

California Foreclosure

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California Foreclosure Intervention: The Good, the Bad and the Ugly

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To foreclose or not to foreclose? There is no doubt that California is experiencing one of its worse real estate downturns in recent history. In fact, California is ranked third in the nation among states with high foreclosure rates behind Nevada and Arizona.¹ By the end of 2008, nearly 4 percent of its housing units were in some stage of foreclosure.

The allure of easy money through flipping properties, the withdrawal of equity to pay for lavish vacations or cars, the advent of creative financing, and relaxed lending requirements have all contributed to California's current economic crisis. This article addresses the latest in California and federal foreclosure legislation along with various options for distressed homeowners to consider in an effort to avoid losing their home.

New Developments in California Foreclosure Law

On Feb. 20, 2009, as part of the state budget, the Legislature and Gov. Arnold Schwarzenegger passed into law the California Foreclosure Prevention Act. The CFPA manifested as an amendment to California Civil Code § 2923. The new law was widely reported to impose a "90-day moratorium" on all foreclosures in the state. However, the 90-day provision applies only under certain circumstances that will be discussed below.

The CFPA is only one of the new foreclosure laws instituted through changes in the Civil Code.

Prior to the recent amendments, a nonjudicial foreclosure (one that does not involve court action) typically took about four months. The first step in the process was the lender's recording of a notice of default in the county where the property is located, which could technically be done immediately after a missed payment. The first round of amendments to California foreclosure law, which went into effect Sept. 6, 2008, added an extra step to this process.²

Under new Civil Code § 2923.5, a lender must contact the borrower by telephone (a voicemail is insufficient) or in person at least 30 days before filing a notice of default. The purpose of this contact is to assess the borrower's financial condition and discuss alternatives to foreclosure.³ If the lender is not able to contact the borrower after two weeks of calls at different days and times, it must send a certified letter.⁴ In addition, the lender is required to post links on its Web site discussing a borrower's options and provide a toll-free telephone number for borrowers to call to reach a live person.⁵ Failure to comply with any these requirements can void the entire foreclosure.

However, none of these rules applies if:

- The borrower has surrendered the property;
- The borrower has filed for bankruptcy; or
- The borrower has contracted with a business that assists in extending the foreclosure process and "avoiding [the borrower's] contractual obligations."⁶

Finally, Section 2923.5 is effective for loans entered into from Jan. 1, 2003, through Dec. 31, 2007, that are secured by residential, owner-occupied real property.⁷

Through Section 2923.6, the Legislature seems to be encouraging lenders to offer more loan modifications or workout plans whenever economically feasible. In the typical situation, a borrower is "upside-down" on his property, that is, he owes more than the property is worth. If a lender chooses to foreclose on the property, it likely will only recover the diminished value of the property minus the fees and costs associated with the foreclosure itself. Accordingly, it is often in the lender's best interest to agree to modify the loan rather than foreclose.

Section 2923.6 states that a "servicer acts in the best interest of all parties if it agrees to or implements a loan modification or workout plan" whenever a loan is in default and the anticipated recovery under the modification will exceed the recovery gained by foreclosure.⁸ Essentially, the Legislature is asking lenders to be more reasonable in their dealings with borrowers and to avoid playing counterintuitive hardball to get more than the property is worth.

Another new foreclosure law extends some protections to the tenants of homes that are being foreclosed.

Generally, under the old laws, a new owner only had to give tenants of a foreclosed property 30 days notice prior to eviction. However, new Civil Code § 2924.8 has increased this notice period to 60 days and requires that the new owner give notice through a posting on the property.⁹ For obvious reasons, this section only applies if the billing address for the mortgage notice is different from the property address.¹⁰

Civil Code § 2929.3 is a potentially expensive new law that requires new owners of foreclosed properties to "maintain" them. "Failure to maintain" means failing to properly care for the exterior of the property, including allowing excessive lawn growth, failing to evict squatters/trespassers and, in a state full of swimming pools, "failing to take action to prevent mosquito larvae from growing in standing water."¹¹

