BusinessWeek

COVER STORY January 3, 2008, 5:00PM EST

Dirty Deeds

The mortgage crisis has blighted the landscape with boarded-up houses. Now a few cities are holding giant lenders accountable for what foreclosure leaves behind

by Michael Orey

On Dec. 17 in a windowless Buffalo courtroom, Cindy T. Cooper, a prosecutor for the city, buzzes among a dozen men in suits, cutting deals. "You've got to unboard [the house], go in, and clean it out," she tells one. "If all the repairs are done quickly, I wouldn't ask for any fines." To another, she says, "the gutters weren't done right," and asks to see receipts for the work. It's "Bank Day" in Judge Henry J. Nowak's housing courtroom, more typically a venue where landlords and tenants duke it out over evictions and back rent. Instead, Cooper is asking lawyers for CitiFinancial (C), JPMorgan Chase (JPM), and Countrywide Financial (CFC) to fix problems like peeling paint, broken masonry, and overgrown or trash-filled yards at houses the city says the banks are responsible for maintaining. It may be surprising to find these financial-services giants hauled before this obscure local tribunal. In fact, Cooper and Nowak are at the forefront of a pioneering effort to deal with a vexing problem: the surging number of vacant and abandoned homes resulting from the mortgage market meltdown. The vacancies occur when lenders bring foreclosure suits against delinquent borrowers. Mere notice that such an action might be filed often sends residents packing. In Buffalo and other Rust Belt cities, the problem has been particularly acute, because in many cases banks are abandoning the houses, too, after determining that their value is so low that it's not worth laying claim to them. When city officials try to hold someone responsible for dilapidated properties, they often find the homeowner and bank pointing fingers at each other. Indeed, the houses fall into a kind of legal limbo that Cleveland housing attorney Kermit J. Lind calls "toxic title". While formal ownership remains with a borrower who has fled, the bank retains its lien on the property. That opens up a dispute over who is responsible for taxes and maintenance. Even when lenders do complete the foreclosure, they may walk away from the property, leaving it to be taken by a city for unpaid taxes, a process that can take years. Orphaned properties quickly fall into disrepair, the deterioration sometimes hastened by vandals who trash the interiors, lighting fires and ripping out wiring and pipes to sell for scrap. Squatters or drug dealers may move in.

The impact goes far beyond the defaulting homeowner, as neighbors and entire communities confront a spreading blight. Vacant residences (BusinessWeek, 1/4/08) deprive cities of tax revenue and can cost them thousands to maintain. A 2001 Temple University study in Philadelphia found that simply being within 150 feet of an abandoned property knocked $7,600 off a home's value.

In Buffalo, prosecutor Cooper is bringing lenders before Judge Nowak to hold them accountable. Wielding the threat of liens, which can hold up the lenders' other real estate transactions, she aims to make banks keep foreclosed homes in good condition until a buyer can be found. As an alternative, Cooper or Nowak may try to get lenders to donate properties to community groups or to pay for demolition when houses are beyond repair. "At least in Buffalo," says Cooper, "the days are gone when you can do a foreclosure and walk away without taking care of the property."

Those charged with violations by Cooper include participants all along the complex mortgage-industry food chain, from loan originators to servicers to the Wall Street trusts that buy up the vast majority of home loans and then securitize them. A similar initiative is under way in Cleveland, where Judge Raymond L. Pianka puts lenders on trial in absentia when they fail to respond to charges.

Even places with high property values, like Chula Vista, Calif., a San Diego suburb, are taking steps to avoid the neglect that can occur during lengthy foreclosures. "It seems like a number of the lenders aren't even doing things that are in their own best interest to preserve the asset," says Pianka—a problem he attributes to the fragmented nature of the business. "It's not an address. It's not a property. It's just a loan number," he says. "So they'll push a button in San Francisco, and it will set things in motion to do things with [a] property that don't even make sense."

SPREADING THE PAIN

The proceedings in Pianka's and Nowak's courtrooms offer a sobering reminder that underlying the attenuated ownership and esoteric products spun out of mortgages are actual buildings, some with leaky roofs or broken porch railings. The industry denies responsibility for properties to which it has not taken title. "The notion that a mortgage company has an obligation to make repairs on a property that it doesn't even own is very hard to comprehend," says Marco Cercone, a Buffalo attorney who represents a range of lenders before Nowak in the courtroom. Cooper says that banks and other financial firms once extolled houses as the best possible collateral for a loan. Now they're stuck with that collateral, and they don't like it.

If there ever is a national response to the messy legacy left by foreclosures, it might include something like the Buffalo system, which seeks to take action before the presence of abandoned houses hurts entire neighborhoods and which spreads the pain among many players. "We're kind of a crystal ball into what might happen" elsewhere, Cooper says.

Lenders may rue the day the State University of New York at Buffalo admitted Cooper to pursue a PhD in sociology and a law degree. The subject of her doctoral thesis, submitted in December, 2006: the role of banks in residential abandonment and why they should be accountable for property-code violations. The fourth-generation Californian says she quickly became attached to Buffalo for its history and architecture. Now 33, Cooper and her husband are rehabilitating a house that she bought after getting an IRS tax lien removed from the property. "My passion for this work is because I love this town," she says.

