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The Exposure of Securitization Trustees to Liability Under the Federal Fair Housing Act for Poorly Maintained Real Estate Owned Properties

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Securitization trustees face unexpected exposure to claims under the Fair Housing Act for the discriminatory maintenance of their REO properties.

As the effects of the foreclosure crisis continue to ripple in unexpected ways, federal regulators, municipal governments, and fair housing advocates have recently begun a spate of investigations and enforcement actions against lenders with large inventories of Real Estate Owned ("REO") properties, obtained as a result of massive foreclosures of their defaulting residential mortgage loans.

These investigations have focused increasingly on the condition and maintenance of lender REOs. A 2011 study conducted by the U.S. Government Accountability Office reported that "improperly maintained vacant properties create costs and other problems for neighborhoods and local governments."[1] Vacant, foreclosed properties can reduce prices of nearby homes by $8,600 to $17,000 per property, and may attract crime, cause blight, and threaten public safety.[2] Local governments reported spending millions of dol-

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lars on inadequately maintained vacant properties.[3] The U.S. Department of Housing and Urban Development ("HUD"), the Federal Housing Finance Agency ("FHFA"), and the GSEs are particularly sensitive to the risks posed by large REO inventories. A Joint HUD/FHFA Inspector General Report published in May 2013 concluded that "HUD did not have adequate procedures in place to ensure consistent and adequate enforcement" of its property maintenance contracts, and that 39.6 percent of the properties managed by the one property maintenance contractor audited by the Inspector General "materially failed" to meet contract requirements because homes were not properly maintained.[4]

Federal regulators have recently announced standards specifically addressed to the proper maintenance of REO properties by lenders.[5] Enforcement actions by local governments, typically filed in state court, seek to hold lenders holding legal title to REOs as a result of foreclosure proceedings responsible for the condition and ongoing maintenance of the properties.[6]

The inadequate maintenance of REO properties has also caught the attention of fair housing advocates. In 2011, and again in 2012, the National Fair Housing Alliance ("NFHA") published reports of its investigation into the maintenance by lenders of REOs in communities of color as compared to their maintenance of REOs in predominantly white communities.[7] NFHA found a "stark disparity" in REO maintenance based on neighborhood racial composition:

> While REO properties in White neighborhoods were more likely to have well-maintained lawns, secured entrances, and professional sales marketing, REO properties in African-American and Latino neighborhoods were more likely to have poorly maintained yards, unsecured entrances, look vacant or abandoned, and have poor curb appeal.[8]

NFHA and over a dozen of its member organizations have since filed complaints with HUD asserting violations of the Fair Housing Act[9] because of the lenders' allegedly discriminatory maintenance of REO properties based on neighborhood racial composition.[10]

THE FAIR HOUSING ACT AND DISCRIMINATORY MAINTENANCE OF REO PROPERTIES

Potential liability under the Fair Housing Act for the discriminatory maintenance of lender REO properties based on neighborhood racial composition is fairly straightforward. The Act has been uniformly interpreted to prohibit race-based discrimination based on neighborhood racial composition, typically referred to as racial "redlining" when engaged in by lenders.[11] HUD and the U.S. Department of Justice have been particularly aggressive in suing lenders who allegedly treat neighborhoods differently because of their racial composition.[12]

Section 3604(b) of the Act makes it unlawful "[t]o discriminate against any person in the terms, conditions, or privileges of sale or rental of a dwelling, or in the provision of services or facilities in connection therewith, because of race[.]" In 1989 HUD issued interpretive regulations construing the Act, and included a regulation specifically identifying "property maintenance" as a "service or facility" related to properties for sale or rental. HUD's regulations implementing this section provide in relevant part:

> (b) Prohibited actions under this section include, but are not limited to:
>
> (2) *Failing or delaying maintenance or repairs of* sale or rental dwellings because of race....[13]

HUD's interpretations of the Fair Housing Act have been provided substantial deference by the courts.[14]