Under this section, a governmental agency is authorized to assess a civil fine of up to \$1,000 *per day* after giving the new property owner 30 days to cure.¹² If the agency deems the property a threat to public health or safety, less than 30 days notice may be given.¹³

Finally, the California Foreclosure Prevention Act, Civil Code § 2923.52, was enacted to combat the high rates of foreclosure in the state by providing "additional time for borrowers to work out loan modifications."¹⁴ This new section requires lenders to delay for 90 days after filing a notice of default before filing the notice of sale.¹⁵ The 90-day delay only applies to first-mortgage loans secured by owner-occupied real property that were entered into from Jan. 1, 2003, through Dec. 31, 2007.¹⁶

In theory, this new legislation should accomplish its goal of forcing lenders to spend more time discussing loan modifications with borrowers, but the exemptions tend to swallow the rule. The requirement of an additional 90 days does not apply to any mortgage loan servicer that obtains an exemption from the provisions of the new law.

To be eligible for this exemption, the loan servicer must have a "comprehensive loan modification program" in place.¹⁷ Currently, almost all major lenders are exempt from this law and are not subject to the 90-day delay.¹⁸ Accordingly, borrowers (or their agents) should not rely on this supposed "90-day moratorium" without making sure that the lender is not on the voluminous list of exempt servicers.

New Developments in Federal Foreclosure Law

President Obama signed the Helping Families Save Their Homes Act, 12 U.S.C.A. § 5201, into law May 20, 2009, as part of the economic stimulus package. The purpose of the HFSTHA is to prevent mortgage foreclosures and revitalize the housing sector.¹⁹ The law's provisions include the creation of a "safe harbor" against investor liability during the loan modification process, relaxation of the HOPE for Homeowners program, and a new notice requirement whenever a residential loan is sold, assigned or transferred.

Title I of the HFSTHA amends the Guaranteed Rural Housing Loan Program to encourage lenders to modify loans that are secured by the borrower's principal residence and located in a rural area.²⁰ These new incentives allow for loan modifications with terms extended up to 40 years and for the U.S. Department of Housing and Urban Development to accept assignments of modified loans at reduced interest rates the borrower is able to pay.²¹

Title II amends portions of the Truth in Lending Act²² to provide a safe harbor that allows for servicers to enter into a "qualified loss mitigation plan" for residential mortgages.²³ Essentially, the plan is a loan modification, workout or other loss mitigation plan.²⁴ The lender's obligation to enter into a mitigation plan will only apply if the loan is in default and is secured by the borrower's principal residence, and if the servicer believes that a modification will exceed the anticipated recovery of a foreclosure.²⁵

The safe-harbor provision also limits a loan originator's or issuer's liability, stating that a person "shall not be liable for monetary damages...or other equitable relief...based solely on the cooperation of such person with a servicer" in furtherance of establishing a qualified loss mitigation plan.²⁶

Changes to the HOPE for Homeowners Act²⁷ are also outlined in Title II of the Helping Families Save Their Homes Act. To qualify for an insured refinance loan under the HOPE for Homeowners program, the borrower had been required to certify that he or she did not intentionally default on a mortgage or other debt. The new provisions of the HFSTHA only require that the borrower certify this *within the last five years*. Additionally, the borrower cannot have been convicted of fraud during the preceding 10-year period.²⁸

Under the HOPE for Homeowners program, a borrower's debt-to-income ratio could not exceed

31 percent. However, the new HFSTHA only requires that the borrower be "likely to have" this debt-to-income ratio after the terms of the mortgage are reset.²⁹ This allows for considerable flexibility in obtaining refinancing through the program. The HFSTHA additionally imposes a "ban on millionaires" that prevents anyone with a net worth of over \$1 million from participating in the program.³⁰

Another modification to the Truth in Lending Act requires new owners, assignees or transferees of mortgage loans secured by a borrower's principal residence to provide written notice not later than 30 days after the date of transfer.³¹ This notice must include:

