There are a million financial and legal traps awaiting the unwary and overly naive mortgage servicer. These come into stark relief in default servicing, where a balance must be struck between compassion and reality when sizing up the appropriate remedy.

Reality-Based Servicing

By Bruce J. Bergman

LET ME BEGIN WITH THE PREMISE THAT THERE IS ANOTHER side to compassionate servicing and loss mitigation—the compelling need to temper understandable zeal with caution, selectivity and elevated vigilance. ■ It almost seems as though compassion has become the watchword of the servicers' faith—and why not? Benevolence to one's fellow man is virtually biblical. ■ That being so, there is some risk that anyone seen as even a marginal naysayer becomes suspect of blasphemy. There was, after all, a particularly telling observation in these very pages in February 2001: "Bad things happen to good people." (See article titled "Compassionate Servicing," *Mortgage Banking*.) That's true enough, and it sets a convincing stage for all the propositions supporting that compassionate approach to mortgage servicing. In the end, the notion appears unassailable, except that it doesn't explore all the components of the equation—leading to the earlier suggestion that there is another aspect of this subject worthy of consideration.

ILLUSTRATION BY SARAH HOLLANDER

Note initially that the perspective has somewhat less application to loss-mitigation efforts that occur before a defaulted mortgage loan is referred to counsel for foreclosure.

How vigorously early loss mitigation should be pursued is a function of business decisions and investor guidelines. The real focus of this article is instances when loss-mitigation efforts may affect or impede the foreclosure process. But first, some truths to buoy the skeptical.

Compassion and giving the borrower another chance are built firmly into the system already. Because nonperforming loans are inherently anathema to everything sacred in the mortgage industry, preventing them is systematically pursued as a matter of course. Fannie Mae and Freddie Mac, for example, have an elaborate mandate of correspondences to defaulting borrowers even *before* the required 30-day cure (breach) letter obliged by the widely used Fannie Mae/Freddie Mac form of mortgage.

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Even without Fannie and Freddie imperatives, calls and letters from the lender or servicer to a defaulting borrower are pervasive. Institutional lenders are almost never prone to pounce, and foreclosure only ensues after considerable warning.

No matter how many calls or letters—and regardless of how often the borrower may have defaulted in the past—still one more rescue opportunity is routinely afforded most borrowers. The commonly employed Fannie Mae/Freddie Mac form of mortgage and its derivatives require a breach (or 30-day cure) letter be sent to the borrower before and as a prerequisite to declaration that the entire debt is due acceleration. This correspondence must clearly advise the borrower of the nature of the default, what must be done to remedy the default and the fact that 30 days are available for that purpose. It must also recite the borrower's sundry rights under the mortgage.

So, even were there no conscious impetus to invoke compassion in the servicing methodology, a rational approach is already in place.

Next, begin with confidence in appreciating that the lender or servicer is the good guy. The lender made the loan. The borrower received the funds. This was not conceived to incur a loss. You should be as gracious as possible, but you do not need to become a patsy in pursuit of a perceived and sometimes abstract ideal.

The collection process—mortgage foreclosure cases in particular—typically must adhere to strict time frames or time lines. Weeks or months consumed in loss mitigation—if unsuccessful—could result in guidelines being exceeded.

Imposed constraints aside, perhaps more than in any other business or judicial endeavor, time is money. Interest literally accrues every day, sometimes at high default rates. Unless property values increase at a rate greater than interest accrual, eventually whatever equity cushion may have existed will be erased. In turn, any foreclosure surplus that would have been available to other creditors, and ultimately the borrowers themselves, has vanished. Concurrently, in most states the borrowers are personally liable for any deficiency. So in the event of misdirected compassion, both lender and borrower suffer more than if no time had been spent searching for an amenable solution.

Even beyond bureaucratic time constraints and mounting debt, delay occasioned in the collection or foreclosure process increases the duration of the property's exposure to deterioration. Frozen pipes in the winter, vandalism if the property is abandoned, pipes ripped out or other destruction by vindictive borrowers and loss by fire—arson or otherwise—are but a few of the perils naturally increased by the passage of time.

If insurance coverage has lapsed and the lender or servicer has been less than vigilant—and it happens on occasion—then a hazard loss becomes a disaster. Even if insurance is in force, carriers rarely write checks immediately, and the amount eventually paid does not always coincide with the true loss in value or cost to reconstruct.

