<u>INSECURITY</u>
<u>(The State of the State on Borrower Attacks on Enforcing Securitized Loans)</u>

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In the history of the United States, as long as there have been loans secured by a borrower's home, there have been efforts by defaulting debtors to avoid foreclosure on their property. Every State permits some form of judicial foreclosure and roughly half the States also recognize the right to conduct a "private" or non-judicial sale pursuant to an agreement in the loan documents. In order to protect the borrowers, the States have taken different approaches involving various degrees of regulating the conduct of such sale. In California, since the 1930s, these steps have been codified by Civil Code §§ 2924, et seq.

As recognized by the California Supreme Court in *Dreyfuss v. Union Bank of California*, (2000) 24 Cal. 4th 400, 411:

> The nonjudicial foreclosure provisions evince the legislative intent to establish an equitable trade-off of protections and limitations affecting the defaulting borrower and his or her creditor. In a nonjudicial foreclosure, the borrower is protected, inter alia, by notice requirements and a right to postpone the sale, in order to avoid foreclosure either by redeeming the property from the lien before the sale or finding another a purchaser. (Civ. Code, §§ 2903, 2924, 2924g.) Nonjudicial foreclosure proceedings must be conducted by auction in a fair and open manner, with the property sold to the highest bidder (*id*., § 2924g), permitting the borrower, or anyone else, to participate in setting the price for the property. Most important, the borrower is relieved from any personal liability on the debt. (*See Roseleaf Corp. v. Chierighino* (1963) 59 Cal. 2d 35, 42 [27 Cal.Rptr. 873, 378 P.2d 97].) Thus, in the event of a default, the borrower stands to lose only such property as he or she specifically chose to place at risk, leaving the creditor to carry the burden of any additional loss in value if the amount of the debt exceeds the value of the assets pledged as security for the loan. For its part, the creditor gains the certainty of a "quick, inexpensive and efficient remedy." (*Moeller v. Lien, supra*, 25 Cal. App. 4th at p. 832.) **A properly conducted sale does not require judicial oversight and constitutes "a final adjudication of the rights of the creditor and debtor.**" (ibid).
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> [emphases added].

Indeed, the California Supreme Court in *I. E. Associates v. Safeco Title Insurance Company*, (1985) 39 Cal.3d 281, 288 had previously cautioned that: "There are, moreover, persuasive policy reasons which militate against a judicial expansion of those duties. The nonjudicial foreclosure statutes -- an alternative to judicial

foreclosure -- reflect a carefully crafted balancing of the interests of beneficiaries, trustors, and trustees."

For many years, these precepts precluded most borrower challenges to non-judicial foreclosures from getting very far. The most successful attacks often tended to be on issues as to the origination of the loan or alleged failures to comply with the statutory requirements for non-judicial foreclosures. However, as a result of the financial crisis created, in part, by the sub-prime mortgage "melt-down" starting around 2007, the number of foreclosure proceedings boomed. As a reaction to that boom, an ever-increasing number of legal challenges by borrowers began to be filed. Compounding the problems, on both sides of the foreclosure process, was the ever-increasing number of loan securitizations.

Whereas real estate secured loans used to traditionally be made and serviced by the original lender, the past few decades have seen many such loans being sold in the secondary market after origination, often in the form of bundled loans sold to a securitized trust. According to recent figures, as of the third quarter of 2014 over $2.7 *trillion* dollars in loans were being held in mortgage pools or securitized trusts. In most cases, the securitized trust utilizes a third party to service the loans and, where the loan was a MERS loan, no formal assignment of the deed of trust from the original lender to the securitized trust would occur at the time of actual acquisition but, rather, often not until after a default on the loan or the transfer of the loan to a non-MERS member.

Borrowers and their counsel eventually sought to capitalize on the unique aspects of the securitization by raising challenges specifically geared to those unique aspects. The most common challenges have been:

A. Standing – essentially asserting that only the original lender and/or foreclosure trustee could enforce the loan and foreclose on the deed of trust. Sometimes the borrowers maintain that they never consented to their loan being sold or securitized; other times, the focus is on borrower demands that the new servicer or owner of the loan produce the (properly endorsed) original note or deed of trust and show an unbroken chain of transfer (that is to say, recorded assignments) as a precondition of enforcement.

B. Splitting – particularly where MERS is named as the beneficiary in the transaction, borrowers insist that the deed of trust has been separated from the note and that, as a result, the note has become an unsecured obligation.