- The name, address and telephone number of the new creditor;
- The date of transfer;
- Information about how to reach the creditor's agent;
- The location of the debt recordation; and
- Any other "relevant information regarding the new creditor."³²

The Helping Families Save Their Homes Act also provides for a private right of action in the event that a transferee violates the new provisions.³³

Finally, the HFSTHA protects tenants of foreclosed properties by mandating that they be given at least 90 days notice before eviction. In the case of a tenant with a "bona fide lease," executed prior to the foreclosure, the new owner is prevented from evicting the tenant before the expiration of the lease *unless* the new owner plans to occupy the property as his or her primary residence.³⁴ A "bona fide lease" is defined as a tenancy in which the tenant is not the mortgagor or a child, spouse or parent of the mortgagor; in which the lease was the result of an arm's-length transaction; and in which the required rent was not below the fair market value.³⁵

Options for Residential Homeowners Facing Foreclosure

Short Sale

A "short sale" occurs when a property is worth less than the loan(s) secured against it and the lender agrees to accept the lesser value. Not all lenders will accept

short sales or discounted payoffs, nor will all borrowers qualify for a short sale.

Technically, a short sale *does not* stop a foreclosure. However, if the buyer is moving at a pace acceptable to lender, the lender will likely extend the timeline of the foreclosure in order to give the short sale sufficient time to process. Lenders generally require a significant amount of paperwork to complete a short sale, including a written explanation of hardship (which may require proof), a copy of the fully executed purchase contract, a copy of the transfer disclosure statement, pre-approval of buyer for a new loan, certified escrow instructions, a preliminary title report, certified estimated closing costs, tax forms, a signed financial worksheet, tax returns for the previous two years, employment paycheck stubs for the previous two months, and bank statements for the previous three months.

A lender may prefer a short sale to a foreclosure for various reasons, including California Senate Bill 1137, which amended several sections of Civil Code § 2923, Chapter 2, governing mortgage foreclosure procedures. The amendments impose strict requirements on lenders prior to exercising their right to foreclose; the expense and time of foreclosures; and other expenses for eviction, maintenance and repair. In a short sale the lender will be able to take the unit off its books with little down time and expense.

Although the distressed homeowner will be free from the mortgage after a short sale, there are other issues to consider. For one, the amount of the debt written off by the lender is considered “ordinary income,” which is taxed at a higher rate than capital gains. The borrower will likely receive a 1099c tax form from the lender in the amount of the canceled debt. Fortunately, under the Mortgage Forgiveness Debt Relief Act, 26 U.S.C.A. § 108, amended in February 2009, a taxpayer *will not* be taxed upon cancellation of debt if the following conditions are met:

- The property sold in the short sale is the taxpayer’s principal residence as per Internal Revenue Code § 121;
- There is a cancellation of debt per Internal Revenue Code 163(h)(3)(B); and
- The indebtedness was discharged after Jan. 1, 2007, and before Jan. 1, 2013.

Additionally, the impact of a short sale on a borrower’s credit is significant. After a payment is 30 days

late, a lender can report the delinquency to the credit bureau. This may also show up on the borrower’s credit report as a “foreclosure in process” or “foreclosure proceedings” or in various other ways that impact his or her credit rating. When the short sale is completed, it can be reported on a credit report as “settled for less than full balance.” This negative mark would show up on the credit report for seven years.³⁶

Deed in Lieu of Foreclosure

A lender may also be willing to accept a distressed homeowner’s deed to the property in lieu of a foreclosure. The borrower would need the lender’s permission to transfer title. In the past, homeowners have independently quitclaimed the property and recorded the instrument without the lender’s permission. In 1993 the California Legislature passed a law to protect lenders from involuntary and invalid transfers of real property to the lender.³⁷ The lender must record a “notice of nonacceptance of a recorded deed” in the county where the real property is located. Simply redelivering a grant of the real property back to the original homeowner does not legally retransfer the title.

