

Authors:**Nanci L. Weissgold**

+1.202.778.9314

nanci.weissgold@klgates.com

Morey E. Barnes

+1.202.778.9215

morey.barnes@klgates.com

K&L Gates comprises approximately 1,700 lawyers in 29 offices located in North America, Europe and Asia, and represents capital markets participants, entrepreneurs, growth and middle market companies, leading FORTUNE 100 and FTSE 100 global corporations and public sector entities. For more information, visit www.klgates.com.

New Jersey's New Anti-Foreclosure Law Discourages Modifications

With home retention as one of the major public policy goals of federal and state governments, states are churning out foreclosure relief bills at record speed. One of the first foreclosure relief acts enacted in the new year came on January 9, 2009 when New Jersey Governor Jon Corzine enacted S.B. 1559/A.B. 3506, the "Mortgage Stabilization and Relief Act" ("Act"). In addition to establishing two new programs to help borrowers at risk of foreclosure, the new law gives certain borrowers a six-month forbearance after a foreclosure action has been filed. During that time, the borrower is obligated to continue to make payments on the loan. However, it is not clear what happens if the borrower fails to make those payments. Does the obligation to forbear cease or does the borrower essentially have an incentive to default and obtain a six month grace period? Similarly, what incentive does a servicer have to defer the filing of a foreclosure as long as possible when it knows that the failure to reach a settlement will result in a six-month forbearance? The new law may create perverse incentives to delay serious loan modification discussions.

The six-month foreclosure forbearance applies to "high risk mortgage loans." New Jersey legislators failed to completely define the characteristics of such loans. Servicers are left wondering not only what loans are subject to this six-month foreclosure forbearance, but whether it will be in addition to the three-year foreclosure suspension imposed in 2008. (The Save New Jersey Homes Act of 2008, A.B. 2780, which took effect on September 15 of last year, imposes a mandatory three-year modification and foreclosure suspension on certain introductory rate mortgage loans.) Although the Act went into effect upon enactment, its key provisions – including the implementation of the foreclosure forbearance, Mortgage Stabilization Program, and Housing Assistance and Recovery Program – will not become operative until April 1, 2009.

Foreclosure Forbearance and Other Lender Obligations.

Building on the "Save New Jersey Homes Act of 2008," the new Act imposes additional requirements on lenders foreclosing on mortgages.

Six Month Foreclosure Forbearance

The Act requires a creditor, upon the filing of a complaint for foreclosure, to grant a borrower a six-month forbearance of the foreclosure action on a borrower's "high risk mortgage loan."

A "high risk mortgage loan" is a first-lien loan that has one or more of the following characteristics:

- (1) is an interest-only mortgage whose interest rate will reset in the future;
- (2) has a reset mortgage interest rate that increases the interest rate on the mortgage;
- (3) contains a payment option or "pick a payment" plan;
- (4) contains a negative amortization schedule;
- (5) is a subprime loan;

- (6) contains an unenforceable prepayment penalty; or
- (7) is a “high cost home loan,” as described by the New Jersey Home Ownership Security Act of 2002.

After filing the foreclosure complaint and at the beginning of the six month forbearance period, the creditor and homeowner must participate in the mediation program sponsored by the state’s Administrative Office of the Courts. (New Jersey launched the mediation program, through which housing counselors, attorneys, and court-trained mediators work with homeowners to avoid foreclosure, on January 9.) During that time, the homeowner may pursue a loan modification or workout or other alternative to foreclosure through the mediation program. The creditor may not take steps to remove the homeowner from the property and the interest rate on the mortgage loan may not increase during the forbearance period, but the borrower must continue making monthly mortgage payments.

If the homeowner abandons the property, the forbearance period ends and the creditor may recommence its foreclosure action. If a borrower who remains in his or her property redefaults, it is unclear if the borrower could be entitled to more than one forbearance period, although this right expires April 1, 2011. Also unclear is the result if a borrower fails to make payments during the forbearance period. If the borrower were making the payments in the first place, a foreclosure action would not arise. It is unrealistic to believe that the borrower should be required to make the full scheduled payments as a condition of obtaining the forbearance. If the borrower does not make those payments, is the effect the same as the borrower’s abandonment of the property, ending the forbearance period? Does the failure to pay eliminate the borrower’s entitlement to another forbearance period or to other remedies available under New Jersey law? Whatever the result, it seems that legislators failed to address a possibility that could be critical to the operation of this provision.

