The 20 Greatest Loan Servicing MYTHS

Here are some common misconceptions about the intricacies of loan servicing.

BY ALAN WOLF AND BRUCE J. BERGMAN

THE DICTIONARY DEFINES "MYTH" as: "an unfounded or false notion or a . . . thing having only an imaginary or unverifiable existence." In the mortgage servicing world, there are a variety of myths that govern loan servicing practices. These myths may spring from a view that "it's always been done that way" instead of a careful analysis of the law and the facts. ■ In this article, we try to expose some of those myths, encourage loan servicers to think outside the box and challenge a variety of loan servicing practices that, upon closer analysis, may not be so well-founded. Perhaps this challenge will result in a helpful shift in many servicing practices. ■ We offer what we view as the 20 greatest loan servicing myths, provided in ascending order of importance. Careful consideration to each is invited.

ILLUSTRATION BY SARAH HOLLANDER

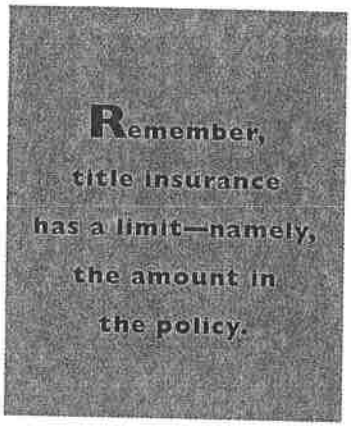
20. If a foreclosure sale is accidentally conducted, it can simply be canceled.

It would be very convenient if this were true, because there are more than a few occasions when the foreclosing servicer regrets that a foreclosure sale has occurred. For example, when a forbearance agreement was entered into but the loss-mitigation department forgot to advise the foreclosure department and/or the foreclosing attorney, and the sale occurs despite the agreement.

Similar mistakes can occur where lack of communication allows a foreclosure sale to proceed even though a reinstatement check was accepted. Having erred, the servicer would like simply to ask its counsel to declare the sale void. But it is not that simple.

In judicial foreclosure states, some court or public officer was involved who would often be reluctant to simply cancel the result of an important event—the foreclosure sale. And if a third party purchased at the sale, that person will be loathe to lose his or her gain merely because the servicer made a mistake.

Finally, in non-judicial foreclosure states, the power to sell the property is sometimes lost after a foreclosure sale, despite the sale having been conducted in error. In short, a court order will most often be needed, and whether the relief would be granted is often problematic. If the foreclosing lender acquired the property through its bid at the foreclosure sale, the motion to set aside the foreclosure sale will likely be successful. However, if a third party was involved, success is often unlikely.



19. If there is a fire loss on the eve of a foreclosure sale, the servicer must cancel the sale.

Where there is an insurable loss, such as a fire or flood, loan servicers often wait for the recovery of insurance instead of pursuing their right to foreclose. While insurance proceeds might solve the problem, the delays in recovery often put the servicer in a worse position; the losses accruing due to the delay may exceed the limits of the insurance.

A servicer can continue with its foreclosure despite its insurable loss, as long as it does so carefully. The key lies in the concept of an "insurable interest."

While the mortgage is in existence, the mortgage holder has an insurable interest. Once a foreclosure sale is concluded, either the money it received at the sale, or the property (if it took the property back) is deemed to be full payment of the debt—even if the mortgage holder was not fully compensated. This is because once the loan is considered fully satisfied, there is no loss and the insurable interest has evaporated.

Understanding that point presents an alternative to delaying the foreclosure sale and merely waiting for the insurance proceeds. The foreclosing party can indeed conduct the sale as long as it bids an amount equal to the reduced fair market value of the property at the time of the sale, and that bid is less than the amount owed on the debt. In judicial states, the foreclosing party must also pursue and obtain a deficiency judgment to preserve its insurable interest.

So, yes, a foreclosure sale after a fire loss could be postponed to pursue collection of insurance proceeds. However, a better approach in non-judicial states is to bid a deficiency equal to the value of the property at the time of the foreclosure sale, and in judicial states to seek a deficiency judgment.