There is yet another level of nuance to the time/hazard loss juxtaposition. Should a lender or servicer proceed to a foreclosure sale without pursuing a deficiency judgment, and before the insurance loss is paid, in most states the insurable interest has been extinguished. So the lender cannot collect at all.

While it is certainly true that bad things happen to good people, ill also befalls the less sympathetic. The following litany of those in the latter grouping will be familiar to most lenders and servicers:

■ The borrower who was supposed to be an owner/occupier, but wasn't.

■ The borrower who was just speculating in properties and bought too many at the wrong time.

■ The borrower who lied on the application about her income or employment status.

■ The borrower who was somehow in cahoots with a broker and an appraiser and stuck the lender with a falsely inflated value.

■ The borrower who engaged in a flip scheme.

■ The borrower who wasn't even who he said he was--such as the co-borrower's boyfriend instead of the husband.

■ The couple whose divorce action is so acrimonious that they are consumed with venom against each other and will not address the mortgage obligation.

■ The borrower who simply enjoys his Mercedes more than his house.

■ The borrower who adheres to the squeaky-wheel imperative; other creditors are more aggressive than the mortgage holder, so those others are paid, thereby exhausting available funds.

■ The borrower who knows how to use and abuse the system (especially in judicial foreclosure states), whose goal is to stall the foreclosure rather than settle it. Living for free for years is viewed by some as a worthwhile end.

■ The borrower who is in earnest but may simply lack the wherewithal to honor even the most generous of settlement terms. (But he or she still makes promises and seduces gracious lenders.)

■ The borrower influenced by the entreaties of his or her representatives—be they lawyer, friend, relative or debt counselor—whose advice, for a multitude of reasons, may be detrimental to the settlement process.

If the prospective recipients of the lender's largesse are borrowers who fit any of these categories (or any number of others), then caution is certainly in order. Such a warning is pointedly acute in judicial foreclosure states, where the foreclosure process is more tortuous and time-consuming. Even assuming that servicers have already tried to factor out the wily, the slippery and others abusing the system, the time factor in prosecuting foreclosures in judicial foreclosure states still demands servicers' wariness.

Each stage of a foreclosure case is a prerequisite to the next, and each must be methodically pursued. In general terms, and presuming a lender or servicer desires to offer or accept some settlement path, a possible error is to halt prosecution efforts awaiting resolution, all in an attempt to be indulgent and not increase the legal fees borne by the defaulting borrower. Some lenders or servicers may adopt such a posture because the borrower has, for example, "promised" to pay, or deliver a deed in lieu of foreclosure or enter into a mortgage modification agreement.

It is possible, though, that the promise to pay (or perform some act) in 10 or 20 or 30 days was overly optimistic—or disingenuous at the outset. Then the lender or servicer is stalled for weeks, or months, with only promises in hand and the foreclosure no nearer to completion.

Rather than allow borrowers' ability—or perhaps more accurately, inability—to settle to actually control the progress of the case, it is usually recommended that the action continue apace. In any event, continuation of the foreclosure should not cost the lender or servicer anything additional in legal expense if the matter is eventually settled or if the property brings the full upset price. (It does expose the borrower to some greater liability for legal fees, but there is *some* cost attendant to prosecuting the case and mortgage documents contemplate this as a borrower's responsibility.)

As an example, upon receipt of the acceleration letter, a borrower may call the lender or servicer seeking reinstatement and offering or promising to pay the overdue amount. The lender or servicer may very well view this favorably. (With a Fannie Mae/Freddie Mac uniform mortgage document, reinstatement must be accepted up until judgment.) At the same time (in the judicial foreclosure jurisdiction), counsel has started the machinery to prepare the legal papers, or "pleadings."

In any case, the borrower should be directed to have contact only with the lender's attorney. The attorney, as directed by the lender or servicer, then must decide whether to refrain from preparing the pleadings while awaiting the promised reinstatement or to proceed with the action notwithstanding the promise.

This is a business decision, not a legal one. If the borrower's promise is entirely sincere and supported by the ability to deliver the requisite sum relatively quickly (or settle in some other fashion), there is little danger in relying on the representation. The problem is the great difficulty in assessing borrowers' good faith and financial wherewithal. Servicers can likely attest to the conclusion that more often than not, borrowers' pledges will not be timely kept. Mindful that such is the case a significant percentage of the time, thought should be given to continuing case progress until sufficient amounts are actually paid or until some other form of settlement is achieved.