LIABILITY OF "TRUSTEES" UNDER THE FAIR HOUSING ACT

Despite the potential exposure that lenders have to liability under the Fair Housing Act for racially discriminatory maintenance of their REO properties, lenders who hold title to REO properties as trustees for securitization trusts[15] have publicly expressed the view that they cannot be held liable under the Act for such behavior. Their stated rationale is that securitization trustees "have no legal ability" to service or maintain properties that they hold in trust.[16]

First it should be noted that there is no support — whether in the case

law, the implementing regulations, or the statute itself — for the proposition that trustee entities serving as fiduciaries are shielded from liability under the Fair Housing Act. To the contrary, the term "person" in the Act is defined to include:

> One or more individuals, corporations, partnerships, associations, labor organizations, legal representatives, mutual companies, joint-stock companies, *trusts*, unincorporated organizations, *trustees*, trustees in cases under Title 11, receivers, and fiduciaries.[17]

Trustees are often named as defendants in claims brought under the Fair Housing Act without any suggestion that they enjoy any immunity thereunder.[18]

Instead of looking to provisions of the Act itself, lenders holding title to REO property as securitization trustees have argued that the complicated contracts governing the management of securitized loans, typically known as Pooling Service Agreements ("PSAs"), limit the scope of their responsibility for the management of loans and the properties by which they are secured, including their servicing, collection of payments, and maintenance. They argue that the servicers who are parties to the PSA, not the lender serving "as trustee," are solely responsible for any discriminatory behavior involving property that eventually becomes a lender REO after foreclosure.

There are several conceptual errors in this argument.

First, the PSA allocates and assigns duties and responsibilities only as between the parties to the PSA. It does not, and cannot, change the legal obligations of the trustee to third parties, to persons who come into contact with properties owned by the trust, or to the public at large. Courts have refused to permit securitization trustees to foreclose on loans to which they cannot prove ownership, despite the intent of the PSA under which they claim title.[19] Courts have not allowed the terms of contractual arrangements between defendants in fair housing cases to serve as limitations, or even to have any bearing, on their liability to third persons.[20]

Second, a trustee's legal status changes as soon as it steps outside its role as administrator of a trust of pooled mortgage loans, and assumes the mantle of a property owner. Once title to a property becomes vested in the name of

a lender as trustee after foreclosure, *i.e.*, once the property becomes an REO Property, the legal and relational dynamics change significantly. As soon as it becomes a titled owner of the real estate, the lender as trustee exposes itself to ultimate liability on many fronts, including responsibility for real estate taxes, zoning and code compliance, nuisance avoidance and abatement, and compliance with all other federal and state laws imposing duties on landowners — including the Fair Housing Act. As one court has explicitly observed, "The financial institutions know the law charges the one with title…with maintaining the property."[21]

TYPICAL PSA LANGUAGE

The terms and conditions of PSAs are ill-suited to address the many potential issues of legal liability to third parties that might flow from the ownership of land. PSAs were created to address the complexities and nuances of loan ownership and consequent loan securitization, complying with IRS regulations for the creation of REMICs, insuring favorable tax treatment of mortgage-backed securities, managing the different levels of risk associated with various loan pools, servicing and managing those loans, etc. By definition the primary concern of PSAs is the ownership and servicing of loans. Their focus is not to circumscribe, delimit, chronicle, or account for the legal responsibilities of the ownership of property securing those loans. Indeed, one must assume that the underlying loans themselves were originated in good faith with the understanding that they would be performing loans, and that the resulting REO inventory would be minimal.[22] Typical PSA provisions governing the legal consequences of owning REO property are therefore fairly minimal and sorely deficient. They are largely silent as to the trustee's exposure to liability in its status as a landowner, *e.g.*, for real estate taxes, nuisances on the property, zoning and code compliance, environmental pollution, and the like.

PSAs were created with a complete lack of foresight as to the legal consequences that flow to the trustee as the owner of land, as distinct from the trustee as the owner of loans. [23]

Once it becomes owner of an REO property, the lender as securitization trustee is technically the owner of record of the real estate secured by a mortgage that has been bundled into a mortgage-backed security. The PSAs

typically designate the loan servicers as responsible for maintenance of REO property. But the PSAs are just contracts that bind the parties to them; they do not change, alter, or affect the rights of persons who are not party to them. [24] Court cases deciding issues between trusts, servicers, insurers and certificateholders, where only those parties are involved in the litigation, routinely fall back on the PSAs in assigning liability for issues arising from the business deals or the agreement. However, any action against the servicer ultimately goes against the trustee, which still retains title and reporting responsibilities to various financial agencies (and also to the trust/certificateholders).