This provision of the Act creates two additional potential legal problems for servicers. First, because the legislators did not define “subprime loan,” either in the Act or by reference to other provisions of New Jersey law (or provide authority to promulgate regulations under this section of the law), the definition

of “high risk mortgage loan” remains unclear. We know it includes interest-only loans, ARM loans, negative amortization loans, high-cost loans under the state’s anti-predatory lending law and loans with a prepayment fee in excess of what is allowed under law (New Jersey’s Licensed Lenders Act prohibits prepayment fees). But, what else? Although some industry experts believe that virtually all subprime loans were negative amortization loans or hybrid ARMs, it is unclear if New Jersey adopts that view.

The second problem lies in the interaction of the new Act with similar provisions of the Save New Jersey Homes Act. Because the Act’s provisions regarding the forbearance period do not refer to the Save New Jersey Homes Act, it is not entirely clear how the forbearance period might interact with the three-year foreclosure moratorium created by that measure. The Save New Jersey Homes Act applies to an “introductory rate mortgage,” defined to capture loans with a lower introductory rate.¹ By definition, this would be limited to loans with an adjustable interest rate. As the Act defines a “high risk mortgage loan” to include two types of first-lien loans with interest rates that have or will reset, it is possible that a loan could be subject to both measures. However, under the Save New Jersey Homes Act the foreclosure proceedings are suspended for three years only if the borrower affirmatively acts, completing a certification of extension form agreeing to modification of the loan and to repayment of the modified loan. By contrast, the Act requires the creditor to provide a six-month foreclosure forbearance without any action on the part of the borrower. If an interest rate loan falls under both, can a borrower take advantage of the six-month forbearance and then apply for the moratorium? And how would the respective expiration dates of the two measures – January 1, 2011 and April 1, 2011 for the Act and the Save New Jersey Homes Act, respectively – impact a borrower’s ability to do so if it were permitted? Although the Save New Jersey Homes Act declares its priority over other laws, certain questions remain. Furthermore, because this provision of the Act is the only one under which New Jersey regulators do not have authority to draft regulations, a regulatory answer may not be possible.

Quarterly Reporting Obligation

The Act requires a creditor instituting a foreclosure action in the state’s Superior Court to provide a quarterly report on the number of foreclosure actions it has filed in the state to the Department of Banking

and Insurance (“Department”). The Department in turn must use those reports to produce its own quarterly report detailing foreclosure filings in each county, breaking down the data into eight categories: (1) prime rate mortgages; (2) subprime rate mortgages; (3) fixed-rate mortgages; (4) adjustable rate mortgages; (5) nonconforming mortgages (as defined by Fannie Mae or Freddie Mac); (6) Federal Housing Administration-insured mortgages; (7) Veterans Administration-insured mortgages; and (8) mortgages in any other category the Department deems appropriate to include in the report. The Act provides authority to promulgate regulations to implement this provision, which could provide clues as to how New Jersey distinguishes prime and subprime loans as well as whether any types of creditors are excluded from this reporting obligation.

Notice Requirements/Selling Credit Inquiries

The Act also requires any creditor serving a notice of intent to foreclose upon a residential mortgage to serve a copy of the notice upon a designated public officer in the municipality in which the property is located. According to a press release issued by Governor Corzine’s office, that provision is intended to provide recourse against creditors who fail to comply with the state’s notice requirements when foreclosing upon property.

Finally, the Act prohibits a consumer reporting agency or other business entity from selling to, or exchanging with, a third party the existence of a credit inquiry arising from a consumer mortgage loan application when the sale or exchange is triggered by an inquiry made in response to an application for credit. This requirement does not apply to a third party holding an existing mortgage loan on the property, or to information a mortgage originator or servicer provides to a third party providing services in connection with the mortgage loan origination or servicing, a proposed or actual securitization, a secondary market sale (including sales of servicing rights), or a similar transaction related to the consumer mortgage loan.