Assume next in a judicial foreclosure state that the defaulting—and until now, silent—borrower has been served with process and suddenly awakens and pledges to pay all arrears within 30 days, including late charges, legal fees and disbursements incurred. Nevertheless, the time for all defendants to answer expires in less than 30 days, at which time the action could proceed to the next stage. Completing that next step would increase the legal fee for which the borrower should be liable. If the lender or servicer is willing to accept reinstatement of the mortgage, a choice must then be addressed. Should it wait the 30 days or proceed to the next plateau?

The second option should be carefully considered. While it is correct that the lender's or servicer's attorney will be entitled to a fee commensurate with bringing the case to the next stage (whatever the amount of that sum), the additional expense is justifiably to be paid by the borrower. While there could be compelling reasons (which should be evaluated) to wait the 30 days, across a portfolio of mortgages, the likelihood is that most cases will be enmeshed in delay awaiting the promised payments.

In the rush to get a borrower's attention and start a dialogue, there is a clear danger that oral discussions can come back to haunt the servicer.

If lender's or servicer's counsel advises the borrower that nothing will be done for 30 days pending receipt of the reinstatement, an action that could have gone forward must stop. That 30th day must be entered into counsel's diary. If on that day payment has not arrived, only then can the attorney go forward—although specific permission may first have to be obtained from the servicer. That presents a potential for a few additional days (or more) added to the process. Multiplying this scenario by tens, hundreds or thousands of case files underscores the burdens, extra time and inefficiency created by delay incurred in anticipation of promised payments.

Even convinced of the wisdom that the foreclosure process should perhaps not be halted in the name of compassion, there are still safeguards concerning details and mechanics of the loss-mitigation or workout process that are important to avoid negative consequences.

In the rush to get a borrower's attention and start a dialogue, there is a clear danger that oral discussions can come back to haunt the servicer. This is one reason why, in commercial cases (such as foreclosure of shopping centers or apartment buildings), settlement efforts are always preceded with a letter that must be signed by the borrower confirming that all discussions are without prejudice to the servicer's rights and that the servicer is absolutely not bound by any verbal exchanges. Although recognizing that the volume of loans in the residential arena may prohibit such formal protections, nevertheless, underscoring the danger of oral discussions or agreements may have a salutary effect.

Case study No. 1

One way to dramatically highlight the perils is to review actual examples. In one instance, a corporate mortgage guaranteed by two individuals went into default when three consecutive quarterly installments (aggregating in excess of $8,500) remained unpaid. After three payment intervals, the bank declared due the entire balance of the mortgage. Three days later, and apparently chastened by the acceleration of the debt, counsel for the borrower and guarantors, together with an attorney for a partnership contemplating rescue financing for the corporate obligor, commenced negotiations with plaintiff's vice president. An oral agreement was struck, in furtherance of which the sum of $10,000 was delivered to plaintiff's attorney.

But an oral modification *is* enforceable if the party seeking enforcement can show partial performance of that agreement clearly tied in to the modification.

Later, unsatisfied with compliance upon the agreement's terms, plaintiff instituted foreclosure. The borrower contested the case. Through its vice president and attorney, plaintiff argued that the substance of the post-acceleration agreement was that defendants were to remit $10,000 in escrow, in return for which plaintiff would refrain from foreclosing, pending satisfaction of the full mortgage balance on a specific date. Obviously, the payment intended to elicit satisfaction was not forthcoming.

Defendants, their attorney and counsel for the prospective investor interpreted the tenor of the understanding quite differently. They said that the $10,000 represented payment of full arrears with the right granted to thereafter resume submission of the usual quarterly installments.

To some extent, the bank protected itself because, as the court observed, correspondence in the record *tended* to support plaintiff's version of the situation. In the face, however, of defendants' sworn statements, sufficient confusion was found to deny summary judgment to the lender.

The correspondence expected to be the saving grace proved inadequate to the task. The underlying truth in the case remains unknown. Although not stated in the decision, what was conspicuously fortuitous for the borrower, and at the same time unfortunate for the lender, was that the money paid rather neatly coincided with the amount of the delinquency, factoring in legal fees, late charges and perhaps some additional interest. One can infer that the court observed that the payment *looked* like what borrower urged it to be, that is, payment of arrears. And, the lender's file, although "tending" to highlight its position, was too irresolute to clarify the confusion without benefit of a written stipulation. Lack of a firm, written agreement, then, is really the key.

