May, 2016

Sloppy, Sloppy, Sloppy: The State of the Mortgage Market

David J Reiss

Homeowner Bill of Rights in 2012, which requires the loan servicer to ensure that the necessary documentation is in place before foreclosing.

Sloppy, Sloppy, Sloppy: The State of the Mortgage Market

David Reiss

David is a Professor of Law at Brooklyn Law School and the Academic Program Director of the Center for Urban Business Entrepreneurship (CUBE). He is also the editor of REFinBlog.com, a real estate finance blog.—RB

Much of the discussion about the recent California Supreme Court case *Yvanova v New Century Mortgage Corp.* (2016) 62 C4th 919 has focused on the scope of the court's narrow holding, "a borrower who has suffered a nonjudicial foreclosure [in California] does not lack standing to sue for wrongful foreclosure based on an allegedly void assignment merely because he or she was in default on the loan and was not a party to the challenged assignment." 62 C4th at 924. This is an important question, no doubt, but I want to spend a little time contemplating the types of sloppy behavior at issue in the case and what consequences should result from that behavior.

Sloppy Practices All Over

The lender in *Yvanova* was the infamous New Century Mortgage Corporation, once the second-largest subprime lender in the nation. New Century was so infamous that it even had a cameo role in the recently released movie, *The Big Short,* in which its 2007 bankruptcy filing marked the turning point in the market's understanding of the fundamentally diseased condition of the subprime market.

New Century was infamous for its "brazen" behavior. The Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States (Jan. 2011) (Report), available online at https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf, labeled it so because of its aggressive origination practices. See Report at p 186. It noted that New Century "ignored early warnings that its own loan quality was deteriorating and stripped power from two risk-control departments that had noted the evidence." Report at p 157. It quotes a former New Century fraud specialist as saying, "The definition of a good loan changed from 'one that pays' to 'one that could be sold." Report at p 105.

This type of brazen behavior was endemic throughout the mortgage industry during the subprime boom in the early 2000s. As Brad Borden and I have documented, Wall Street firms flagrantly disregarded the real estate mortgage investment conduit (REMIC) rules and regulations that must be complied with to receive favorable tax treatment for a mortgage-backed security, although the IRS has let them dodge this particular bullet. Borden & Reiss, *REMIC Tax Enforcement as Financial-Market Regulator,* 16 U Penn J Bus L 663 (Spring 2014).

The sloppy practices were not limited to the origination of mortgages. They were prevalent in the servicing of them as well. The National Mortgage Settlement entered into in February 2012 by 49 states, the District of Columbia, and the federal government, on the one hand, and the country's five largest mortgage servicers, on the other, provided for over $50 billion in relief for distressed borrowers and in payments to the government entities. While this settlement was a significant hit for the industry, industry sloppy practices were not ended by it. For information about the Settlement, see Joint State-Federal National Mortgage Servicing Settlements, available at http://www.nationalmortgagesettlement.com/, and State of California Department of Justice, Office of the Attorney General, *Mortgage Settlements: Homeowners*, available at https://oag.ca.gov/mortgagesettlement.

As the subprime crisis devolved into the foreclosure crisis, we have seen that those sloppy practices have persisted through the lifecycle of the subprime mortgage, with case after case revealing horrifically awful behavior on the part of lenders and servicers in foreclosure proceedings. I have written about many of these Kafkaesque cases on www.REFinBlog.com. One typical case describes how borrowers have "been through hell" in dealing with their mortgage servicer. *U.S. Bank v Sawyer* (Me 2014) 95 A3d 608, 612 n5. Another typical case found that a servicer committed the tort of outrage because its "conduct, if proven, is beyond the bounds of decency and utterly intolerable in our community." *Lucero v Cenlar, FSB* (WD Wash, Sept. 30, 2014, No. C13–0602RSL) 2014 US Dist Lexis 139847, *23. *Yvanova* alleges more of the same.

Alleged Sloppy Practices in *Yvanova*

Central to the allegations of *Yvanova* is the claim that "her deed of trust was assigned to the Morgan Stanley investment trust in December 2011, several years after both the securitized trust's closing date and New Century's liquidation in bankruptcy, a defect plaintiff claims renders the assignment void" for the purposes of the foreclosure action. 62 C4th at 942. If true, this allegation encapsulates the whole range of sloppy behaviors in the subprime sector in one short sentence: The deed of trust was not dealt with properly at the time of origination for the purposes of the REMIC rules; it was not dealt with properly while Yvanova was current with her payments; and it was not dealt with properly at the time of its foreclosure. To me, this type of behavior seems pretty outrageous. But it does have its apologists.

Joshua Stein, a preeminent real estate lawyer, is one. He agrees that (*Dirt Lawyers versus Wall Street: A Different View*, 27 Probate & Property 6 (Nov./Dec. 2013)):

> Notes were not properly endorsed. Lenders lost them. Assignments were never recorded, or were recorded in the wrong order or with gaps. Transfers that should have been made weren't. Notes followed one path of transfers, mortgages another. When the music stopped, enforcement became a problem because servicers couldn't figure out the

paper trail. To fill gaps, those in the back room sometimes undertook a goal-oriented creative writing program.

