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The Foreclosure Crisis and Legal Change

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The Registry - With the “housing collapse” and the ensuing “foreclosure crisis” behind us, it is time to assess the myriad changes in the law of mortgage lending and foreclosure enacted in response to the crisis. The short space of this article cannot begin to summarize all of these changes. However, several themes have emerged that will affect the home mortgage lending and foreclosure process for some time to come.

Increasingly Federalized Loan Origination And Servicing Standards for Home Mortgages. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 created a new federal agency, the Consumer Finance Protection Bureau, with regulatory jurisdiction over a number of mortgage lending and consumer credit programs formerly administered by other agencies, including the Real Estate Settlement Procedures Act and the Truth In Lending Act. Over the past 18 months, CFPB has issued a series of new or revised regulations embodying more direct and pervasive regulation of home mortgage lending, underwriting and servicing practices by the federal government. With respect to servicers, this includes a prohibition of “dual tracking” of loan modifications and foreclosures, mandatory obligations to discuss “loss mitigation options” and “foreclosure alternatives”, duties to respond to borrower requests and provide timely and accurate information to homeowners in default and a number of other federally mandated requirements. The CFPB regulations also include tighter standards for “qualified mortgages” sold in the secondary market, including “ability to pay” standards for underwriting home loans and restrictions on “teaser rates,” “negative amortization” and balloon payment loans. These changes have probably reduced credit availability, although they might reduce the likelihood of a major collapse of mortgage lending or housing markets in the future, depending on whether they are kept in place and enforced over time.

Increased Complexity And Delay In State Regulation Of The Foreclosure Process: Several “temporary” California statutes enacted in 2008-2011 that imposed new pre-foreclosure procedural and substantive requirements were extended or made permanent by the “Homeowner Bill of Rights” legislation of 2012. These are intended to compel lenders to offer borrowers meaningful workout proposals, avoid dual tracking to foreclosure while these proposals are considered, and comply with additional notification and consultation requirements before the usual notice of default and trustee’s sale process can proceed. With few exceptions, these legislative changes apply only to first mortgage liens on one-to-four family residential properties, and have negligible effects on commercial loan servicing, workouts and foreclosures, as to which the laws remain essentially unchanged since before the foreclosure crisis. For affected residential loans, the net effect of the CFPB regulations and these state enactments is additional expense, delay and potential for mistakes by lenders, title insurance companies and others involved in the foreclosure process, and some opportunities for private causes of action to postpone or enjoin foreclosure or recover damages on the part of the homeowners. The actual number of borrowers who are aided by these requirements is difficult to assess. While many anecdotal examples of sloppy paperwork, mistakes and sheer bad faith on the part of lenders and others were the precipitating factors for the adoption of these changes, they offer scant benefits when a borrower ultimately cannot afford to pay the mortgage in the first place, as is commonly the case when the homeowner is in default.

Reduced Availability And Effectiveness Of Personal Legal Advice: The “foreclosure crisis” also led to a proliferation of “loan modification specialists” and “foreclosure consultants” who preyed on vulnerable homeowners in default, taking large upfront fees and producing no meaningful results. The legislative reaction was to further restrict the ability of anyone, including real estate brokers and lawyers, to offer services to homeowners in foreclosure or facing imminent default proceedings. By law, such persons are prohibited from accepting any compensation before all “loan modification services” are complete. The legislation was written in such a way that an attorney consulting with a homeowner client on a pay-as-you-go basis risks disbarment and criminal prosecution for attempting to guide a homeowner through the increasingly labyrinthine and bureaucratic processes of loan modification, servicing and foreclosure under the aforementioned regulatory developments at the state and federal level. The only persons who are clearly exempt from these restrictions are the employees of lenders negotiating with their borrowers and certain non-profit agencies designated by the CFPB as parties to whom the homeowner may turn. Both federal and state laws now strongly support referral of homeowners to such agencies or to their lenders, rather than to third party professionals, in connection with the pre-foreclosure loan modification and default process.

Judicial Restraint in the Oversight of the Nonjudicial Foreclosure Process. Quite a few California appellate decisions have now declined borrower invitations to review the standing or authority of a trustee or lender nominee who files a notice of default and proceeds to sale under California power of sale foreclosure procedures. These courts have sustained the non-judicial nature of the process as an important element of California public policy. In doing so, they have limited the ability of borrowers to compel the lending or servicing parties to provide evidence of authority, original promissory notes, or other indicia of their rights to foreclose, leaving the owner/trustor to pursue post-foreclosure remedies for wrongful foreclosure, if any, as to such matters. More than one court of appeal has refused, in so many words, to allow “technicalities” such as the identity of the lender, the servicer, the trustee, or other person conducting the sale to be raised as a defense by a borrower in default. In contrast to a number of other states, California courts also have generally upheld attacks on the Mortgage Electronic Recording System (MERS) deeds of trust as well as against gaps and deficiencies in the chain of ownership of securitized or pooled mortgages, an area where the new CFPB regulations also have made few changes.

Evolving Concepts Of Promissory Fraud In The Loan Work-Out Process: Most efforts by sophisticated parties to claim they were duped into signing loan documents or guarantees have failed. However, a greater level of judicial sympathy for the borrower may have emerged in the area of promissory fraud or promissory estoppel and fraudulent inducement. The California Supreme Court’s abolition of the 80-year old *Pendergrass* exception to the parol evidence rule in the *RiverIsland* decision marginally increases the opportunity for borrowers to claim they were misled as to the meaning and intent of loan documents or of modification and workout transactions despite the written terms of the contractual documents that they signed. Several decisions have allowed borrowers to allege that loan modification proposals by their lenders were binding on the lender when the borrower changed position in reliance, and have required forbearances from foreclosure in a variety of contexts when there was credible evidence of lenders’ failure to follow through on their parol or preliminary agreements. Although many borrowers have lost such cases where their claims were bogus, there has been a noticeable shift in judicial attitudes towards such claims over the past six or seven years, with courts somewhat more likely to give credence to borrower claims they were misled, although it remains to be seen whether this will have a significant effect on the behavior of parties in such negotiations.

As has been observed frequently, the Home Affordable programs implemented by the Bush and Obama administrations to mitigate the loss of homes in foreclosure reached only a very small percentage of defaulting borrowers across the country, and did very little to stem the volume of foreclosures over the last several years. Most of the other legislative developments have imposed communication and processing requirements that increase the time and expense of completing a foreclosure, and make the process significantly more complicated and paper-intensive than it was previously. The sheer volume and technical complexities of both the federal regulations and the state legislation have increased the administrative burden of compliance in the mortgage industry, but ultimately cannot help a borrower who is unable to perform and pay the mortgage.

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