Federal Preemption

A remaining question will be whether the new Act’s requirements apply to federally-chartered banks (i.e., national banks and federal thrifts) and their operating subsidiaries (collectively, “Federal Lenders”). As a general rule, Federal Lenders must follow the procedures set forth by state law when foreclosing on mortgage loans. However, there are limits to

this general rule. For example, the Office of Thrift Supervision took the position in a 2003 opinion letter that a state (New Jersey, in fact) could not enact a “backdoor” restriction on the credit terms that federal thrifts may contract for by imposing more onerous foreclosure procedures in connection with federal thrift-originated loans that contain disfavored terms.² Arguably, this is exactly what the foreclosure provisions described above do—impose special, more onerous, foreclosure procedures for loans that contain certain credit terms. One could therefore argue that the Act’s new foreclosure requirements represent the kind of “backdoor” regulation of credit terms that the OTS concluded was preempted.

Counsel for borrowers might not be willing to accept this preemption argument, however. This means that a Federal Lender that wants to rely on preemption might need to litigate the issue, which is not an attractive option from a reputational risk perspective. Although unlikely at this point, the federal banking agencies should weigh in on the question of when a state foreclosure law morphs into indirect, impermissible banking regulation.

Mortgage Stabilization Program.

The Mortgage Stabilization Program, administered by the New Jersey Housing and Mortgage Finance Agency (“Agency”), is intended to facilitate the restructuring of “covered mortgages,” which are first-lien mortgage loans at imminent risk of foreclosure, by offering qualified homeowners a mortgage stabilization loan to help make their mortgage payments affordable. However, the entire process is contingent upon a lender agreeing to refinance a covered mortgage into a new first mortgage amount that is less than its appraised value and results in an affordable payment to the borrower.

More specifically, first, the lender³ holding the first-lien mortgage on the borrower’s principal dwelling that is in imminent danger of foreclosure must elect to modify or refinance the loan into one that (1) has an “affordable mortgage payment” for the borrower and (2) is in an amount less than the appraised value of the property. The Act defines an “affordable mortgage payment” as a monthly payment that does not exceed the greater of (1) 33 percent or (2) another percentage rate designated by “governmental or private first

mortgage loan insurance” of the borrower’s monthly average gross household income.

Second, the homeowner must qualify for assistance. To qualify, the homeowner must have resided in the property for at least one year, must not exceed the maximum income limit (defined as the greater of 120 percent of area median income or the income limit for the Agency’s Mortgage Revenue Bond Program), must not hold an interest in any other real residential property at the time he or she applies for assistance, and must participate in state-approved budget counseling sessions.

If both sets of requirements are satisfied, the program will provide the borrower with a “mortgage stabilization program loan” and a “mortgage lender loan.” These are co-equal second mortgage loans. The “mortgage stabilization program loan” is a non-amortizing (no monthly payment) second mortgage loan provided by the Agency, in an amount equal to half of the difference between the new first mortgage loan the homeowner receives from the lender and the appraised value of his or her property (not to exceed \$25,000), the proceeds of which are paid to the lender making the new mortgage loan. The “mortgage lender loan” is a subordinate-lien loan provided by the lender that also is equal to half of the difference between the new first mortgage loan and the appraised value of the homeowner’s property. Each of these loans must be made at an interest rate and term identical to that of the new first mortgage loan and must be repaid by the homeowner on a proportional basis out of the net sale proceeds from the sale of the property; neither may include a prepayment penalty. If a homeowner participating in the program has an existing subordinate-lien loan secured by the mortgaged property, the holder of that subordinate lien must agree to subordinate its position behind both the mortgage stabilization program loan and the mortgage lender loan. The Act appropriates \$25 million for a Mortgage Stabilization Program Fund, from which the mortgage stabilization program loans are to be made.

Housing Assistance and Recovery Program.

Of less concern to servicers, but still meriting mention, is the second program that the Act created. The Housing Assistance and Recovery Program (“HARP”) is intended to assist homeowners in imminent danger of foreclosure to remain in their homes by encouraging a lease-purchase arrangement. Specifically, HARP outlines a process through which a state-approved “sponsor,”⁴ primarily not-for-profit organizations and public entities, may purchase the principal dwelling of a homeowner in imminent danger of foreclosure, and then enter into a lease-purchase agreement⁵ permitting the homeowner to continue residing at the property while making affordable rent payments.⁶ To support these efforts, the Act appropriated \$15 million to establish a HARP Support Fund. In the case of any individual distressed property, fund monies may be used to: (1) appraise the property to determine its current market value; (2) repair or rehabilitate the property to bring it into compliance with all applicable codes and standards; (3) pay property taxes that accrue during the lease period; (4) pay property insurance premiums; (5) pay up to \$25,000 between the appraised value and purchase price of the property; and (6) undertake any other activity “necessary to effectuate the purposes of the program.” A sponsor may not use the funds towards the purchase of real property, with the exception of the \$25,000 allotment described above.