18. Interest on the mortgage is just a matter of mathematics.

Mathematics is of course critical (the numbers must be right), but the most precise of calculations does not respond to the question of what interest rate should apply. The underlying point is that in many states (particularly in judicial foreclosure venues) the applicable rate of interest will vary with different stages of the foreclosure action. For example, in many jurisdictions the rate of interest applicable to the debt from the moment a payment is due until a declaration of acceleration is the rate in the note. Once the default is declared (or acceleration is manifested), then the default rate of interest (found in many mortgages) prevails. That typically higher rate controls until the judgment of foreclosure and sale is issued, at which time the interest rate reverts to the legal rate in the particular state.

Indeed, there is more nuance to these formulations—that is, a default rate can apply even to the judgment if the mortgage so states. Moreover (in New York, for example), interest can accrue upon not only principal, but the interest of each particular payment as well on all installments until acceleration is declared. A bankruptcy filing adds another layer of complexity to these calculations. Mindful that formulations such as these can be somewhat different throughout the states confirms the actuality that math alone does not yield the proper calculation.

17. If the mortgage was never recorded, it is just a problem for the title company.

It would be wonderful if title insurance always covered everything, but unfortunately that is not the case. Remember, title insurance has a limit—namely, the amount in the policy. Suppose, then, that a default ensues shortly after inception of a mortgage. Assume further that interest accrues at a default rate. Upon ordering a foreclosure search, it is revealed that the mortgage was never recorded and so a title claim is filed.

Title companies do not simply write a check under those circumstances. They most often pursue a cure—whether by searching for the missing mortgage, beginning an action to impose an equitable mortgage on the property, or any number of other approaches. To the extent that such avenues consume time, it is entirely possible that the amount of debt will very quickly accrue and exceed the amount of the title

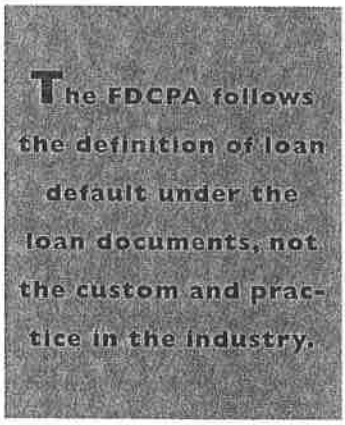
policy limits. Thus, delay in the resolution of a title loss, even if there is clearly insurance coverage, can result in damage beyond the policy limits and thus loss to the mortgage lender.

Under such circumstances, servicers should recognize that merely making a title claim is not enough. In addition, loan servicers should take vigorous action to cajole the title insurer to quickly resolve the claim. They may even have to call upon larger business relationships to secure the attention of the insurer or obtain the insurer's approval to pursue self-help methods with the servicer's own counsel.

16. You must always send out a 30-day default letter prior to foreclosing.

This myth arises from a provision in the uniform Fannie Mae/Freddie Mac mortgage form, which does indeed impose this obligation upon a mortgage holder. However, the mandate is usually confined only to those mortgage documents that actually impose it, and many non-Fannie/Freddie documents do not include this requirement.

In addition, state law throughout the United States generally does *not* require any notice to cure or notice of default as a prerequisite to acceleration and foreclosure. (There are some exceptions, sometimes applying only to junior mortgages or home-equity lines of credit [HELOCS].) So, for example, nonprime and commercial loan documents, among many others, would not necessarily have a provision requiring a 30-day default letter. Without it, there is most often no obligation to send such a letter.



Also, if the borrower is deceased, sending him or her a letter to afford 30 days to cure a default will hardly be productive. Similarly, if a mortgage has matured, there is no default to cure to return the loan to performing status; the money is just due, and so the cure letter is really of no value. And what is a servicer to do if the nature of the default is one that cannot be cured—for example, if the borrower has lied on an application and that is the basis of the foreclosure? Further mischief arises when an automatic stay is lifted, and a servicer may wonder if there is some necessity to send a new cure letter. (There isn't.)

