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Déjà Vu All Over Again? California's Latest Foreclosure Prevention Legislation

To quote Yogi Berra, "It's like déjà vu all over again." Just last July, we reported on SB 1137, California legislation that requires lenders to expend significant effort trying to notify borrowers of the possibility of foreclosure and the options that may be available to avoid foreclosure.¹ The net result for investors and loan servicers was an extended time frame for nonjudicial foreclosures, increased foreclosure and holding costs, and arguably lower bids from third parties at the foreclosure sale. In a Second Extraordinary Session that ended February 19, 2009, the California Legislature further expanded the time frame and costs for certain loans by passing a pair of bills that are being referred to as a foreclosure moratorium, but that are really backdoor attempts to force (or at least coerce) loan servicers into instituting loss mitigation programs. They do so by imposing a 90-day delay on foreclosure proceedings unless the loan servicer is willing to implement a loss mitigation program acceptable to the state. The bills were purportedly modeled after the approach the Federal Deposit Insurance Corporation took to help IndyMac borrowers. Similar legislation is cropping up in other states.

Background

On February 20, Governor Arnold Schwarzenegger signed SBX2 7 and ABX2 7 (the "Twin Bills"),² companion bills extending the foreclosure process by at least 90 days. The Legislature's stated intent in enacting the Twin Bills is to lessen the economic impact resulting from California's high foreclosure rate by providing additional time for borrowers heading to foreclosure to work out loan modifications, while at the same time providing an exemption for servicers that have implemented a comprehensive loan modification program. It is our understanding that because the Twin Bills were enacted at a special session, they go into effect on the 91st day after the February 19, 2009 adjournment of the special session, which is May 21, 2009. However, one section (see "90-Day Foreclosure Delay" below) will not take effect until 14 days after the issuance of regulations by the Commissioner of Corporations, Commissioner of Financial Institutions, and Real Estate Commissioner (collectively, the "Commissioner"),³ which is mandated within ten days of what we understand was the February 19 enactment date.⁴ The Twin Bills will sunset on January 1, 2011, unless that date is extended or removed by subsequent legislation.

The Twin Bills build on SB 1137. To understand the full impact of the Twin Bills, a review of certain of the provisions of SB 1137 is useful.⁵

Before the enactment of SB 1137, a mortgage lender in California was under no statutory obligation to give notice of its intent to conduct a nonjudicial foreclosure. To initiate the foreclosure process, the lender merely needed to record a statutory form of notice of default ("NOD") pursuant to Section 2924 of the Civil Code. After three months passed, the mortgagee, trustee, or other authorized person provided notice of the sale to the borrower and other interested parties.

SB 1137 changed that as of September 6, 2008, but only for residential mortgage loans that were originated between January 1, 2003 and December 31, 2007 and secured by the borrower's principal residence. For these loans, the beneficiary under a deed of trust or the beneficiary's authorized agent ("Mortgagee") must wait at least 30 days after contacting the borrower before the Mortgagee can record the NOD. This "30-Day Contact Requirement" effectively extends the 120 days in which a nonjudicial foreclosure in California could have been completed by a minimum of 30 days, and often by longer, for loans subject to this requirement. The 30-Day Contact Requirement is not limited to first-lien loans, but it is not clear whether it applies to loans that were the borrower's principal residence at the time of origination but that are no longer occupied by the borrower at the time of default.

90-Day Foreclosure Delay

The Twin Bills build on, rather than amend, SB 1137 by effectively adding 90 days to the existing 90-day NOD period. During this added 90-day period, the Mortgagee must pursue a loan modification to try to prevent the foreclosure. Although there is substantial overlap between loans subject to the 30-Day Contact Requirement and those subject to the 90-Day Foreclosure Delay, not all loans subject to the 30-Day Contact Requirement will be subject to the 90-Day Foreclosure Delay.

For the 90-Day Foreclosure Delay to apply:

- The loan must have been recorded between January 1, 2003 and January 1, 2008, and must be secured by residential real property;
- The loan must be a first-lien loan;
- The borrower must have occupied the property as his or her principal residence at the time the loan became delinquent; and
- An NOD must have been recorded on the property pursuant to existing Section 2924 of the Civil Code.

Thus, the 90-Day Foreclosure Delay, unlike the 30-Day Contact Requirement, applies only to first-lien residential mortgage loans. Furthermore, the 90-Day Foreclosure Delay applies only to loans

"recorded" between January 1, 2003 and January 1, 2008, whereas the 30-Day Contact Requirement applies only to loans "made" between January 1, 2003 and December 31, 2007. It is conceivable that a loan made on December 31, 2007 would not have been recorded until three or more days following the date it was made. In that case, arguably the 30-Day Contact Requirement might apply while the 90-Day Foreclosure Delay might not. Also, although the 90-Day Foreclosure Delay applies to properties that are occupied by the borrower as his or her principal residence at the time the loan is delinquent, it is not clear if the 30-Day Contact Requirement looks only to the occupancy status at the time of origination.