But he concludes that, "[R]ealistically, lenders don't often try to foreclose on loans they don't own or that aren't in default." 27 Probate & Property at 7. To make matters worse, "[W]hen loan servicers tried to clean up the files, borrowers cried fraud." Instead, for Stein, the situation cries out for relief for lenders from the formalistic requirements of real property law. 27 Probate & Property at 6.

The *Yvanova* court repudiates that view. It states that it "is no mere 'procedural nicety,' from a contractual point of view, to insist that only those with authority to foreclose on a borrower be permitted to do so." 62 C4th at 938. Quoting Georgetown Law Professor Adam Levitin, the court finds (62 C4th at 938, quoting Levitin, *The Paper Chase: Securitization, Foreclosure, and the Uncertainty of Mortgage Title*, 63 Duke LJ 637, 650 (Dec. 2013)):

> Such a view fundamentally misunderstands the mortgage contract. The mortgage contract is not simply an agreement that the home may be sold upon a default on the loan. Instead, it is an agreement that if the homeowner defaults on the loan, *the mortgagee* may sell the property pursuant to the requisite legal procedure. (Emphasis added and omitted by court.)

Sounds like common sense to many dirt lawyers, but there are many others who agree with the "Wall Street" perspective of Joshua Stein.

Sloppy Future?

Before we celebrate *Yvanova*'s commitment to the rule of law, let us remember that courts have not consistently required close adherence to foreclosure laws and that many homeowners have not had the opportunity to pursue their claims in court. So *Yvanova* stands for a good principle, but one that is too often breached. There are many powerful players on Wall Street and in the Capitol who fundamentally disagree with this principle. So, while *Yvanova* should make our hearts glow for its upholding of procedural safeguards, we must continue to wait for systemic fixes at the state and local level that will make such protections the norm, not the exception, throughout the life cycle of residential mortgages.

Yvanova and Nothing-Backed Securities—REMIC Rules the PSA

April Charney

April is a consumer lawyer specializing in foreclosure defense trial work and lawyer education and training. She is licensed in Florida and Arkansas.—RB

The standard pre-2015 pooling and servicing agreement (PSA) provides that the "Trustee … undertake[s] to perform such duties and only such duties as are specifically set forth in this Agreement." See, *e.g.,* §6.01(a) ("Duties of Trustee and Security Administrator") of the trust agreement ("sample PSA") available online at http://www.sec.gov/Archives/edgar/data/1349285/000114420406006271/v035256_ex4–1.htm. See also sample PSA §2.01 ("Creation and Declaration of Trust Fund; Conveyance of Mortgage Loans"), which limits the assets that the trustee can accept for placement into the trust.

Section 10.02 of the sample PSA ("Prohibited Transactions and Activities") provides that "[n]either the Depositor, … nor the Trustee shall … accept any contributions to any REMIC after the Closing Date" in order to avoid a result adverse to the status of any Trust REMIC as a REMIC or to cause any Trust REMIC to be subject to a tax on "prohibited transactions" or "contributions" pursuant to the REMIC provisions. Mortgage notes have to be properly endorsed and "delivered" to the trustee by the Depositor showing a complete chain of endorsement from the originator as part of a REMIC qualified mortgage loan with the transfer of the note to the trust occurring before the closing date identified in the PSA. This process ensures that the mortgage loan is protected from the clawback powers of a bankruptcy trustee to avoid a preferential transfer, should the originating lender file for bankruptcy.

There is some confusion about whether New York's statutory or common law applies to REMIC trusts when the PSA specifies that New York law applies. But even under the New York statute, "[i]f the trust is expressed in the instrument creating the estate of the trustee, every sale, conveyance or other act of the trustee in contravention of the trust, except as authorized by this article and by any other provision of law, is void." NY Estates Powers & Trusts Law §7–2.4. Under the PSA, REMIC beneficiaries are explicitly forbidden the power to ratify a trustee's acceptance of an untimely and nonconforming transfer of a mortgage loan into the REMIC trust. The mortgage loan is defined as the note and mortgage transfer memorializing documents specified in Article 2 of the sample PSA. There are no New York Court of Appeals decisions directly on point.

A beneficiary of a REMIC trust cannot ratify an untimely, nonconforming, nonqualifying transfer of a mortgage loan past the closing date of the trust without risking an adverse result to the REMIC's special tax status; the REMIC trustee is constricted to act in a manner that will not jeopardize the trust's REMIC status. The applicable IRS REMIC regulations are referenced in the definitions section (1.01) of the sample PSA. Under IRC §860G(d)(1), the beneficiaries would be exposed to a 100 percent tax on the value of the nonconforming, nonqualifying asset contributed to the trust by the ratification of ultra vires acts of the trustee.

There is no opportunity for the beneficiaries of a REMIC trust to ratify the untimely stuffing of mortgage loans that are already in default into the res of the trust. Such an act by a REMIC trustee is not voidable, but is void ab initio. It is not possible for REMIC beneficiaries to ratify untimely nonqualifying asset transfers that would bring on an adverse tax consequence. *Glaski v Bank of America* (2013) 218 CA4th 1079, 1096, reported at 36 CEB RPLR 111 (Sept. 2013). The decision in *Springer v U.S. Bank* (SD NY, Dec. 23, 2015, No. 15–CV–1107(JGK) 2015 US Dist Lexis 171734, appeal