Moreover, the trustee is still legally responsible for actions against the trust, even if the trustee could later recover from the trust for expenses or costs incurred in fulfillment of its fiduciary duties. The trustee is charged with monitoring the servicer's reports and actions with respect to REOs and maintains continuing obligations to the trust and certificateholders regarding trust property. Even if it is the servicer who fails to perform its duties appropriately, the trustee still would be responsible to the trust because of negligent oversight of the servicer. This is strengthened by the fact that there are various provisions in typical PSAs that command the trustee to act in instances where the servicer fails (*e.g.* the financial collapse of the servicer, failure of the servicer to remit funds to the trust, or the failure of the servicer to file certain regulatory reports). Where the servicer fails to remit payments to the trust, the trustee must make the servicing advances and must act as backup servicer in the event that the servicer cannot perform its duties.

SERVICERS ACT AS AGENTS FOR THE TRUSTEE

Under typical PSAs, servicers who are responsible for maintenance of REO properties subject to the trust act as agents for, and owe corresponding duties and obligations to, the lender serving as securitization trustee. Under the Fair Housing Act a principal can be held responsible for the discriminatory acts of its agents.[25] Thus, even if it is the servicer who is contractually responsible under the PSA to maintain REO properties held in the name of the securitization trustee, the servicer's unlawful behavior and liability will be imputed to the trustee.

Parties to the PSA, Including the Servicer, Perform Their Duties for the Benefit of the Trustee

The definitions section of a typical PSA stipulates that the servicer named in the trust document maintains all collection accounts for mortgages in the trust "as Servicer for [lender] as trustee." The entity acting as the custodian of the mortgage files does so "on behalf of and for the benefit of the trustee." Moreover, all "right, title, and interest in" the mortgage loans in the trust, including the mortgage Notes themselves, are assigned and conveyed to the lender as securitization trustee. All original documents are held by the Depositor in trust "for the benefit of the trustee." The parties to the PSA "intend that the assignment and transfer herein contemplated constitute a sale of the Mortgage Loans, the related Mortgage Notes..., conveying good title thereto free and clear of any liens and encumbrances, from the Depositor to the trustee...."

Thus, the duties and obligations of the servicers and others under the PSA are performed on behalf of and for the benefit of the lender as securitization trustee. They are acting as its agents.

The agency relationship of the Servicer to the lender as securitization trustee is expanded upon in several sections of the typical PSA. For example, servicers are required to service and administer the Mortgage Loans, and to institute foreclosure proceedings,[26] "on behalf of the trust." In addition,

> [T]he Servicer in its own name or in the name of a Sub-Servicer or in the name of the trustee, solely in its capacity as trustee of the trust, is hereby authorized and empowered by the trustee when the Servicer believes it appropriate in its best judgment in accordance with the servicing standards set forth above, to execute and deliver, on behalf of…the trustee, any and all instruments of satisfaction or cancellation, or of partial or full release or discharge, and all other comparable instruments, with respect to the Mortgage Loans and the Mortgaged Properties and to institute foreclosure proceedings or obtain a deed-in-lieu of foreclosure so as to convert the ownership of such properties, and to hold or cause to be held title to such properties, on behalf of the trustee.... The Servicer shall service and administer the Mortgage Loans in accordance with applicable state and federal law....

Also,

> The Servicer further is authorized and empowered by the trustee…to execute and deliver, on behalf of the trustee…any and all instruments of assignment and other comparable instruments with respect to such assignment or re-recording of a Mortgage in the name of MERS, solely as nominee for the trustee and its successors and assigns.

In other words, the servicer "is empowered by" the trustee to perform certain acts relating to specific mortgage loans in the trust and does so "on behalf of the trustee." This is the classic language of an agency relationship.