C. Effect – some borrowers attempted to claim that their loan had been "paid off" by the securitization and, thus, no debt was still owed.

D. Timing – here the borrowers seek to use the securitization documents against the servicer and/or investor, pointing to the closing date for the securitized trust set forth in the Pooling & Servicing Agreement (or other documents) and claiming that the recording of the assignment of the deed of trust (or sometimes the transfer of the note itself) took place after that closing date. As a result, the argument goes, the transaction violated the terms of the Pooling & Servicing Agreement, the governing state trust law (typically New York), and/or federal regulations. The borrowers then take the position that the violation(s) render the whole transfer void and entitle them to retain the property free and clear of any lien.

In most instances, of course, the reality is very different than the borrowers hope it would be but proving the lack of merit of their challenges through a law suit can be time consuming and expensive for servicers and their principals, the trustee of the securitized trust and/or its investors. Fortunately, despite occasional adverse decisions, the majority of cases have rejected or at least limited the majority of the borrowers' theories.

One of the most successful lines of attack on borrower claims has been to point out that the borrowers are not parties to the securitized trust nor are they intended third party beneficiaries of the trust documents. Similarly, the borrowers are not parties to the recorded assignments or substitutions of trustee. As they are not parties to these documents, the defendants contend that the borrowers are the ones who lack standing to dispute the rights of the servicer, the foreclosure trustee and/or the trustee of the securitized trust to enforce the note and deed of trust. In other words, the borrowers should not even be allowed into the courthouse with these claims.

This argument seemed to catch the eye of most of the judges who considered it and defendants had very good success in defeating challenges based on claimed defects in the securitization process. However, in 2013, one of the California Courts of Appeal took a different approach. In *Glaski v. Bank of America*, 218 Cal. App. 4th 1079, 1095 (2013), the court bucked the trend and held that: "We reject the view that a borrower's challenge to an assignment must fail once it is determined that the borrower was not a party to, or third party beneficiary of, the assignment agreement. Cases adopting that position 'paint with too broad a brush.' …. Instead, courts should proceed to the question whether the assignment was void." The *Glaski* court then went on to find that *if*, as alleged in Glaski's pleadings, the transfer to the securitized trust occurred after the closing date of the trust then, under New York Trust law, it would be void rather than merely voidable. The *Glaski* court acknowledged that there were opinions in other (federal) courts that held otherwise but chose to side with the contrary view as, in its opinion, better reflecting the language and intent of the New York Trust law and the principles underlying the favorable tax treatment given to certain types of securitized trusts. NOTE that the court in *Glaski* did not find that there was in fact a post-closing

transfer nor that the transaction was void; rather, it merely determined that the borrower had pled a sufficient case which, *if proven*, would render the transaction void.

The California Supreme Court rejected the request to depublish *Glaski* and the defendants in *Glaski* never petitioned the California Supreme Court for review. Nonetheless, virtually every subsequent California case, both State and Federal, to consider the *Glaski* decision has, in some form or fashion, rejected it and its interpretation of New York Trust law as rendering a post-closing transfer void. In a December 14, 2014 ruling, one Judge noted that there were 77 decisions declining to follow the *Glaski* holding. A few of these contrary opinions were also published, originally, but at least three of them have since been depublished as a result of the grant of the unsuccessful borrowers' petitions for Supreme Court review. Currently pending before the California Supreme Court, and in the midst of briefing, is the case of *Yvanova v. New Century Mortgage Corporation*, the two other petitions granted by the Supreme Court [*Keshtgar v. U.S. Bank, N.A.* and *Mendoza v. JPMorgan Chase Bank*] have been held in abeyance while the Court decides *Yvanova.* Pursuant to the direction of the Court, the <u>sole</u> issue up for review in *Yvanova* is: "In an action for wrongful foreclosure on a deed of trust securing a home loan, does the borrower have standing to challenge an assignment of the note and deed of trust on the basis of defects allegedly rendering the assignment void?"

