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California's New Law Trading Foreclosure Moratorium for Mortgage Modification – Updated

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The California Foreclosure Prevention Act (the "Act") was enacted by the state Legislature, and signed by Governor Arnold Schwarzenegger on February 20, 2009. The bill (ABX2 7) was established as Chapter 5 of the 2009-2010 statutes. The Act resulted from Governor Schwarzenegger's legislative proposal to stem foreclosures in California by incentivizing servicers to offer "comprehensive loan modification programs." Although limited to California, the Act could serve as a model for similar legislation by other states. We last reported on this bill in November 2008 at: http://www.mofo.com/news/updates/files/14857.html.

Mechanics

The Act, which amends the California Civil Code as it relates to residential mortgage loans, uses a "carrot and stick" approach to advance its stated goal of allowing "additional time for borrowers to work out loan modifications while providing an exemption for mortgage loan servicers that have implemented a comprehensive loan modification program."

The "stick" is a mandatory 90-day moratorium on home foreclosures applicable to certain first lien mortgages. New Civil Code Section 2923.52 will add 90 days to the existing 3-month statutory waiting period between the recording of the notice of default and the giving of the notice of sale. Loans that are covered by the new legislation must meet four conditions: (1) the loan must have been recorded during the January 1, 2003–January 1, 2008 (inclusive) period, and must be secured by residential real property; (2) the loan must be a first mortgage or deed of trust; (3) the borrower must have occupied the property as his/her principal residence at the time the loan became delinquent; and (4) a notice of default must have been recorded against the property.

The "carrot" is an applied-for exception to the 90-day moratorium at new Civil Code Section 2923.53. Servicers may apply for an exemption order issued by the relevant "commissioner." The "commissioner" means the Commissioner of Corporations, the Commissioner of Financial Institutions, or the Real Estate Commissioner, as applicable. The law effectively provides that national banks, federal savings banks, and their respective operating subsidiaries will submit applications for exemption to the Commissioner of Corporations. Upon receipt of an "initial application" for exemption, the relevant commissioner "shall immediately notify the applicant of the date of receipt" and "shall issue a temporary order, effective from that date of receipt," exempting the servicer from the 90-day moratorium. The commissioner must make a final determination on an application within 30 days of receipt. If the commissioner concludes that the servicer has a comprehensive loan modification program, then the commissioner shall issue a final order of exemption. If the commissioner denies an application, the temporary order will remain in place for 30 days after the date of denial. Upon denial, the servicer may submit a revised application. The Act does not provide for the issuance of an additional temporary order upon receipt of the revised application. There is a process for revocation of final orders upon notice and a hearing, but a revocation will not be retroactive in effect.

The commissioner will issue an order only if the servicer evidences that it has implemented a "comprehensive loan modification program." To be "comprehensive," the loan modification program must have four key features. *First*, it must be intended to keep borrowers in their homes when the anticipated recovery under the loan modification "exceeds" the anticipated recovery through foreclosure on a "net present value basis." *Second*, the program "targets" a housing-related debt-to-gross-income ratio of 38% or less on an aggregate basis (i.e., based on all of the servicer's loans under the program; this ratio need not be achieved for each individual loan). *Third*, the program includes "some combination" of the following: (a) reducing the interest rate for at least five years; (b) extending the amortization period up to 40 years from the original date; (c) deferral of some unpaid principal until loan maturity; (d) reducing the principal; (e) compliance with a federally mandated loan modification program (note – the federal program must be mandated, not optional); and (f) "other factors" that the commissioner determines are appropriate. *Fourth*, the program seeks to achieve "long-term sustainability" (which is not a defined term) for the borrower. For the target 38% ratio, the borrower's housing-related debts include loan principal, interest, property taxes, certain housing-related insurance, and homeowner association fees.

A notice of sale is required to include a declaration from the servicer stating whether the servicer has obtained a temporary or final order of exemption from the commissioner, and whether the 90-day moratorium does not apply.

Violations of new Sections 2923.52 and 2923.53 are deemed to be violations of the person's "license law as it relates to these provisions." No separate right of action is expressly stated, but any violation presumably can create exposure under a variety of legal theories, including the California Unfair Competition Law.

The final version of the Act contains the following limited exceptions:

- The loans were made, purchased, or serviced by a California state or local public housing agency or authority. There is also an exception for loans that are collateral for securities purchased by such an agency or authority.