In sum, avoiding yet another 30 days in the collection or foreclosure process is helpful, and servicers should not stumble by imposing it upon themselves *unless* the mortgage documents or state law actually require it. Most often, they don't.

15. Sending a communication to debtor's counsel instead of the debtor protects you from a stay violation.

Generally, any act that can be construed as an act against the interests of the debtor is a bankruptcy stay violation. Mortgage servicers are generally good in avoiding stay violations, because they are aware that acts in violation of the bankruptcy automatic stay are generally deemed to be void and, worse yet, may subject the servicer to damages, attorneys' fees and even significant sanctions. In short, it is rarely, if ever, wise to willfully violate the automatic stay.

However, a myth has developed in mortgage servicing that communications to debtor's counsel, as opposed to the debtor, somehow protect a servicer from a stay violation. This notion is simply false. Debtor's counsel is an agent of the debtor, and under laws of agency anything communicated to debtor's counsel is like speaking to the debtor directly. Thus, anything that might be said to the debtor that is a stay violation is similarly a stay violation if said to debtor's counsel. There is no free pass.

This is not to say that communications should be sent directly to the debtor. The Fair Debt Collection Practices Act (FDCPA) requires communication with debtor's counsel as opposed to directly with the debtor. But servicers need to be careful that the communication itself does not violate the stay even though it is sent to debtor's counsel as opposed to directly to the debtor.

14. A servicer can properly separate acquired loans into those subject to and those not subject to the Fair Debt Collection Practices Act.

The Fair Debt Collection Practices Act is applicable to all consumer loans where the beneficial interest, or servicing rights, are acquired at a time that the loan was in default. Where applicable, it places onerous and costly burdens on the servicing of loans.

Because of these burdens, it is understandable that servicers sometimes try to separate those loans subject to the FDCPA from those not subject to it, and service each group differently. Unfortunately, the belief that a servicer can properly separate acquired loans into these groupings is largely a myth. This is because the mortgage industry's definition of default, and the definition of the default under the standard loan documents, are quite different.

While the mortgage industry defines default as those loans 30 or more days past due, most loan documents define default as any payment not made by the payment date under the note. Thus, if the payment is due on the first day of every month, a payment not made by the first of the month renders the loan in default even though under industry custom and practice the loan is not yet in default until it is 30 or more days past due.

The FDCPA follows the definition of loan default under the loan documents, not the custom and practice in the industry. Therefore, it applies to the acquisition of the beneficial interest or servicing rights of any loan where payment has not yet been made by the due date under the loan documents. For example, if payment is due on the first day of the month and payment has not yet been made by the second day of the month, acquisition of the loan on that second day renders the loan subject to the FDCPA.

Given this definition, virtually all transferred loans are subject to the FDCPA. Instead of trying to determine which loans are subject to the act, servicers should simply treat all acquired loans as subject to it.

13. When I delete my e-mail, it's gone.

E-mail is a pervasive and wonderful communication tool when properly used. However, it is not always properly employed. The conversational tone of e-mail often leads servicers to write things that they never would write in the servicing system or in a carefully drafted letter. Accordingly, e-mail often constitutes the proverbial "smoking gun" in litigation. Servicers need better training in e-mail. They also need to be made aware that once e-mail is sent, there is no way to put the genie back in the bottle.

12. "Freemen" complaints can be ignored.

"Freemen," "militiamen," "gulchers," "bank freedom fighters" and "copyrighted natural persons" are names often given to describe borrowers who send nonsensical documentation to loan servicers claiming that the loan is not valid because the entire American commercial and legal system is invalid. The documentation often includes claims of a common-law copyright of a person's name and assertions that a person is a "natural person" and not subject to a court's jurisdiction; copies of purported liens against property to secure "self-executing security agreements"; and defenses based on the gold standard and the Magna Carta. Most of these documents are copied from a variety of Internet sites that cater to this philosophy.