The Servicer Maintains REO Properties in Particular for the Benefit of the Lender as Securitization Trustee

The PSA specifically addresses the situation in which title to the real estate used as collateral for a foreclosed loan becomes vested in the name of the securitization trustee — *i.e.*, the property becomes an REO.

First, in the event that title to an REO property in the trust is acquired through foreclosure, the PSA requires the lender, as trustee, to take and hold title to the REO property.

Second, the Servicer is required to "manage, conserve, and protect each REO property" and must separately account for all funds collected and received in connection with an REO property "for the trustee...."

Third, in fulfillment of its duties to the lender as securitization trustee, the Servicer may contract with any independent contractor for the operation and management of any REO property; provided that none of the actions taken through any such independent contractor "shall be deemed to relieve the Servicer of any of its duties and obligations to the trustee…with respect to the operation and management of any such REO Property."

Not only do duties and obligations flow from the servicer to the lender as securitization trustee with respect to REO properties, but the converse is also true; the lender as securitization trustee owes duties and obligations to the Servicer with respect to REO properties. Specifically, the lender as securitization trustee "shall furnish the Servicer and the Master Servicer with any powers of attorney and other documents in form as provided to it necessary

or appropriate to enable the Servicer and the Master Servicer to service and administer the Mortgage Loans and REO Properties."

In addition, "the trustee shall execute and deliver to the Servicer and the Master Servicer any court pleadings, requests for trustee's sale or other documents necessary or desirable to (i) the foreclosure or trustee's sale with respect to a Mortgaged Property; (ii) any legal action brought to obtain judgment against any Mortgagor on the Mortgage Note or Security Instrument; (iii) obtain a deficiency judgment against the Mortgagor; or (iv) enforce any other rights or remedies provided by the Mortgage Note or Mortgage or otherwise available at law or equity."

The PSA's indemnity provisions are consistent with the notion that the lender as securitization trustee may be held liable or responsible for the Servicer's failure to perform, including its failure to properly maintain REO property. The PSA requires the Servicer to indemnify and hold harmless the lender as securitization trustee "against any and all claims, losses, penalties, fines, forfeitures, reasonable legal fees and related costs, judgments, and any other costs, fees and expenses that…the trustee…may sustain in any way related to the failure of the Servicer to perform its duties and service the Mortgage Loans in compliance with the terms of this Agreement." The potential for indemnity from the servicer has no bearing on the trustee's liability under the Fair Housing Act.[27]

CONCLUSION

It is common in the mortgage loan industry to pool mortgage loans into trusts, and to pledge these mortgages as collateral for the duties set forth in PSAs. Under typical PSAs, servicers act as agents for, and owe corresponding duties and obligations to, the trustee, who holds title to the REO property after foreclosure. The Fair Housing Act and its implementing regulations by their express definitional terms contemplate that trusts may be held liable for violations of the Act. The Supreme Court has held that agency principles apply to actions under the Fair Housing Act. To the extent a servicer under a PSA is responsible for maintaining REO property as an agent for, and acts on behalf of, a lender as securitization trustee, the servicer's racially discriminatory maintenance of REO property can be imputed to the securitization trustee under the Fair Housing Act.

NOTES

[1] Government Accountability Office, *Vacant Properties: Growing Number Increases Communities' Costs and Challenges*, GAO-12-34 (Nov. 4, 2011), at p. 27 (*available at* http://www.gao.gov/products/GAO-12-34).

[2] *Id.* at 45-47.

[3] *Id.* at 37.

[4] HUD/FHFA Joint Report on Federally Owned or Overseen Real Estate Owned Properties, at pp. 15-16 (May 2013) (*available at* http://fhfaoig.gov/Content/JointReportFederallyOwnedorOverseenRealEstateOwnedProperties).

[5] Office of the Comptroller of the Currency, *Comptroller's Handbook: "Other Real Estate Owned"* at 14 (Sept. 2013), *available at* http://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-20.html; Federal Reserve Board, *Questions and Answers For Federal Reserve-Regulated Institutions Related to the Management of Other Real Estate Owned (OREO) Assets*, *available at* http://www.federalreserve.gov/bankinforeg/srletters/sr1210.htm.