- The borrower has surrendered the property. This is demonstrated by the borrower's letter to the servicer confirming the surrender, or the borrower's delivery of the keys to the property to the servicer. The new Act does not prescribe the specific contents of the surrender letter.

- The borrower 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." As a practical matter, it will probably be extremely difficult for a servicer to demonstrate the availability of this exception.

- The borrower has filed for bankruptcy under Chapter 7, 11, 12, or 13.

The Act provides nothing more than a basic framework for the 90-day moratorium and exemption process, with the details to be set forth in implementing regulations. The effective date of the new law is May 21, 2009. The commissioners are to issue emergency and final regulations no later than 10 days after the effective date. The regulations must create an application form for the exemption process, clarify the application of Sections 2923.52 and 2923.53, and establish requirements regarding the reporting of loan modification data by servicers. The moratorium provisions become operative 14 days after the issuance of the regulations. The new provisions remain in effect until January 1, 2011, unless extended.

The new law requires the Secretary of Business, Transportation and Housing to make periodic reports to the Legislature on implementation and actions taken under the Act. The initial report is due three months after the first exemption is granted, and subsequent reports are due every six months thereafter. The commissioners are required ("within existing resources") to collect data from "some or all" servicers on loan modifications accomplished under the Act, and to make the data available on an Internet web site at least quarterly. The Secretary of Business, Transportation and Housing is required to maintain an Internet web site that contains information regarding final exemption orders, including links to web sites that describe loan modification programs. This might suggest that servicers who receive final orders must maintain such web sites, but the new law does not specifically require it.

The new law does throw a few bones to loan servicers, but they are likely to give small comfort because of the additional expenses to which servicers will be exposed:

- The failure to comply with Sections 2923.52 and 2923.53 does not invalidate a sale that is otherwise valid under Civil Code Section 2924f. However, the effect of this is unclear, given a corresponding amendment to Civil Code Section 2924(a)(3) to incorporate the 90-day moratorium provisions of Section 2923.52.

- Sections 2923.52 and 2923.53 do not require a servicer to violate contractual agreements for investor-owned loans, or to provide a modification to a borrower who is not willing or able to pay under the modification. However, no details are provided regarding the standards for making such determinations regarding the borrower.

- The submission of an application for an exemption by a national bank, a federal savings bank, or the operating subsidiary of either shall not confer on the commissioner visitorial authority over the institution. Further, nothing in Section 2923.53(j) is "intended to affect the authority of the commissioner over a federally chartered financial institution pursuant to federal law or regulation."

Although it remains to be seen how many servicers will actually adopt a "comprehensive loan modification program" and submit to the exemption process in return for avoidance of the 90-day moratorium, it is likely that many servicers will submit to this process, particularly if the federal bankruptcy laws are amended to allow cramdowns for residential mortgages. If California's "carrot and stick" approach is successful, it may become a model for other states. Some elements of the Act, in particular the 38% ratio, are similar to the program that the FDIC has implemented for mortgage borrowers at IndyMac Federal Bank. The 38% ratio also dovetails with the Obama Administration's announced mortgage plan (for eligible loans), because once a servicer achieves the 38% ratio mark, the federal plan would match interest reductions dollar-for-dollar to bring the ratio down to 31%.

Unanswered Questions

The proposal leaves many questions unanswered, including:

- If a servicer services loans for multiple investors, must the servicer's comprehensive modification program be put into place for all of its investors' loans, or only for the investors holding the particular loans that would otherwise be subject to the new 90-day moratorium?

- What impact will the Act have on national banks, federal savings banks, and their respective operating subsidiaries? Can these institutions avoid the new law by use of the federal preemption doctrine? Is there an enforceable legal basis to require these federal institutions to seek an order from a state regulator? If the Act is preempted, will it be preempted based upon the federal status of the owner of the loan or the federal status of the servicer of the loan? The Act contains language (noted above) that pays lip service to the federal preemption doctrine, but it remains to be seen whether this language will be sufficient to save the Act from a federal preemption challenge.

- The servicer's modification program must be intended to keep borrowers in their homes when the anticipated recovery under the loan modification "exceeds" the anticipated recovery through foreclosure on a "net present value basis." But, how will the net present value be determined, what numerical assumptions will be employed to calculate the net present value, and what level of excess will be enough? Will these issues be addressed by the implementing regulations?

- If a servicer's application for an exemption is denied, what is the process to challenge the rejection?

- Will the Act be challenged by servicers and investors, who can expect their expenses to increase substantially?

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