Deed-in-lieu is not very common and is not a special instrument; it is simply a conveyance of property to the lender by grant deed or quitclaim deed. In exchange, the lender cancels the promissory note secured by the property.

A deed-in-lieu effectively saves the lender from having to incur the cost of a foreclosure and helps a borrower avoid a notice of default on the property.³⁸ However, unlike in a foreclosure, any junior liens are *not* extinguished, the borrower may later try to set the conveyance aside because of duress or fraud, the lender will spend more money fighting this action, and the borrower’s other creditors may argue that the conveyance was “fraudulent,” which jeopardizes their ability to satisfy their claims against the borrower.

A deed in lieu of foreclosure is treated the same as a sale for income tax purposes. It is reported on the taxpayer’s tax return as a sale or exchange in the year the foreclosure is finalized or the deed is given to the lender. The homeowner can receive “capital gains or loss” as in any other sale of real property. Also, the owner can receive “forgiveness of debt” income.

If the debt is recourse (a debt for which a prior guarantor is liable in the event of the borrower’s default), the homeowner can receive income from the amount

of debt that is forgiven by the lender. For non-recourse loans (where the lender's only recourse is repossessing the secured property), there is no taxable income from forgiveness of debt, but there still may be income from capital gains. A distressed homeowner who successfully negotiates a deed in lieu of foreclosure may be able to also save his or her credit rating.

Bankruptcy

Bankruptcy is often the initial option considered by distressed homeowners who are facing foreclosure. Bankruptcy may or may not have the effect of saving a property from foreclosure. The filing of bankruptcy triggers an automatic stay that stops all creditors from any action to collect their claims, including foreclosure. At minimum, filing for bankruptcy will buy the defaulted homeowner some time. However, in a Chapter 7 proceeding, the stay lasts only as long as the property is not abandoned by the trustee (the homeowner) as either valueless to the estate or as exempt, or until the case is closed.

What happens to a house in Chapter 7 proceeding is a function of several issues, but, in general, if the equity in the house is "exempt" (removed from the bankruptcy estate and not available to pay the claims of creditor) and the borrower can keep making the payments, *then* the borrower will likely be able to retain the property.

The bankruptcy discharge eliminates the borrower's personal liability for the mortgage, but it does not disturb the lien. Thus, after Chapter 7 bankruptcy, the mortgage lender still has its rights in the property, including the right to foreclose if the borrower breached the loan agreement by failing to make payments.

However, if the equity in the home is not "exempt," or if the secured claim will become greater than the value of the security during the bankruptcy, a creditor secured by the property can seek relief from the stay to complete the foreclosure. Since the creditor's lien is not eliminated by the bankruptcy, Chapter 7 provides temporary relief from foreclosure, but no lasting solution in this situation.

If the distressed homeowner has substantial equity in the home, he or she should consider filing Chapter 13 since the stay lasts as long as the case is pending. Chapter 13 is designed to allow debtors to cure defaults in their home mortgages by paying the arrearage over as long as three to five years. However, mortgages

on primary residences cannot be included in Chapter 13 bankruptcy proceedings.

Contrarily, mortgages on second homes and investment homes can be included. Recently, the U.S. Senate voted down a portion of President Obama's Helping Families Save Their Homes Act that would have allowed bankruptcy judges to include primary residences in Chapter 13 proceedings so their mortgages could be modified.

Generally, in a Chapter 13 proceeding a judge tries to determine what debts need to be paid, which can be reduced, what terms can be changed to help pay off debts and whether any debt should just be written off. Unsecured debts, such as credit cards, are lower on the priority list than a secured debt. Mortgages would be a secured debt and therefore be higher on the priority list. For second homes and investment property, the judge may address the terms of the loan, the interest rates, and even the loan principal in an effort to find a way to create a payment plan so the borrower can pay off his or her debts and emerge from bankruptcy.

Loan Modifications

Distressed homeowners facing foreclosure may also contact their lender and discuss options to modifying their original mortgage. There is no boilerplate loan modification plan, and lenders take each request on a case-by-case basis with different workouts.

