



Local Land Use Issues Arising In Foreclosure

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Most commercial lenders will typically arrange for at least a modest amount of land use due diligence prior to making a real estate secured loan. Depending upon the type of transaction and property type, that due diligence should include, but not be limited to zoning confirmation, a review of site plans, plans of development and building construction plans, and an analysis of the receipt of all necessary permits, approvals and entitlements from the applicable governmental authority.

Regardless of the amount and sufficiency of any such due diligence at the time of the loan, a secured party that decides to foreclose or accept a deed-in-lieu should be concerned with certain land use matters that may arise from time to time. Below are limited examples of land use matters that can arise with which a lender should be concerned.

Determination of Available Entitlements

Most entitlements are easily determined to be applicable to a certain property. Any conditional proffers accepted as part of a rezoning approval must be noted on a locality's official zoning map. However, some localities are not as diligent as others in properly posting all land use approvals. A zoning confirmation letter will certainly be required to ensure all granted entitlements are picked up.

On the other hand, some entitlements may not be specifically granted by the locality. Some rights granted to a land owner may be vested, but may not be specifically granted. For example, having vested rights (commonly known as being "grandfathered") for certain uses or standards may benefit the land in question. These uses or standards may be necessary to maximize the value of the property or to complete a development that has begun by the defaulting landowner. Once a right is vested, the government can not deprive the landowner of such rights so long as the owner diligently pursues or actively retains such rights. Losing any vested rights by not properly protecting such rights can provide for additional costs or loss in value of the subject property.

Many entitlements, whether specifically granted or vested, are also subject to specific conditions, such as time limits, that require action to preserve or retain the rights granted. Failure to comply

with the rules by which the right is granted, will either void the right without further act of the locality, or in some instances, such as use permits, may be voidable upon a public hearing. If a landowner is in default with their lender, it is not a stretch to think he or she may also be in violation of their local land use approvals. A lender needs to determine if any such violations have occurred, and if so, which entitlements are void without further act by the government upon a violation by the landowner and which may be voidable upon a public hearing or other determination.

Analysis of the Benefits and Burdens of Entitlements

Most land use entitlements, while granting certain authority and benefits to the property in question, almost always carry with them certain conditions and thus obligations. A secured lender needs to consider both the benefits and burdens of the applicable land use entitlements and restrictions prior to initiating foreclosure proceedings, just as a prospective purchaser should investigate his or her ability to step into the shoes of a distressed developer/borrower/owner.

The value of the property will be defined at least in some part by the benefits granted but also the obligations arising from such benefits. For example, proffered conditions accepted as part of a rezoning application typically involve restricting the extent of development (such as height and size of buildings, required parking, exterior material and the like), but can also include affirmative obligations (such as dedication of land, cash proffer contributions, or reservation of space for the public) that have a direct impact on the value of the land because of the loss of development potential. Further, certain approvals such as use permits, tentative subdivisions, preliminary site plans and plans of development are almost certainly subject to certain conditions imposed by the locality. Once imposed, these restrictions carry the force of law and have the same impact as the proffered conditions described above.

Most entitlements will run with the land but are not necessarily revealed by a title report. Upon taking title, the transferee typically acquires the entitlements regardless of the lender's desire and this will have a direct impact on the development potential for the subject property. Even if development has already occurred, any potential owner needs to confirm not only that the property is properly zoned for the use being made or proposed for the property, but also that there has been no violation of the zoning ordinance and any applicable conditions.

The curing of any such land use violation is ultimately the obligation of the fee simple owner of the property, regardless of how such owner obtains title. A locality has the power of enforcement, which can include fines, termination of certificates of occupancy or the use permit granting the use, or even, in extreme cases, criminal penalties. While a zoning conformance letter that asks the proper questions can usually identify these violations prior to a change in title, a thorough independent investigation of the compliance with the applicable provisions should also be completed as part of the due diligence process.

Question the Transferability of Entitlements

Most local land use entitlements will run with the land and thus will be available to a successor in

title. There are some localities that limit certain approvals to only the specific land owner and any mortgage lien holder. Finally, in rare instances, there are some localities that provide that certain entitlements do not succeed to any subsequent fee simple owner in title, even a mortgage lien holder. The local ordinance, the state code and the conditions applicable to any such entitlement need to be reviewed carefully to determine which category applies.

There is also some question of whether in the second instance, if the entitled right succeeds only to the mortgage lien holder, will a third party other than the mortgage lien holder, even if related, succeed to those rights. There is no specific law addressing such a situation, but it is something that needs to be determined with the locality prior to the lender taking back title.

Third Party Obligations

While most land use questions deal with the relationships between the locality and the developer, into whose shoes the lender or purchaser is stepping, the issue of completion and other construction bonds introduces a third party, the surety, into the mix. It is quite common for a developer to be obligated to complete certain construction, such as roads, common areas and the like. A locality often requires the posting of a performance bond, upon which the locality can draw in the event of a default (such as failure to complete construction).

Any purchaser, including a lender or its assignee, needs to ensure that the security provided by the surety is transferable and adequate for the purposes for which it is posted. The loan documentation may require transfer of the bond upon foreclosure, but if the surety has not agreed to such a transfer, it may be deemed a material modification that results in the termination of the surety's obligation. Further, the locality will also have a say over any amendment of such surety and the transfer of the land through a foreclosure or deed-in-lieu may cause the locality to call the bond in order to ensure its security for the benefit of the locality. All of these documents need to be reviewed closely to ensure there are no issues with any such transfer.

Conclusion

When contemplating the acquisition of a distressed property, whether by foreclosure or taking back a deed, a lender or prospective purchaser must be wary of land use considerations that do not appear on the title report. While not immediately obvious, lurking obligations may constrain a successor's ability to develop the property. Likewise, specific entitlements provided by a locality can be costly to replace once lost and have a direct impact on the value of the property in question. The transferability of such entitlements should not be assumed and may require investigation beyond merely requesting a conformance letter from the jurisdiction.

With the proper forethought and investigation into land use matters, a lender can avoid foreclosing on inadequate security or stepping into a bigger problem than it bargained for.

For more information about this topic, please contact T. Preston Lloyd at 757.629.0689 or .

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