While researching her thesis, Cooper interned for Judge Nowak. Tall, soft-spoken, and unfailingly courteous, the judge, 39, began holding Bank Day earlier this year and schedules it once a month. The civility of the proceedings and the large number of bank lawyers in attendance belie a noteworthy fact: They are there under coercion. A few years ago, Nowak says, "the city became increasingly frustrated with the banks' role" in contributing to Buffalo's abandoned-property problem. (Estimates put the number of abandoned homes in the city at between 5,000 and 10,000.) In 2004, New York State amended the definition of "owner" in its property maintenance code to include not just titleholders but others who had "control" over a premises.

While the statute makes no reference to lenders, Nowak contends that the letters banks send to defaulting homeowners threatening to boot them from their houses show that they have begun to "assert some measure of control." On this premise, Nowak says, Buffalo began contacting banks "en masse" about foreclosed properties, but "a lot of times we'd just be rebuffed and ignored."

Cooper, as an intern, suggested a tactic that the judge adopted. When banks ignored summonses for code violations, Nowak began entering default judgments against them and imposing the maximum fine, which can reach $10,000 to $15,000. For a big bank, that's not much. The real pain comes because the fines give the city a lien that impedes the banks' ability to buy or sell other properties in the area. In addition, when lenders come to his court to get residents evicted from a particular property, Nowak refuses to grant the request until the bank addresses violations outstanding on other properties. Judge Pianka employs similar tactics in Cleveland. On Dec. 10, for example, he assessed a $50,000 fine against an absentee defendant, Mortgage Lenders Network USA, for 21 code violations at a home.

Even far from the Rust Belt, in places where empty houses retain significant value, the lending industry seems to have trouble preserving its collateral when homes are abandoned during foreclosure. In Chula Vista, a number of houses have been trashed by college students who have held parties in the vacant properties. In other cases, pillagers pull up in rental trucks to cart away cabinets, wood flooring, and fixtures stripped from the homes. But in October, an ordinance went into effect requiring lenders to register and maintain houses that have been abandoned during foreclosure.

Compliance, says Chula Vista code enforcement manager Doug Leeper, has been spotty. "What I need them to do is keep the water on and keep the lawn green," he says, noting that the first sign of abandonment is often a yard that has turned brown and a pool that has gone murky green.

That slide into decrepitude is exactly what Cooper is trying to head off in Buffalo. In February, she joined the city's law department, where one of her duties is prosecuting banks. She and Nowak each say their main objective is not collecting fines but bringing banks to the table to try to find constructive solutions for dealing with abandoned property. That doesn't mean borrowers are off the hook. Cooper typically charges both borrowers and lenders, and Nowak may fine homeowners or sentence them to community service. "Can both be responsible?" asks Cooper. "Absolutely."

The approach in Buffalo is paying dividends. In a case on Dec. 17, attorney Cercone addressed the status of a house that had gone into foreclosure in 2006. Cercone was representing JPMorgan Chase and Ocwen Loan Servicing (which in turn were representatives of a securitized trust that had purchased the mortgage). Cercone submitted an affidavit showing that Ocwen, which had been cited for violations in December, 2006, had spent $30,000 to repair the property, including scraping lead paint from the entire house. In September, the affidavit notes, JP Morgan Chase sold the property at a loss of $19,500, not including the cost of repairs. "The bank in this case dealt with the property as well as could be done under the circumstances," Nowak said from the bench, and he agreed not to impose any fines.

TORTUOUS TRAILS

Still, even with novel and aggressive tactics, the path to resolution for many properties in Buffalo can be tortuous and protracted. A house at 1941 Niagara St.—one of dozens of properties that Cooper examined as a graduate studenthas yet to see its final chapter, though it may be close.

In 1998, Elizabeth M. Manuel obtained a $34,500 mortgage on the property from IMC Mortgage (since acquired by Citibank). By 2002, the loan had been sold into a securitization trust administered by Chase Manhattan (now JPMorgan Chase) as trustee. It also went into default, and Chase began foreclosure proceedings. In a court filing, Manuel (who could not be located for comment) said she left the home while the foreclosure action was pending. More than five years later, though, the title remains in her name. The house, although still standing, has become a fire-gutted wreck.

In May 2007, Nowak issued a default judgment against Chase for $9,000. But these cases can be notoriously difficult to untangle. Thomas A. Kelly, a spokesman for the bank, notes that Chase sold its trustee business to the Bank of New York Mellon (BK) in October, 2006, and couldn't locate anyone at Chase able to comment. But he reiterates the industry view that Chase can't be held responsible for maintaining a property it never owned. He acknowledges that if a home didn't seem worth taking as collateral, the bank may have made a decision to "just walk away."

The value of 1941 Niagara, estimate city assessors, is $4,500, of which $4,300 represents the value of the land. The home, Cooper says, is slated for "imminent" demolition.

Join a debate about who should pay for repairing foreclosed property.

Orey covers corporations for BusinessWeek .