[6] *See, e.g.*, "Deutsche Bank can't shake L.A. claims over foreclosure blight," Chicago Tribune, April 24, 2013, *available at* http://articles.chicagotribune.com/2013-04-24/news/sns-rt-us-deutschebank-ruling-foreclosurebre93o01b-20130424_1_blighted-properties-deutsche-bank-ag-city-services.

[7] National Fair Housing Alliance, *Here Comes the Bank, There Goes Our Neighborhood: How Lenders Discriminate in the Treatment of Foreclosed Homes* (April 11, 2011), *available at* http://www.nationalfairhousing.org/LinkClick.aspx?fileticket=UF6xIHF35rI%3D&tabid=3917&mid=9405 ; *The Banks Are Back, Our Neighborhoods Are Not: Discrimination in the Maintenance and Marketing of REO Properties* (April 4, 2012), *available at* www.nationalfairhousing.org/Portals/33/the_banks_are_back_web.pdf.

[8] *Here Comes the Bank*, supra note 7, at 2.

[9] 42 U.S.C. § 3601 *et seq*.

[10] For a list of complaints filed by the National Fair Housing Alliance against lenders based on alleged discrimination in REO maintenance, *see* http://www.nationalfairhousing.org/NewsReleases/REOComplaintsandPressReleases/tabid/4265/Default.aspx.

[11] R. Schwemm, Housing Discrimination Law and Litigation, § 18:4 (Thomson Reuters 2013) (citing cases).

[12] *See, e.g.,* Remarks of Assistant Attorney General Thomas Perez at the 15th Annual Community Reinvestment Act and Fair Lending Colloquium (Nov. 7, 2011) (observing that since 1994 "redlining cases have been a staple of the Department's fair lending enforcement"), *available at* http://www.justice.gov/crt/opa/pr/speeches/2011/crt-speech-111107.html.

[13] 12 C.F.R. § 100.65 (emphasis added).

[14] *Trafficante v. Metropolitan Life Ins. Co.*, 409 U.S. 205, 210 (1972); *Gladstone Realtors v. Village of Bellwood*, 441 U.S. 91, 107 (1979); *Meyer v. Holley*, 537 U.S. 280, 287-88 (2003).

[15] "Securitization trusts" are private arrangements by which thousands of residential mortgage loans are bundled into mortgage-backed securities, which are then sold by a passive entity as "REMICs" that qualify for favorable tax status under the Internal Revenue Code. *See generally* R. Oppenheim and J. Trask-Rahn, *Deconstructing the Black Magic of Securitized Trusts: How the Mortgage-Backed Securitization Process Is Hurting the Banking Industry's Ability to Foreclose and Proving the Best Offense for a Foreclosure Defense*, 41 Stetson L. Rev. 745 (2012).

Securitization trustees have specific duties and responsibilities toward the trusts that are outlined in Pooling and Servicing Agreements, discussed in the article above, such as keeping records and receiving payments from servicers to disperse among investors. In addition, lenders serving as securitization trustees become the legal owners of record of all mortgages in the trust. GAO Report, supra note 1, at p. 30, n. 37.

[16] "The vast majority of the properties originally identified by [the alliance] are properties where we are trustee," Tom Joyce, a U.S. Bancorp senior vice president, said in response to a complaint filed with HUD under the Fair Housing Act. "We have no legal ability to service or maintain these properties" (*quoted in* "Fair housing group amends U.S. Bank complaint," Chicago Tribune, Oct. 15, 2013, *available at* http://www.chicagotribune.com/business/breaking/chi-fha-foreclosure-complaint-us-bank-20131015,0,4817406.story).

[17] 42 U.S.C. § 3602(d) (emphasis added).

[18] *See, e.g.*, *Covey v. Hollydale Mobilehome Estates*, 116 F.3d 830, opinion amended on denial of reh'g, 125 F.3d 1281 (9th Cir. 1997); *Fialka-Feldman v. Oakland Univ. Bd. of Trustees*, 678 F. Supp. 2d 576 (E.D. Mich. 2009); *MHANY Mgmt. Inc. v. County of Nassau*, 81 Fed. R. Serv. 3d 1231 (E.D.N.Y. 2012); *Sporn v. Ocean Colony Condo. Ass'n*, 173 F. Supp. 2d 244 (D.N.J. 2001).