Conclusion

The Act is the latest in a series of state-level legislative efforts intended to help homeowners avoid foreclosure. The substantive provisions of the Act are scheduled to become effective on April 1, 2009, and it is clear that some issues must be resolved before then. With the foreclosure crisis worsening, it is expected that other states soon will be enacting similar legislation. The open question is whether statutes like the Act will backfire. By providing borrowers with at least one six-month forbearance period, the Act may encourage borrowers to postpone serious discussion regarding how to modify their loans.

Endnotes

- 1 The Save New Jersey Homes Act defines an “introductory rate mortgage” as a loan secured by real estate on which there is a one- to four-family dwelling that the borrower occupies as his or her principal residence, and which provides for either (1) “an introductory payment rate option that is set at least 3 percent below the fully indexed rate at the time the loan was originated and payments may adjust by more than 3 percent at the reset date regardless of whether the variable rate index has increased”; or (2) “an interest rate that may adjust by more than 2 percent at the end of the initial fixed rate period of the loan and which, notwithstanding the payment rate in effect, had an interest rate at origination of more than 200 basis points over the Freddie Mac 30-year conventional interest rate and which provides for an introductory interest rate that is set below the fully indexed rate at the time the loan was originated and may adjust at the reset date regardless of whether the variable interest rate has increased.” The Save New Jersey Homes Act further defines “introductory rate mortgage” to exclude either (1) “a loan that provides for a fixed rate of interest for the first five years or longer,” or (2) “a loan that provides for an introductory interest rate that is set below the fully indexed rate at the time the loan was originated only as a result of the borrower’s payment of bona fide discount points.”
- 2 See OTS Op. Chief Counsel P-2003-5 (July 22, 2003). This conclusion makes sense. It is clear that a state cannot, for example, prohibit a federal thrift from making a loan with an APR in excess of a certain threshold. Logically, then, a state should not be permitted to effectively ban federal thrifts from making such loans by imposing onerous requirements and restrictions on federal thrifts that do. Although the OTS’s letter applied only to federal thrifts, we believe that the same reasoning should apply to national banks.
- 3 The Act defines a “lender” as any lawfully constituted mortgage lender, mortgage investor or mortgage loan servicer that owns and is willing to refinance or is authorized to negotiate the terms of the homeowner’s mortgage.
- 4 A “sponsor” may be a non-profit community development corporation, a non-profit housing organization, or a governmental entity approved by the New Jersey Commissioner of Community Affairs that meets certain criteria set forth in the law, including a requirement to receive a commitment from a regulated financial institution or government entity for a line of credit or other financing mechanism to purchase properties under this program.
- 5 The lease-purchase agreement must include: (1) the terms for reconveyance of the property to the homeowner at the conclusion of the lease period, which may be up to three years; (2) provisions enabling the homeowner to continue residing at the property during the lease period in exchange for the payment of an “affordable rent”; and (3) a provision that the sponsor will sell the property back to the homeowner at a price not higher than that which the sponsor paid for the property, plus any reasonable repair and/or maintenance costs.
- 6 An “affordable rent” payment is one that does not exceed 33 percent of the homeowner’s monthly average gross household income.

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For more information, please contact one of the professionals listed below.

LAWYERS

Boston

R. Bruce Allensworth	bruce.allensworth@klgates.com	+1.617.261.3119
Irene C. Freidel	irene.freidel@klgates.com	+1.617.951.9154
Stephen E. Moore	stephen.moore@klgates.com	+1.617.951.9191
Stanley V. Ragalevsky	stan.ragalevsky@klgates.com	+1.617.951.9203
Nadya N. Fitisenko	nadya.fitisenko@klgates.com	+1.617.261.3173
Brian M. Forbes	brian.forbes@klgates.com	+1.617.261.3152
Andrew Glass	andrew.glass@klgates.com	+1.617.261.3107
Phoebe Winder	phoebe.winder@klgates.com	+1.617.261.3196