Notwithstanding the above, a mortgage loan servicer⁶ is not required to delay the foreclosure sale by the additional 90 days if the borrower:

- Has surrendered the property, either by sending a letter confirming the surrender or by delivering keys to the property to the mortgagee, trustee, beneficiary, or authorized agent;
- Has contracted with an organization, person or entity whose primary business is advising people who have decided to leave their homes regarding how to extend the foreclosure process and avoid their contractual obligations to mortgagees or beneficiaries; or
- Has filed a bankruptcy case under Chapter 7, 11, 12 or 13 of the U.S. Bankruptcy Code, if the bankruptcy court has not entered an order closing or dismissing the bankruptcy case or granting relief from a stay of foreclosure.

Certain loans also are exempt from the 90-Day Foreclosure Delay, including those:

- Serviced by a mortgage loan servicer, if the mortgage loan servicer has obtained a temporary or final order of Comprehensive Loan Modification Exemption, as described below, that is current and valid at the time the notice of sale is given; or
- Made, purchased, or serviced by a California state or local public housing agency or authority, or used as collateral for securities

purchased by such a state or local public housing authority.

The 90-Day Foreclosure Delay provision takes effect 14 days after the issuance of regulations (which are to include the form through which a mortgage loan servicer may apply for an exemption from the requirement) and will be in effect until January 1, 2011 (unless extended or repealed by a subsequent statute).

Comprehensive Loan Modification Exemption from the 90-Day Foreclosure Delay

As mentioned earlier, the real purpose of the Twin Bills appears to be to push mortgage loan servicers to establish robust loss mitigation programs. To achieve this goal, the Twin Bills establish an exemption from the 90-Day Foreclosure Delay for mortgage loan servicers that have implemented a Comprehensive Loan Modification Program, as defined below. Servicers that do will not be required to comply with the 90-Day Foreclosure Delay provisions upon order of the Commissioner.

To qualify for this exemption, the servicer's Comprehensive Loan Modification Program must:

- Be intended to keep a borrower whose principal residence is located in California in his or her home when the servicer's anticipated recovery under the modification will exceed that through foreclosure, as measured on a net present value basis;
- Result in a target ratio of housing-related debt⁷ to gross income of 38 percent or less;
- Include some combination of the following features:
 - Interest rate reduction, as needed, for a fixed term of at least 5 years;
 - Extension of the amortization period for the loan term, to no more than 40 years from the original date of the loan;
 - Deferral of some portion of the principal amount of the unpaid principal balance until maturity of the loan;
 - Reduction of principal;

- Compliance with a federally mandated loan modification program⁸; and
- Other factors identified by the Commissioner.

Overall, the servicer must seek to achieve a modification that will be sustainable in the long term for the borrower. However, in complying with these provisions, the servicer is not required to violate the terms of any contractual agreements regarding investor-owned loans or to provide a modification for a borrower who is unable or unwilling to pay for a modified loan.

The Twin Bills provide for both temporary and final orders of exemption from the 90-Day Foreclosure Delay. Upon receiving an application for exemption, the Commissioner must notify the applicant of receipt of the application and issue a temporary order, which is effective from the date of receipt. That temporary order will remain in effect until the Commissioner issues a final order. If the Commissioner denies the application, the temporary order remains in effect for 30 days after the denial.

Within 30 days of receipt of an initial or revised application, the Commissioner must make a final determination of whether the applicant-servicer meets the criteria for the Comprehensive Loan Modification Exemption. If the servicer has satisfied the exemption criteria, the Commissioner will issue a final order to that effect. If the servicer has not satisfied the criteria, the Commissioner will deny the application, in which case the servicer may submit a revised application. (The Commissioner may also revoke a final order if a servicer-applicant has submitted a materially false or misleading application or if the servicer has materially altered the loan modification program on which its application was based. However, a revocation by the Commissioner may not be retroactive.)

It is unclear whether the Commissioner will consider additional factors (or what combination of the above-listed factors is needed) in determining whether to grant a final order of exemption for a servicer whose loan modification program satisfies the criteria discussed above. Hopefully, these criteria will be clarified in forthcoming regulations, since a servicer applying for exemption must do so in the form and manner determined by the

Commissioner. The Twin Bills require the Commissioner to adopt appropriate regulations no later than ten days after the date this section takes effect – which we believe would be May 31, 2009.