Case study No. 2

Then there is this scenario: Borrower was in default. The borrower claimed that an oral agreement was entered into with a representative of the lender-bank whereby the lender agreed not to declare a default (presumably, not to accelerate). This was to be in exchange for the borrower's agreement to remit rental income from the property to be applied toward reduction of the principal balance.

Whatever the truth of all this, apparently the borrower did send rental income to the bank, but the bank also declared a default. When the borrower sued the lender for damages for breach of contract and to enforce the oral modification agreement, the lender denied the existence of any such agreement. The lender argued that, in any event, the mortgage barred oral modifications. It sounded like a good argument.

It is true, the court said, that generally a written agreement (here, the mortgage) stating it can only be changed by a new writing means just that. But an oral modification *is* enforceable if the party seeking enforcement can show partial performance of that agreement clearly tied in to the modification. In other words, when the borrower sent the rental payments and the lender took them, it looked like there could be an agreement as asserted by the borrower. Again, lack of a written agreement torpedoed the benevolent lender.

This raises the subject of accepting checks after acceleration and when or if that gives rise to a waiver. Consulting with servicers' counsel in the 50 states will bring varying answers and nuance, all of which underscores the need for compassion to be accompanied by something in writing. Any agreement about repayment, satisfaction or recasting—particularly where a lender will refrain from enforcing its rights—should be reduced to an unassailably lucid document. Compassion is no less welcome when it is clear.

Lessons about forbearance agreements

Assuming this lesson was well learned long ago, what the document says is also critical to avoiding miscues. Consider the forbearance agreement, for example. This may very well be the most common loss-mitigation device. Although subject to great variation, in its most basic sense it is the mortgage-holder's pledge to forbear (not to foreclose) in exchange for certain remedial actions by the borrower.

Usually this means the borrower resumes remitting monthly installments with the addition of amortization of arrears over some period of time. Common variations include reduction of the installments for some duration with the shortfall added as a balloon at the conclusion, with or without interest.

Whatever the financial terms, the lender can still be punished for its beneficence. One of the most fertile defenses available to a defaulting borrower (primarily meaningful in judicial foreclosure states) is the claim of lack of jurisdiction. "I wasn't served." If true—or more precisely, if accepted by a court as true—it is fatal to foreclosure actions and wastes all the time consumed to that point. Therefore, a forbearance agreement must contain the borrowers' acknowledgment that they were properly served with the legal papers. Leaving that out of the agreement just creates a potential mine field for the mortgage-holder.

Servicers are aware that borrowers often default upon forbearance agreements—whether through insincerity, lack of financial wherewithal at the outset or a change in circumstance, among other reasons. Whatever the cause, breach is common. If the lender discontinued the foreclosure in exchange for the agreement, breach transports the lender back to the inception of the case. That leaves the lender relegated to incurring all the time and expense again. It is not lacking in compassion, therefore, to hold the foreclosure in place upon signing of the forbearance, poised to continue the action should default occur.

There is another possible event that could follow breach of the forbearance agreement. A once apparently reasonable but now desperate borrower could elect to litigate the case by asserting innumerable defenses, fanciful or otherwise. Of course, this assures delay in the case and—once again—accrual of interest. To guard against this consequence, the forbearance agreement should always require borrowers to withdraw any answer that had been submitted and waive any defenses claimed to exist.

Because mortgages themselves have grace periods, lenders might assume that adopting a like methodology in the forbearance agreement is appropriate. Doing so, however, means that an already stressed and strapped borrower is given free rein to remit payments with some leisure. If payment is due on the first of the month with a 15-day grace period (for example), why wouldn't the borrower—again, already one in difficulty—wait until around the 15th day? Well, he or she probably would, every month. That is hardly an aid to cash flow. But it can be worse. If payment is not received by expiration of the grace period, staff time is then incurred chasing yet another delinquency, and the situation becomes akin to what it was before the forbearance agreement ever existed.

There is also room for the borrower to insist that the check was sent, but either lost in the mail or misplaced by the lender's personnel. Then there is a legal dispute for future litigation. A recommended solution for these dilemmas is a provision in the forbearance agreement that payment must be *received* on the first day of the month (or whatever day it is), with time deemed of the essence. This shifts the burden to the borrower to assure receipt on a specific day, with no excuses available.

A related point is the issue of notice of default. The borrower, or his or her attorney, will often insist upon notice so that default doesn't silently precipitate continuation of the foreclosure. Putting aside the reasonable obligation upon the borrower to make sure the check is delivered in timely fashion, the problem with notice is that it again allows the borrower to be late with impunity. There would be no penalty for a tardy remittance. A warning would come and *then* the borrower could pay.

