

Chicago Mandates that Lenders Register and Maintain Vacant Properties Before Acquiring Ownership

Author: Cynthia Jared, Partner, Chicago

Author: Daniel J. Slattery, Partner, Chicago

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Since the onset of the recession, we have become well familiar with the nationwide foreclosure crisis, particularly as to residential properties. Cities and states have grappled with how to address the adverse impact on neighborhoods and communities of properties that have been abandoned by the owners or that sit vacant after foreclosure. Vacant properties are subject to increased vandalism and attract criminal activity, and the absence of an on-site presence can lead to a decline in the maintenance of the building and grounds.

Some local governments require buildings to be registered when they become vacant, so that the local government can identify potential problems. To deal with abandoned and run-down properties, local governments have traditionally used the tools of building inspections and code enforcement actions to ensure that properties are maintained and secure. Property owners can be cited and fined for failure to comply with minimum standards of maintenance. The local government also has the right to perform the maintenance and secure the property or, in certain cases, demolish the improvements. Such fines and any amounts expended by local government are secured by a super-priority lien against the property.

Historically, under all of these approaches, the fee title owner has been the only entity liable for a failure to comply with the legal requirements. Although the liens in favor of the city would prime the lien in favor of the lender holding the mortgage on the property, the mortgagee would not be legally responsible to the city for the condition of the building until and unless the lender became fee owner of the building through foreclosure or deed in lieu of foreclosure. Once the lender (or its subsidiary) became the owner, the lender (or its subsidiary) would be obligated to comply with the local code requirements, including registration and maintenance.

In late July 2011, the City Council of Chicago (the "City") passed an ordinance shifting the liability to the lender before the lender owns the property. The City amended the existing vacant building ordinance to make it apply directly to the lender. Most significant, under the amendment, lenders can now be held legally responsible for the maintenance and upkeep of

vacant Chicago properties that they do not own or control. Lenders now risk being subjected directly to governmental enforcement actions and fines should the vacant properties be found to violate the maintenance standards set out in the ordinance. The amendment also requires lenders to register vacant properties with the City, take actions to secure the properties, post information signs at the properties, and carry liability insurance. Thus, the City has imposed liability on lenders for taking action that they have no legal right to take since they are not in possession or control of the properties. This is an untenable burden on the lenders. The amended ordinance is expected to become effective in mid-September 2011. The requirements of the vacant building ordinance, as amended, apply to properties of all types, including residential buildings and commercial buildings.

The amendment likely will be challenged as unconstitutional on due process grounds, and perhaps on other bases, including preemption as applied to national banks. Such a lawsuit could be filed before the amended ordinance goes into effect, and it is possible that the application of the ordinance could be stayed or suspended as a result of the filing of the lawsuit. However, until and unless such a lawsuit is filed and an injunction issued, or the ordinance is otherwise invalidated, lenders are faced with the real and immediate need to understand the requirements of the ordinance and to take appropriate action to comply. The ordinance contemplates that the building commissioner may issue rules and regulations to implement the amendment to the ordinance, but as of this date, we know of no such rules or regulations having been issued.

Many questions are raised by the amended ordinance, beyond those relating to possible constitutional challenges. Most of the questions relate to the very real and practical problem that the mortgagee has neither the legal right nor the practical ability to access and maintain the property until it becomes an owner. How can a mortgagee take action to maintain the property, secure the property and post signs as required by the ordinance? Are both the fee owner and the mortgagee required to register the vacant building, or does a registration by the fee owner alone suffice? Does contact information have to be provided as to both the fee owner and the mortgagee? It seems as if a legal duty is being imposed upon multiple parties, with significant penalties attached for non-compliance and unclear allocation of responsibilities.

The most immediate concern for lenders holding mortgages on properties located in the City is determining what actions to take immediately with regard to these properties. The first action we

recommend is to determine whether the property is "vacant" for the purposes of the ordinance. Assuming the building is indeed vacant, the next step would be to ensure that it is properly registered with the City, if possible by the borrower, and that the borrower has taken the required measures to secure the building, post signage, and carry the minimum amount of liability insurance as required by the ordinance. The third action would be to ensure that the borrower is maintaining the vacant building in compliance with the minimum standards as dictated by the ordinance. Absent borrower cooperation, of course, any of these actions would be problematic to implement. Failure to comply with the ordinance will be an event of default by borrower under most mortgages, permitting the lender to exercise remedies, including the appointment of a receiver who would be empowered to take actions necessary to comply.

Given the very real prospect of a court challenge, and the likelihood that rules and regulations or other guidance will be issued by the City, it remains to be seen if this law as now written will become fully effective and fully implemented. It also remains possible that this law could be further amended to modify or eliminate the burden on lenders. In the interim, however, lenders must become familiar with the ordinance, and must work proactively with borrowers to ensure compliance to the maximum extent possible. Reed Smith counsel can assist with this process. If you have questions or require assistance with regard to this ordinance, please contact Cynthia Jared or Daniel Slattery at the Chicago office of Reed Smith.

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