The Commissioner is authorized to collect, from some or all mortgage loan servicers, data regarding loan modifications accomplished by the Comprehensive Loan Modification Exemption and to make that data available on an Internet website at least quarterly. The Secretary of Business, Transportation and Housing will maintain on an Internet website a list disclosing the final orders granting exemptions, the date of each order and a link to the Internet websites describing the loan modification program.

Federally Mandated Loan Modification Programs

One criterion the Commissioner must consider when considering requests for exemptions from the 90-Day Foreclosure Delay is compliance with a “federally mandated loan modification program.” It is unclear whether such a program even currently exists under federal law.

A brief segue to federal laws is necessary to determine what might qualify as a “federally mandated loan modification program.” One current possibility is the “Homeowner Affordability and Stability Plan,” which President Obama announced on February 18, 2009. Among other programs, the “Homeowner Affordability and Stability Plan” includes the Homeowner Stability Initiative (the “Initiative”), through which loan modifications will result in sustainable monthly payments for borrowers. A participating lender would modify an existing loan so that the resulting mortgage payments were equal to no more than 38 percent of the borrower’s gross monthly income (the same ratio included in the Twin Bills). After the lender’s modification, the government and lender would share the cost of further modifying the mortgage to result in a housing-related debt to gross income ratio as low as 31 percent. But will the Initiative constitute a “federally mandated loan modification program”? Guidance on the Initiative issued by the U.S. Department of Treasury (“Treasury”) on March 4, 2009 provides that participation will be mandatory for any institution that accepts future funding from Treasury’s Financial Stability Plan.

That guidance also provides that Fannie Mae and Freddie Mac will implement the Initiative for loans that they own or guarantee. It is clear that Treasury intends this Initiative to serve as a standard industry practice for loan modifications and hopes that its guidance will be implemented across the entire mortgage market. Nonetheless, it also recognizes that except as set forth above, investor and servicer participation in the program is voluntary. Thus, the question is whether a plan that is mandated for some but not others, and potentially implemented by all, will be considered federally mandated by the Commissioner.

Declaration

For all mortgage loans subject to the notice of sale (“NOS”) under Section 2924f⁹ of the California Civil Code, a new special declaration is required. The mortgage loan servicer must include a declaration in the NOS stating:

- Whether or not the servicer has obtained from the Commissioner a final or temporary order of exemption from the 90-Day Foreclosure Delay that is current and valid on the date the NOS is filed; and
- Whether the loan is not subject to the 90-Day Foreclosure Delay, either because one or more of the conditions in new Section 2923.52 of the Civil Code are not satisfied or because the loan is exempt.

(These are in addition to declarations required under SB 1137.¹⁰) This provision takes effect upon the enactment of the Twin Bills on May 21, 2009. Presumably, for any loan foreclosed before the 90-Day Foreclosure Delay takes effect, a mortgage loan servicer would include a declaration in the NOS that the loan is not subject to the foreclosure delay.

Preemption

The Twin Bills raise an interesting preemption question—will their requirements apply to federally regulated institutions such as national banks, federal thrifts and their operating subsidiaries? Federal law preempts most—but not all—state laws regulating lending and servicing practices for these institutions.

For example, Office of the Comptroller of the Currency¹¹ (“OCC”) regulations (applicable to national banks and their operating subsidiaries) and Office of Thrift Supervision¹² (“OTS”) regulations (applicable to federal savings associations and their operating subsidiaries) preempt most state laws that regulate mortgage lending activities of the institutions to which they apply.¹³ (There are some differences between the regulations, but these differences are not important to the issue at hand.) Both sets of regulations specifically provide that the institutions they cover are not required to comply with state laws concerning licensing, registration, filings, or reports by creditors; or concerning the terms of credit.¹⁴ There are similar preemptions applicable to state laws that limit or restrict the manner in which federally regulated institutions service residential mortgage loans.

Those same regulations identify certain types of state laws that are not preempted, provided (i) they are not inconsistent with the real estate lending powers of the institutions to which the regulations apply and (ii) they only incidentally affect the exercise of those institutions’ real estate lending powers.¹⁵ This list includes state laws relating to contract law and the real property law.¹⁶ These regulations reflect the long-standing position of the OCC, OTS, and courts that federally regulated institutions enjoy no special exemption from state laws that govern the mechanics of creating, perfecting, and enforcing interests in real estate. Thus, federally regulated institutions must generally follow the same foreclosure procedures—defined under state law—as other institutions.

