comment, *Mortgage Acceleration: The Lender's Prescription for Avoiding the Comprehensive Environmental Response Clean-up and Liability Act (CERCLA)*, 35 Wash. U. J. Urb. & Contemp. L. 129 (1989).

d. **Surveying the Surrounding Social Conditions, Including Criminal Activity**

Very negatively impacted property may not be suitable deed-in-lieu material, may dictate the appointment of a receiver before sale, may motivate the lender to walk away or facilitate a direct sale by the borrower. As part of the lender's preparation to take ownership, the social/criminal audit should measure (a) appropriate security needs for tenants, guests and invitees, (b) the history, if any, of criminal activity on site which may require costly abatement by the owner under local law, and/or (c) the need for coordination with other service agencies where vagrants are a problem. *See* Cowan, *Due Diligence Issues for Distressed Real Estate: From Investment Recovery to Asset Management*, 12 Cal. Real. Prop. J. 8, 9 (No. 2, 1994) (discussing nuisance laws). (Spirited advice for the owner defending a nuisance action is given in Horowitz, *Defending Property Closures Under the Narcotics Nuisance Abatement Act*, 16 CEB Real Prop. L. Rptr. 213 (1993).)

For impairment of the lender's position under criminal forfeiture laws, *see generally* § IV(K), *supra*.

3. **The Take-Over Should Be Professional and Decisive**

"Days or even hours of delay can result in lost information and missing or stolen property," Pringle, *Special Property Management Concerns in an REO Takeover*, 2 Real Est. Workouts & Asset Mgmt. 8 (No. 4, 1993). Review insurance policies, including the scope of insurance carried by business tenants. *See Morales v. Fansler*, 209 Cal. App. 3d 1581, 258 Cal. Rptr. 96 (1989). (Property insurance probably will not cover loss due to criminal forfeiture. *Counihan v. Allstate Ins. Co.,* 827 F. Supp. 132 (E.D.N.Y. 1993).)

4. **The Lender's State Law Defenses Against Acquiring Owner**