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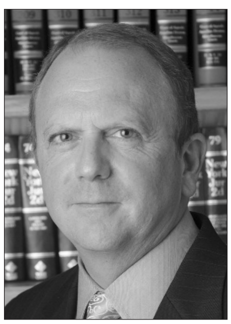
Banking/Bankruptcy Law Focus

The slow road to economic recovery

Despite the real estate and financial markets' efforts to rebound, global, national and local pressures are squeezing the markets, causing them to sputter. In an effort to assist delinquent homeowners, our State and Federal Governments have promulgated laws that delay the foreclosure process and have increased banks' expenses and liabilities. Though well intended, the new laws and government programs will most likely cause a continuation of the depressed real estate market and more bank failures, which ironically, was the impetus of the current recession. This article seeks to explore the new State and Federal foreclosure laws and to illustrate their impact on real property foreclosures and the banking industry.



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The Recession

According to the United States Department of Labor, national unemployment figures are presently 9.5 %, New York stands at 8.6%, and the Long Island metro area is at 9.3%.

The present cycle of credit restriction and real property foreclosures, fueled by job losses, corporate retrenchments, and increased bank regulations, is pressuring residential and commercial property owners and small businesses. The previous influx of "subprime" residential mortgage foreclosures is now being replaced by another wave of "prime" residential mortgage and commercial mortgage foreclosures.

According to Long Island Business News, as of March, 2010, about 7.5 million loans nationwide are in default or foreclosure, and 1 million properties are already bank-owned. An estimated 8.5 million distressed homes are soon to hit the market.

The Federal Government's Response

In response to the foreclosure crises, in February 2009, the Obama administration enacted the $75 billion Home Affordable Modification Program ("HAMP"), which requires Troubled Asset Relief Program ("TARP") recipients, their servicers, servicers of Fannie Mae and Freddie Mac mortgages, as well as those servicers voluntarily participating in the HAMP program, to attempt to modify distressed loans prior to a foreclosure sale. Some courts require an affirmative pleading that HAMP has been complied with, or an explanation for why HAMP does not apply.

Federal regulators have also required that banks maintain increased reserves against bad or troubled loans and the FDIC is increasing the fees healthy banks must pay into the fund to support failed banks.

New York State's Response

In response to the foreclosure crises, the New York State Legislature enacted amendments to the Real Property Actions and Proceedings Law ("RPAPL") and the Civil Practice Laws and Rules ("CPLR"), which are discussed in greater detail below.

The Effect on Residential Foreclosures

The impact of the Federal Government's response remains inconclusive, but on May 18, 2010, Newsday reported that 23% of the borrowers enrolled in HAMP have dropped out. It is estimated that the number of people dropping out of the assistance plan is almost equal to the number of people who have received permanent relief.

As for the impact of New York State's response, the RPAPL amendments, effective as of January 14, 2010, require lenders or servicers to send borrowers a 90 day notice of intent to foreclose, and require a filing of specified information with the superintendent of banks, prior to commencing a foreclosure action. This resulted in a statewide moratorium on the commencement of residential foreclosure actions from January 14, 2010 through April 14, 2010.

In addition, the CPLR has been amended to now require mandatory settlement conferences for every residential foreclosure case (with limited exceptions) that is pre-Judgment of Foreclosure and Sale. The mandatory foreclosure conferences not only allow borrowers the chance to modify their loan, but they also allow borrowers who are in default in the foreclosure action, with the assistance of the court, their attorneys and housing counselors, the opportunity to examine their loan documents and challenge them for the lender's failure to comply with Federal disclosure laws. To complicate matters further, the borrower's attendance at the settlement conference is not considered an appearance for purposes of the foreclosure action. It is essentially granting borrowers greater rights in the litigation than the average litigant has ever received.

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Furthermore, we see Judges becoming more pro-active, requiring affirmative pleadings that were never required before, enforcing procedural requirements, raising defenses sua sponte, and over all increasing burdens of proof on lenders. Several cases have been dismissed for failure to affirmatively plead compliance with these procedural requirements, thereby creating additional delays in the already lengthy foreclosure process.

The amendments to the RPAPL and CPLR in conjunction with HAMP have significantly slowed the foreclosure process and have skewed recent statistical reports. Several recent reports indicate that Long Island's foreclosure filings have dropped, however, the statistics are due more to the effect of recent amendments to the foreclosure laws than they are a sign that the real estate market and the economy are recovering.

The Effect on Commercial Foreclosures

The new foreclosure laws impact commercial properties as well. The amended New York State statutes redefine "Residential real property" to include property "improved by any building or structure that is or may be used, in whole or in part, as a home or residence of one or more persons, and shall include any building or structure used for both residential and commercial purposes." This definition includes cooperative, apartment, and mixed-use buildings.

The laws impose a duty on residential and commercial lenders to notify tenants of the foreclosure, and to maintain the premises and give tenants the right to remain in a dwelling post-foreclosure. Therefore, lenders must continue to pay real estate taxes and insurance, and may have to provide utilities and other services to properties that are not generating income. The amendments necessarily lengthen the foreclosure process in an already overcrowded court system, increase expenses, and introduce new lender responsibilities and liabilities, which will undoubtedly hamper the liquidity and balance sheets of commercial lenders.

