PUBLICATION

Playing Zone(-ing) Defense

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ZONE(-ING) DEFENSE --- With March Madness in full swing, now is a great time to review how local zoning ordinances can turn a mortgage servicer's foreclosure layup into a blocked shot. Many U.S. states rely on a judicial process for foreclosing on real estate title that is similar to a traditional lawsuit.[1] This process means that even without debtor resistance, getting to the foreclosure sale may take months; add resistance and it may take years. In that interim, the servicer may decide not to pursue active property management or the appointment of a receiver to manage the collateral, as these measures tend to involve additional legal and management fees and expenses. On the surface, it may appear to the servicer that the property is being adequately managed by the current owner. But what lies beneath the surface?

Many, if not all, modern zoning ordinances contain so-called "grandfather clauses", permitting an ongoing use of land to continue, even though the use is otherwise not permitted under the current zoning restrictions. As with any permit, such grandfathered use may be revoked upon certain occurrences. A common occurrence in the foreclosure environment, and one that servicers should heed, is abatement of the ongoing grandfathered use. In essence, if a non-conforming use is discontinued for a period of time, then the use is no longer permitted, with grave consequence to the mortgagee and servicer.

In a recent case, a special servicer accelerated payment and filed a foreclosure suit on a multi-family apartment building in a judicial foreclosure state. Since the apartment's construction, the property had been zoned single-family residential, but the apartment use was a permitted non-conforming, "grandfathered" use. The applicable zoning ordinance allowed that if the non-conforming use discontinued for more the six-months, the permitted use was essentially revoked, meaning that the multifamily apartments could not be occupied without a grant of rezoning or variance.

In this case, just prior to the foreclosure sale, the debtor filed for bankruptcy protection. Even though the bankruptcy petition was eventually dismissed as an obvious stall tactic, the foreclosure suit was substantially delayed and it took over a year from when the suit was filed for the property to be sold at foreclosure auction. With no competing bidders, the servicer entered a bid and gained title to the property at auction. Upon subsequently marketing the property, the servicer learned from a potential buyer that the zoning board had issued a no-occupancy decision[2] for the apartment building---not welcome news to the servicer![3]

The local zoning appeals board elected to reverse their no-occupancy decision, presumably upon their own discretion (although we like to emphasize the charm and persuasive abilities of the servicer's attorneys). If the zoning appeals board had seen the opportunity to enforce its zoning regulations and redevelop the property, it may have denied a request for variance. Furthermore, *caveat emptor* would have probably left the servicer stuck with the unmarketable title, or the costs involved in bringing the property to its permitted use.

To avoid this risk, foreclosing parties should consider the following measures: (1) be aware of and review zoning ordinances *before* deciding to initiate the foreclosure process; (2) keep an eye on the property during foreclosure for any use (or non-use) that could violate the zoning restrictions; and (3) if the property is of substantial value or non-permitted use is likely to occur, consider appointment of a receiver early in the process. Modern commercial mortgages provide the servicer many protections against misuse of the collateral

that shift the risk of unmarketable title to other entities, but these protections are only words on paper until the servicer takes the precaution of establishing a solid zoning defense.

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[1] 22 States including the following within Baker Donelson's primary footprint: Florida, South Carolina and Louisiana.

[2] Unlike tax liens or other clouds on title, zoning restrictions may not require record or public notice, and even if they do, the debtor who has title would receive the notice. A defaulting debtor is unlikely to forward such notice to the mortgagee, even though such notice is typically required by the mortgage document.

[3] If the servicer is holding the mortgage through a REMIC entity, only a certain percentage of the holdings can be real property to maintain the tax advantages. When title cannot be easily transferred, the REMIC could lose tax-preferred status.