But the lender's problems here are many. If the borrower will regularly or often be late (which is easy to predict), staff will be assured of the monthly task of sending letters and awaiting whatever cure period is afforded. That generates more time and expense when a solution was supposed to be in place. There is also the possibility that the lender's system could stumble and the notice would not be sent. Or the borrower could claim he or she never received the notice. Even if certified mail is required (another expense), the borrower might conveniently never be home and therefore never sign for receipt.

The solution is not to provide notice. If, nonetheless, the lender believes some notice is appropriate, it can be limited to perhaps two or three defaults. In that way, a cap is put on the number of times the lender must be subject to the exercise.

Not surprisingly, there are more than a few other provisions that would help the lender's or servicer's posture in the forbearance agreement, but the lesson should be apparent: An excess of compassion attending the forbearance agreement can backfire. A mutually fair agreement can readily co-exist with the concept of compassion.

Some thoughts on the deed in lieu of foreclosure

Related thoughts apply to another common loss-mitigation device—the deed in lieu of foreclosure. If a foreclosure must proceed to its conclusion, the outcome is that the lender receives either the proceeds of the sale or the property itself if no one bids or if the amounts bid are unacceptably low. Should a borrower sense a hopeless situation that cannot be rescued in any fashion, he or she might offer to give the lender what would in the end be received anyway—title to the property. That is the deed in lieu of foreclosure.

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The advantage to the lender is getting the asset sooner rather than later, with commensurate savings in both time (translated into interest accrual) and actual expense of the foreclosure case. Should a borrower suggest a deed in lieu of foreclosure, it may present an amicable solution. But there are potential traps here, too.

Title to the property must be unencumbered. If the borrower has obtained other mortgages or suffered judgments, the lender would inherit those, which in turn could render the deed-in-lieu of little or no value. So no matter what the borrower might say, a search must be analyzed.

Just because a borrower expresses a desire to convey a deed-in-lieu does not mean the transaction will actually be concluded. Therefore, the collection or foreclosure process should not be stopped awaiting the professed conclusion that may never happen. Then, too, because the lender is in fact buying a parcel of property, the purchase of title insurance is appropriate. Although the search may show a clean title, there is room for error. This necessitates certain sworn statements by borrowers promising that there are no judgments or liens against them. Beware the borrower who refuses to sign such an affidavit—a refusal, not incidentally, that contributes to a waste of time.

Finally, the later in the progression of the foreclosure the deed-in-lieu is offered, the less value it has. Mindful that the idea is to shortcut the foreclosure process, acceptance of a deed near the auction sale date is of considerably diminished efficacy.

And what about the borrower who appears to be the perfect candidate for compassion because on the eve of the foreclosure sale he or she claims to have a buyer for the property who will save the day? The borrower therefore implores the lender to cancel or adjourn the foreclosure sale to accommodate the conveyance.

This is certainly tempting because it seems to offer the best of all worlds—the lender receives its money and the borrower is rescued. But without a written contract of sale, when—or if—the property will be sold is purely speculative. Even if there is a contract, whether it is legitimate—or if it is, whether the buyer has the financial ability to complete the purchase—may be unclear or uncertain. Even if those questions are answered, most sales are subject to the purchaser obtaining a mortgage commitment. Will the borrower's purchaser be approved for the mortgage? No one knows. Should the mortgage commitment be issued, it still does not assure a closing and it would hardly be the first time that a buyer got cold feet.

Regardless of all these imponderables, a lender might yet entertain canceling the sale. If the borrower's deal proves illusory, though, the lender will have incurred interest accrual for the hiatus period (weeks or months), additional sale advertising costs, possible further referee's or sheriff's fees and possible additional legal expense. So, an understanding attitude on the lender's part in this situation may not be without penalty.

By presenting these pitfalls in the loss-mitigation arena (although these are just a sampling of all the ones out there), have we created a straw man? To a certain extent, yes—to make a point. But the point is no less valid.

For every example of a sympathetic borrower saved by a compassionate loss-mitigation plan, there could be another borrower who abused the good deed and caused an even greater loss as a result. Certainly, there are defaulting borrowers who merit every ounce of consideration that can be extended, but caution is always advised in case the borrower proves unable or unwilling to work toward the hoped-for solution. Lenders and servicers can be careful and amenably determined while still being compassionate. **MB**

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