Charlotte

John H. Culver III	john.culver@klgates.com	+1.704.331.7453
--------------------	-------------------------	-----------------

Los Angeles

Thomas J. Poletti	thomas.poletti@klgates.com	+1.310.552.5045
-------------------	----------------------------	-----------------

Miami

Paul F. Hancock	paul.hancock@klgates.com	+1.305.539.3378
-----------------	--------------------------	-----------------

New York

Philip M. Cedar	phil.cedar@klgates.com	+1.212.536.4820
Elwood F. Collins	elwood.collins@klgates.com	+1.212.536.4005
Steve H. Epstein	steve.epstein@klgates.com	+1.212.536.4830
Drew A. Malakoff	drew.malakoff@klgates.com	+1.216.536.4034

San Francisco

Jonathan Jaffe	jonathan.jaffe@klgates.com	+1.415.249.1023
Erin Murphy	erin.murphy@klgates.com	+1.415.249.1038

Seattle

Holly K. Towle	holly.towle@klgates.com	+1.206.370.8334
----------------	-------------------------	-----------------

Washington, D.C.

Costas A. Avrakotos	costas.avrakotos@klgates.com	+1.202.778.9075
Melanie Hibbs Brody	melanie.brody@klgates.com	+1.202.778.9203
Daniel F. C. Crowley	dan.crowley@klgates.com	+1.202.778.9447
Eric J. Edwardson	eric.edwardson@klgates.com	+1.202.778.9387
Anthony C. Green	anthony.green@klgates.com	+1.202.778.9893
Steven M. Kaplan	steven.kaplan@klgates.com	+1.202.778.9204
Phillip John Kardis II	phillip.kardis@klgates.com	+1.202.778.9401
Rebecca H. Laird	rebecca.laird@klgates.com	+1.202.778.9038

Laurence E. Platt	larry.platt@klgates.com	+1.202.778.9034
Phillip L. Schulman	phil.schulman@klgates.com	+1.202.778.9027
H. John Steele	john.steele@klgates.com	+1.202.778.9489
Ira L. Tannenbaum	ira.tannenbaum@klgates.com	+1.202.778.9350
Nanci L. Weissgold	nanci.weissgold@klgates.com	+1.202.778.9314
Kris D. Kully	kris.kully@klgates.com	+1.202.778.9301
Morey E. Barnes	morey.barnes@klgates.com	+1.202.778.9215
David L. Beam	david.beam@klgates.com	+1.202.778.9026
Emily J. Booth	emily.booth@klgates.com	+1.202.778.9112
Holly Spencer Bunting	holly.bunting@klgates.com	+1.202.778.9853
Krista Cooley	krista.cooley@klgates.com	+1.202.778.9257
Elena Grigera	elena.grigera@klgates.com	+1.202.778.9039
Melissa S. Malpass	melissa.malpass@klgates.com	+1.202.778.9081
David G. McDonough, Jr.	david.mcdonough@klgates.com	+1.202.778.9207
Stephanie C. Robinson	stephanie.robinson@klgates.com	+1.202.778.9856
Kerri M. Smith	kerri.smith@klgates.com	+1.202.778.9445
David Tallman	david.tallman@klgates.com	+1.202.778.9046

DIRECTOR OF LICENSING

Washington, D.C.

Stacey L. Riggin	stacey.riggin@klgates.com	+1.202.778.9202
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REGULATORY COMPLIANCE ANALYSTS

Washington, D.C.

Dameian L. Buncum	dameian.buncum@klgates.com	+1.202.778.9093
Teresa Diaz	teresa.diaz@klgates.com	+1.202.778.9852
Jennifer Early	jennifer.early@klgates.com	+1.202.778.9291
Robin L. Gieseke	robin.gieseke@klgates.com	+1.202.778.9481
Allison Hamad	allison.hamad@klgates.com	+1.202.778.9894
Joann Kim	joann.kim@klgates.com	+1.202.778.9421
Brenda R. Kittrell	brenda.kittrell@klgates.com	+1.202.778.9049
Dana L. Lopez	dana.lopez@klgates.com	+1.202.778.9383
Patricia E. Mesa	patty.mesa@klgates.com	+1.202.778.9199
Jeffrey Prost	jeffrey.prost@klgates.com	+1.202.778.9364

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