This does not mean, however, that a state law is immune from preemption simply because it relates to foreclosure of mortgages. The OTS takes the position that a state foreclosure law will be preempted if it effectively “compels compliance” with a preempted state requirement.¹⁷ For example, the OTS has in the past found federal law preempts provisions in state anti-predatory lending laws that impose special foreclosure procedures or rules for certain classes of loans defined by the annual percentage rate or points and fees. As noted above, OTS regulations clearly preempt state laws that regulate the terms of credit a federal savings association may contract for. The OTS reasoned

that these regulations would also prevent a state from imposing a disability on a federal savings association because the association contracted for certain terms.

Similarly, if a law imposes an obligation on a federally regulated institution to adjust the terms of a particular class of loans once there has been a default, it would arguably be a state law limitation on the terms of credit that would be preempted by OCC and OTS regulations. That seems to be precisely what the Twin Bills are intended to accomplish, and they do it under the pretext that it is part of California’s foreclosure law when the real intent of the Twin Bills is to impose loan modification requirements on loan servicers. The Twin Bills appear to impose a disability on federal savings associations by requiring them to foreclose through less favorable methods or on less favorable terms in connection with certain loans.

It remains to be seen how relevant this preemption argument may be to those banks that have adopted loss mitigation programs that would likely satisfy the Twin Bills’ Comprehensive Loan Modification Program requirements. There is also the practical problem that foreclosure trustees that conduct foreclosures in California might be unwilling to modify their procedures to accommodate assertions by federally regulated institutions that application of the Twin Bills is preempted as to those institutions.

Penalties

Failure to comply with either the 90-Day Foreclosure Delay or the Comprehensive Loan Modification Exemption will not invalidate any foreclosure sale that would otherwise be valid under California law. Moreover, these provisions expressly provide that they do not require a servicer to violate contractual agreements for investor-owned loans or provide a modification to a borrower who is not willing or able to pay under the modification. However, any California law licensee who violates the provisions of either section may be deemed to have violated the law under which he or she is licensed.

¹ California's New Foreclosure Legislation — Will Other States Play "Follow the Leader"?, Jonathan D. Jaffe and Nanci L. Weissgold, July 22, 2008, <http://www.klgates.com/newsstand/Detail.aspx?publication=4788>.

² The Twin Bills, entitled the "California Foreclosure Prevention Act," are essentially identical, and add new Sections 2923.52 through 2923.55 to, and revise Section 2924 of, the California Civil Code.

³ For purposes of the Twin Bills, the term "Commissioner" is defined to mean: (A) the Commissioner of Corporations for licensed finance lenders and broker servicing mortgage loans and any other entities servicing mortgage loans not described in (B) or (C); (B) the Commissioner of Financial Institutions for commercial and industrial banks and savings associations and credit unions organized in the state servicing mortgage loans; or (C) the Real Estate Commissioner for licensed real estate brokers servicing mortgage loans.

⁴ The Department of Corporations indicated on March 4, 2009 that it was still working with the other agencies on draft regulations. Those regulations will have to go through California's Administrative Procedure Act process. That process typically takes at least 60 days from the date the agency submits proposed regulations until the date the regulations are published in final form.

⁵ For a fuller discussion of SB 1137, see *supra* note 1.

⁶ The Twin Bills define a "mortgage loan servicer" as "a person or entity that receives or has the right to receive installment payments of principal, interest, or other amounts placed in escrow, pursuant to the terms of a mortgage loan or deed of trust, and performs services relating to that receipt or enforcement as the holder of the note or on behalf of the holder of the note evidencing that loan."

⁷ The Twin Bills define "housing-related debt" as any debt including "loan principal, interest, property taxes, hazard insurance, flood insurance, mortgage insurance, and homeowner association fees."

⁸ President Obama's recently announced loan modification plan and the federal loan modification program developed for IndyMac are two potential examples of such a program.

⁹ The NOS is filed following the NOD and gives the borrower and other interested parties notice of the date the foreclosure sale is scheduled.

¹⁰ See *supra* note 1.

¹¹ The OCC is the federal agency charged with regulating national banks.

¹² The OTS is the federal agency charged with regulating federal savings associations.

¹³ 12 C.F.R. § 34.4(a) applicable to national banks; 12 C.F.R. § 560.2(b) applicable to federal savings associations.

¹⁴ *Id.*

¹⁵ *Id.* 12 C.F.R. §§ 34.4(b), 560.2(c).

¹⁶ *Id.* 12 C.F.R. §§ 34.4(b)(1), (6); 560.2(c)(1), (2).

¹⁷ See, e.g., OTS Opinion Chief Counsel 2003-2 (January 30, 2003) ("The NY law's [multifaceted compliance scheme, including the potential threat of litigation and application of the foreclosure provisions] could not be applied to federal savings associations in a manner that would compel them to comply with the preempted provisions, including intrusive lending restrictions."); OTS Opinion Chief Counsel 2003-5 (July 5, 2003) (same conclusion as to New Jersey law).

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