[19] *E.g.*, *In re Foreclosure Cases*, 2007 U.S. Dist. LEXIS 84011 (N.D. Ohio 2007).

[20] *See, e.g.*, *Heights Community Congress v. Hilltop Realty, Inc.,* 774 F.2d 135, 141 (6th Cir. 1985) ("Defendants also object that the District Court erred in finding that Hilltop had the power to control the acts of its agents, and hence was liable for the violations committed by those agents. It argues that its agents were independent contractors, over whom under common law it has no control. This argument has consistently been rejected in Fair Housing Act cases.").

[21] *In re Foreclosure Cases*, 2007 U.S. Dist. LEXIS 84011 (N.D. Ohio 2007). *See also National Fair Housing Alliance, Inc. v. S.C. Bodner Co.*, 844 F. Supp.2d 940 (S.D. Ind. 2012) (purchaser of property not constructed in compliance with the

Fair Housing Act can be liable even though not involved in design or construction of non-compliant property); *Office of the Comptroller of the Currency*, Comptroller's Handbook: "Other Real Estate Owned" at 14 (Sept. 2013) ("In acquiring title to foreclosed properties, *a bank assumes the primary responsibilities of an owner*, *including providing maintenance* and security, paying taxes and insurance, and serving as landlord for rental properties."); Federal Reserve Board, Questions and Answers For Federal Reserve-Regulated Institutions Related to the Management of Other Real Estate Owned (OREO) Assets, at 11 ("Institutions should have controls in place to comply with all federal, state, and local laws, *including fair housing laws*."), *available at* http://www.federalreserve.gov/bankinforeg/srletters/sr1210.htm.

[22] *But see Adkins v. Morgan Stanley*, 2013 U.S. Dist. LEXIS 104369 (S.D. N.Y. 2013) (allegations that lender's loan securitization policies and practices targeted toward racial minorities deviated substantially from basic underwriting standards); *Senate Probe Finds Washington Mutual Ignored Warnings*, Wall Street Journal, April 15, 2010 (reporting severe deficiencies in one lender's securitization practices), *available at* http://online.wsj.com/news/articles/SB10001424052702303828304575180403574689576.

[23] *See, e.g.,* R. Coughlin, "Caught in the Cross-fire: Securitization Trustees and Litigation During the Subprime Crisis" (2009) (observing that securitization trustees are now "addressing situations not anticipated by transaction structures and not adequately addressed in transaction documents"), *available at* http://www.nixonpeabody.com/files/securitization_litigation_subprime_crisis.pdf.

[24] The fact that PSAs are lengthy, complicated, contain terms of art, and must comply with IRS regulations does not alter their fundamental character as contracts between private parties. *See In re Foreclosure Cases*, 2007 U.S. Dist. LEXIS 84011 (N.D. Ohio 2007) ("Neither the fluidity of the secondary mortgage market, nor monetary or economic considerations of the parties, nor the convenience of the litigants supersede…obligations" under federal law).

[25] *Meyer v. Holley*, 537 U.S. 280 (2003); R. Schwemm, Housing Discrimination Law and Litigation, § 12B:2 at p. 12B-2 (Thomson Reuters 2013) ("The general rule in fair housing cases is that a principal is legally responsible for the acts, conduct, and statements of the agent done within the scope of the agent's apparent authority.") (citing cases).

[26] *See also* GAO Report, *supra* note 1, at 30, n. 37 ("Any legal action a servicer takes on behalf of the trust, such as foreclosure, generally may be brought in the name of the trustee.").

[27] *Equal Rights Center v. Niles Bolton Assoc.*, 602 F.3d 597 (4th Cir. 2010); *United States v. Bryan Co.*, 2012 U.S. Dist. LEXIS 78407 (S.D. Miss. 2012); *Miami Valley Fair Hous. Ctr., Inc. v. Campus Vill.*, 2012 U.S. Dist. LEXIS 137922 (S.D. Ohio 2012).