At the core of the issue on which the Supreme Court wants to focus its attention is the at least tacit presumption (but not a determination) that *Glaski* was correct, that a post-closing transfer would be void rather than merely voidable. However, that presumption is itself open to challenge. The weight of the case law interpreting New York Trust law does not in fact agree that a transfer after the closing date is void per se, nor that anyone other than a beneficiary of the trust has standing to challenge a late transfer. In *Rajamin v. Deutsche Bank Nat'l Trust Co.* (2d Cir. N.Y. 2014) 757 F.3d 79, 90 the Second Circuit held:

> In sum, we conclude that as unauthorized acts of a trustee may be ratified by the trust's beneficiaries, such acts are not void but voidable; and that under New York law such acts are voidable only at the instance of a trust beneficiary or a person acting in his behalf. Plaintiffs here are not beneficiaries of the securitization trusts; the beneficiaries are the certificateholders. Plaintiffs are not even incidental beneficiaries of the securitization trusts, for their interests are adverse to those of the certificateholders. Plaintiffs do not contend that they did not receive the proceeds of their loan transactions; and their role thereafter was simply to make payments of the principal and interest due. The law of trusts provides no basis for plaintiffs' claims.

The court in *Rajamin* took note of the decision in *Glaski* (and the New York trial court decision upon which *Glaski* relied) and found they had both misinterpreted the governing New York Trust law. Other New York State courts have come to similar conclusions as to the proper interpretation of New York Trust law and, accordingly, have ruled against third parties seeking to challenge trust actions as void.

Of course, the California Supreme Court is not bound by the Second Circuit's holding in *Rajamin* (nor by any of the other lower court decisions from the New York State courts) but it is likely to consider that decision to be persuasive authority as to the interpretation of New York law. In addition, the Court must consider whether it wishes to go against its prior rulings (such as *Dreyfuss* and *I.E. Associates,* discussed above) and impose additional requirements on the extensive legislative framework that governs non-judicial foreclosures. A countervailing consideration might be that the legislative history and intent behind the California Homeowners' Bill of Rights, particularly Civil Code § 2924.17 (requiring that recorded foreclosure documents "be accurate and complete and supported by competent and reliable evidence"), shows that the State Legislature has already determined that there should be borrower standing here. Whether that Section would apply to these types of securitization challenges seems dubious, though, as the attacks are not really based on accuracy or completeness, let alone reliability of evidence; moreover, that Section is scheduled to expire in 2018. Nonetheless, at least for the next few years, violations of § 2924.17 are actionable by the borrower so the Court may therefore need to consider that aspect as well. A final "x" factor in the calculus of how the Court will come out here is the recent appointment of two new Justices, who took their seats in January of this year. Neither has previously served as a judge so there are far fewer tea leaves to read as indicia of how they might view the issues here.

If the California Supreme Court does find that borrowers have standing, something we should know within the next year, it will then likely need to address the ensuing issues of:

1. Whether that standing depends on whether the transfer is void or merely voidable (and what is required of each side to show which);

2. Whether the borrower must show actual damages or other prejudice from the transfer that the borrower would not have suffered but for the transfer—current case law seems to favor such a requirement under a "no harm/no foul" view, with borrowers arguing that the loss of their home (and damage to their credit) is itself the harm while the lenders/servicers counter that any such harm would result from the default on the loan and would have occurred regardless of any transfer.

3. Whether borrowers must plead specific facts to support their contentions. While the general rule in State Court pleading in California allows, with certain exceptions, general pleading, many of the wrongful foreclosure opinions have held that, where a case arises in the context of a non-judicial foreclosure, a borrower needs to plead more specific facts to warrant allowing a challenge to the non-judicial foreclosure since it is designed to be a more expedited process.

The impact of an adverse Supreme Court ruling on the lending and foreclosure industries in California would obviously be significant, if not devastating, as it would create far greater expense and uncertainty for lenders, servicers and foreclosure trustees.

It would also inevitably further inundate an already over-burdened court system—yet another factor the Court will need to weigh, albeit probably not itself a dispositive one.

Although we are currently in a period of uncertainty while we await the Court's decision, the lower courts mostly continue to find in favor of the lenders and servicers' views on these securitization challenges. Even if the California Supreme Court ultimately disagrees and finds that borrowers do have standing, it would not necessarily (or even likely) prove fatal to the right to enforce the loan documents; it would simply create another hurdle which must—and can—be cleared on the path to foreclosure. If it becomes incumbent on the lenders and servicers to "show the note" and prove the chain of title, they should be able to do so. Accordingly, as a matter of good practice and procedure, when a loan is assumed, the prudent lender and/or servicer will make sure it has all the necessary documents to prove its rights to enforce the loans. Finally, if a loan is being modified or a forbearance agreement entered into, lenders and/or servicers should consider including in the documents either recitals or an estoppel certificate confirming that the borrower acknowledges the then current owner and/or servicer of the loan and their right to enforce that loan. These steps can increase the odds of keeping the loan on a secure footing.

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