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Although these "freemen" claims have been soundly rejected by the courts, they cannot simply be ignored. If documentation is filed with a court, servicers know that they need to respond—and they do. The problem arises when the documentation is merely sent to the servicer and not filed with any court. Many servicers believe that these ludicrous claims can then simply be ignored and the documents thrown out. That's a mistake. Despite the frivolous nature of the claims, they should be treated as a challenge to the validity of the debt under the Fair Debt Collection Practices Act, and in some cases even a Qualified Written Request under the Real Estate Settlement Procedures Act (RESPA), and responded to accordingly.

11. An attorney is just a vendor.

A great myth in the mortgage servicing industry is that attorneys are vendors and should be treated just as any other vendor. First, attorneys are not vendors; attorneys are fiduciaries, and as fiduciaries, they are held responsible for the general welfare of the client.

Perhaps even more compelling, the attorney/client relationship creates unique and very important privileges that can protect the servicer, including the attorney/client and work product privileges. Basically, these privileges protect the forced release of certain confidential information to adverse parties during litigation unless there has been a waiver. Unfortunately, treating an attorney as a mere vendor almost always waives the privilege.

10. You must file your bankruptcy proof of claim immediately.

Many servicers operate under the mistaken belief that a bankruptcy proof of claim must be filed immediately. Most have a requirement that the proof of claim be filed within one week of the time the bankruptcy referral is made to the attorney. There is no legal justification for this position, and the practice can lead to problems where, in the rush, the proof of claim contains errors.

Bankruptcy Rule 3002 provides that the proof of claim must be filed within 90 days after the first meeting of creditors (which generally occurs 30 days into the case). Thus, the industry's rush to file is based on a false deadline. In addition, case law and the new bankruptcy law amendments provide substantial penalties for errors in a proof of claim. Servicers need to take their time in filing proofs of claim, and get it right.

9. The Assignment of Rents Clause has no relevance to residential mortgage loans.

One of the most effective—but certainly least-used—remedies in a residential loan servicer's arsenal is the Assignment of Rents Clause. Virtually every mortgage has a provision whereby as further security for the debt, the borrower assigns to the lender all the rents that arise from the property. This is to protect the lender in the event that the loan is in default and the borrower is pocketing the rents produced by the property instead of paying the lender.

Where a commercial loan is in default, it is common practice to exercise the Assignment of Rents Clause by obtaining the appointment of a receiver. The receiver stands in the shoes of the owner, preserves the integrity of the property and collects all the rents to be used in reduction of the mortgage. Should a receiver not be appointed, the mortgage holder can elect to become a mortgagee in possession and do essentially what a receiver would have done, although that imposes issues of liability that lenders most often seek to avoid.

These same principles have application in residential loans. Instead of the current practice of simply waiting for the foreclosure sale to occur while the borrower absconds with the rents, residential mortgage servicers should exercise their rights to capture the rents under the Assignment of Rents Clause. Thus, and just as in the commercial context, a residential mortgage servicer can have a receiver appointed to collect the rents. Or alternatively (because the receivership is likely too expensive and cumbersome), the residential servicer can attempt to collect the rents directly by making written demand upon the tenants. When the income stream to the defaulting owner is denied, the zeal to continue delaying a foreclosure is likely to be reduced—considerably.

8. In the standard Fannie Mae/Freddie Mac loan documents, a mortgage lender is not entitled to the recovery of interest on pre-petition arrearages paid through a Chapter 13 plan.

Many years ago, a U.S. Supreme Court case provided that lenders were entitled to interest on the pre-petition

arrearages paid through Chapter 13 plans. For example, if the arrearages were $10,000 on the date of bankruptcy filing, the lender would receive that amount plus additional interest (often paid at 10 percent or more) over the three- to five-year term of the loan. The additional interest paid through such Chapter 13 plans was not only significant; in many cases it exceeded all the other servicing income combined.