Options for Modifying Mortgage Loans

- Reducing the interest rate.
- Forgoing an upward adjustment of the interest rate.
- Extending the repayment period.
- Reducing the principal balance owed.
- Adding delinquent payments to the principal balance.
- Forbearing a portion of the principal balance.
- A combination of two or more of the above modification terms.

Unfortunately there are many people touting themselves out as "foreclosure consultants" or "loan modifiers" preying upon desperate homeowners. They promise results, but end up absconding with the advanced fees with little or no change to the existing loan. More often than not, a distressed homeowner can find

more success modifying his loan with a lender if he can discover serious legal errors and omissions in the origination of the mortgage. Violations of the Truth in Lending Act, the Real Estate Settlement Procedures Act, and the Home Ownership and Equity Protection Act may even allow a distressed homeowner to rescind the loan for up to three years from the date of the loan origination in addition to statutory and actual damages, court costs, and attorney fees.

Conclusion

There is no simple or quick fix to the current market conditions. However, the recent legislative climate has allowed the distressed homeowner more time and options to consider before he decides whether to allow the lender to foreclose or not to foreclose.

Notes

¹ See www.RealtyTrac.com (data based on Q1 2009 information).
² See Cal. Civ. Code § 2923.5(a)(1).
³ Cal. Civ. Code § 2923.5(a)(2).
⁴ Cal. Civ. Code § 2923.5(g)(1)-(3).
⁵ Cal. Civ. Code § 2923.5(g)(2)(A)-(C).
⁶ Cal. Civ. Code § 2923.5(h).
⁷ Cal. Civ. Code § 2923.5(i).
⁸ Cal. Civ. Code § 2923.6(a)(1)-(2).
⁹ Cal. Civ. Code § 2924.8(a).
¹⁰ Cal. Civ. Code § 2924.8(d).
¹¹ Cal. Civ. Code § 2929.3(b).
¹² Cal. Civ. Code § 2929.3(a)(2).
¹³ Cal. Civ. Code § 2929.3(c).
¹⁴ See Assembly Bill No. 7, Ch. 5, § 2(b).
¹⁵ Cal. Civ. Code § 2923.52(a).
¹⁶ Cal. Civ. Code § 2923.52(a)(1)-(3).
¹⁷ Cal. Civ. Code §§ 2923.52(b), 2923.53(a).
¹⁸ See <http://www.corp.ca.gov/FSD/CFP/default.asp> for a list of all mortgage servicers that have been granted exemptions.
¹⁹ The White House, Office of the Press Secretary Briefing, Reforms for American Homeowners and Consumers (May 20, 2009).
²⁰ See Helping Families Save Their Homes Act, 12 U.S.C.A. § 5201, Title I, § 101.
²¹ 12 U.S.C.A. § 5201, Title I, § 103.
²² 15 U.S.C. § 1641.
²³ 12 U.S.C.A. § 5201, Title II, § 201, amending TILA, § 129A.
²⁴ TILA, § 129(f)(1)(A)-(B).
²⁵ TILA, § 129(a)(2)(A)-(C).
²⁶ TILA, § 129(d).
²⁷ 12 U.S.C. § 1715z-23, § 257.
²⁸ 12 U.S.C.A. § 5201, Title II, § 202.
²⁹ *Id.*
³⁰ *Id.*
³¹ 12 U.S.C.A. § 5201, Title IV, § 404.
³² *Id.*
³³ *Id.*

³⁴ 12 U.S.C.A. § 5201, Title VII, § 702. This requirement is the same for Section 8 housing tenants. See 12 U.S.C.A. § 5201, Title VII, § 703.
³⁵ 12 U.S.C.A. § 5201, Title VII, § 702.
³⁶ Cal. Civ. Code § 1785.13.
³⁷ Cal. Civ. Code § 1058.5.
³⁸ *Hamud v. Hawthorne*, 52 Cal.2d 78 (Cal. 1959).

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