The Effect on the Banking Industry

Reports show 140 banks failed in 2009. The number of troubled banks kept growing last quarter even as the industry as a whole had its best quarter in two years. On May 20, 2010, the Federal Deposit Insurance Corp. reported that the number of banks on its confidential "problem" list grew to 775 in the January-March period from 702 in the previous quarter. The FDIC expects U.S. bank failures to cost the insurance fund around $100 billion through 2013.

On May 5, 2010 Freddie Mac reported a net loss of $6.7 billion for the first quarter of 2010, and that it is requesting an additional $10.6 billion from the United States Treasury. And on May 10, 2010 Fannie Mae reported a net loss of $11.5 billion for the first quarter of 2010, requesting an additional $8.4 billion from the United States Treasury.

Although the benefits of the TARP program are now widely accepted as having saved our economy from collapse, it is also acknowledged that TARP has not been successful in encouraging lending to small businesses, restoring liquidity or creating jobs. Unfortunately, the plan failed to generate needed credit to small businesses and the prospects are not encouraging according to the recent May report from the Congressional Oversight Panel, the watchdog over the $700 billion TARP Program. "Although the Troubled Asset Relief Program (TARP) has launched several initiatives aimed at restoring credit availability, it is not clear that they have had any significant impact on small business lending," the panel's report said. In addition, the panel is casting doubt on the Obama Administration's much heralded $30 billion TARP re-allocation intended to ultimately assist small businesses. The Small Business Lending Fund (SBLF) would provide the $30 billion in low-cost capital to small and mid-sized banks, along with incentives to increase lending.

"Moreover, banks may shun the program for fear of being stigmatized by its association with the TARP, or they may wish to avoid taking on SBLF liabilities at a time when their existing assets, such as commercial real estate, remain in jeopardy," the oversight panel's report said.

In addition, Federal regulators have required banks maintain increased reserves against bad or troubled loans and the FDIC is increasing the fees healthy banks must pay into the fund in order to support failed banks. This will further restrict the availability of credit to the public.

The Next Wave

Although the current nationwide focus is on the residential housing market, the adverse impact on the residential climate will have enormous repercussions on the commercial market. Beyond the direct impact of the new foreclosure laws and regulations, depleted real estate values are greatly impacting commercial properties and commercial lending.

Commercial property owners throughout the country are currently facing plummeting real estate values, falling occupancy rates, and problems with financing. Commercial loans, customarily made with 5 to 10 year terms, made at the height of the commercial real estate boom, are now coming due. These loans were made with presumptions about the value of the property, rents to be received, and occupancy of the buildings that are no longer true.

It is estimated that $1.97 trillion in commercial loans will mature between 2010 and 2018. This will result in an increase in commercial mortgage workouts and foreclosures. As these loans become due, banks will be unable to refinance the loans for several reasons, including the substantial decrease in the value of the property and the heavy governmental restrictions placed on banks, including requiring increased reserves against weak or non-performing loans.

As for the decrease in value, prices are expected to drop about 25-30% from when the property was purchased. Many borrowers are hoping that once their loan matures the banks will simply roll them over in the hopes property values will bounce back. It is unlikely however that this scenario will happen. Because of the current environment, banks are taking a more defensive posture, scrutinizing every aspect of a borrower's financial profile.

In the face of being unable to refinance or sell, many commercial borrowers will be forced to default on their loan obligation with the inevitable ending, foreclosure. There can be no clearer indication of falling victim to the plunge in commercial real estate value than when The Mortgage Bankers Association, one of the leading trade groups for commercial and residential lenders, announced that it was selling its corporate headquarters in Washington D.C., purchased in 2007 for $79 million, for $41.3 million.

The loss of equity and devaluation that has occurred to residential property owners is now being visited on commercial property owners, and the lifeboats put in place by the State and Federal Governments to help delinquent homeowners are having an adverse effect on commercial foreclosures, causing delays and increased costs and liabilities for commercial lenders on the foreclosure of multifamily and mixed use properties.

Conclusion

This recessed economy has prompted a wide range of new laws and protocols for foreclosures and the debt collection process. Although the well intended purpose of these new laws was to further protect distressed homeowners, prevent blighted neighborhoods, establish tenant protections, and prevent homeowner rescue scams, unfortunately, neither the Federal Government programs put in place, nor New York State's efforts to slow the foreclosure process can assist those debtors who have suffered job loses and continue to be unemployed. Instead, the majority of these programs and new laws are placing additional burdens and duties on lenders, increasing costs for borrowers, and restricting the availability of credit.

Presently our Federal and State Governments, while publicly calling on banks to lend to small businesses, are in reality putting additional strains on lenders by requiring increased reserves and fees and slowing the foreclosure process, thereby depriving banks, and Main Street, of liquidity. In the meantime, small businesses are playing defense and are not willing to risk expansion, while unemployment continues to remain very high.

We will find a depressed residential and commercial real estate market for the foreseeable future until the next wave of commercial and residential foreclosures wind their way through our court system, and the stable banks and credit unions that survive the present economic downturn are again willing and able to lend.

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