Congress changed the law in 1994 by adding Bankruptcy Code section 1322(e), which provides that for loans executed after Oct. 22, 1994, a mortgage lender is not entitled to interest on pre-petition arrearages unless allowed under the loan documents and state law. Because the standard Fannie/Freddie documents do not provide for interest on interest, the loan servicing industry has concluded that it is not entitled to interest on pre-petition arrearages. That belief is a partial myth: While mortgage lenders using the standard Fannie/Freddie documents are not entitled to the interest on the interest component of pre-petition arrearages, they are still entitled to interest on any advances. This is because the standard Fannie/Freddie documents uniformly provide for interest on advances. Pre-petition advances can be significant. The failure of mortgage servicers to claim interest on pre-petition advances is a loss of significant income.

7. If all other servicers are doing it, then it must be legal.

Some loan servicers have the mistaken belief that the custom and practice in the industry determine whether a particular action is legal. For example, they often poll other servicers to determine the industry standard on various fees and costs (e.g., fax fees, online payment fees, etc.) to set their own fee structure. Similarly, they may simply assume that long-standing industry vendor structures (such as various outsourcing models) must be legally appropriate (otherwise they wouldn't be long-standing) in deciding whether to enter into such ventures.

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Unfortunately, the custom and practice in the industry, even if they are long-standing, by and large do not determine the legal analysis. Where there is a violation of law, the fact that "everyone is doing it" or "everyone has been doing it for a long time" is simply not a defense.

Instead of analyzing custom and practices, servicers need to shift their attention solely to what is legally permissible under current law. The results can be surprising. Many current practices have no basis in law.

6. If a servicer puts tendered funds into a "suspense account," it hasn't accepted the money.

A "suspense account" is defined as a temporary account in which entry of credits or charges is not made until their proper disposition can be determined. Basically, mortgage servicers use such accounts to place funds where there is some question as to whether and where the fund should be applied.

Unfortunately, there are a variety of myths associated with such accounts that have no basis in law. For example, many servicers wrongly believe that the placement of funds into a suspense account does not result in a legal conclusion that the funds have been accepted by the servicer. In fact, any funds received are generally deemed accepted unless immediately returned to the borrower. Thus, the mere holding of funds (such as a check) without deposit is alone legally sufficient in most states to constitute acceptance of funds. Placement of those funds in a suspense account actually makes the borrower's argument that the loan servicer has accepted the funds even stronger.

In short, a suspense account is not some type of magic account that precludes the legal conclusion that the funds have been received and accepted by the mortgage servicer.

5. There is a discharge of mortgage debt at the end of a standard Chapter 13 case.

Most mortgage servicers believe that a Chapter 13 discharge is like a Chapter 7 discharge in that the personal liability under the mortgage debt is discharged. In fact, long-term mortgage debt is *not* discharged in the typical Chapter 13 case. Bankruptcy Code section 1328(a) specifically precludes from discharge long-term mortgage debt. Thus, in the typical case a Chapter 13 discharge has no effect on mortgage debt.

4. When a judge has a certain view, that's it—you're stuck with the decision.

Servicing is now a national business. And uniformity is the key to controlling costs. Conversely, complexity breeds expense. In short, the servicing of loans is made all the more expensive by the need to service loans differently as required by the laws of a local jurisdiction.

One way around this expense is to obtain federal pre-emption of certain issues. Another way is to influence local laws so that they are consistent with the national mainstream, thus allowing servicing to be consistent among the states. Mortgage lenders are involved in these battles every day. However, a third approach, which is sometimes even more effective, is seldom used. That approach entails the appeal of the local decision to the next higher court.

Just like carefully drafted legislation, an appeal taken under the appropriate facts and circumstances can change an entire practice within a jurisdiction. Moreover, even where the mortgage servicer loses the appeal, at least the practice within the jurisdiction is determined. In short, an appeal generally helps, even when a servicer loses on the particular issue.

3. There can be no collection efforts or loss mitigation after a Chapter 7 discharge.

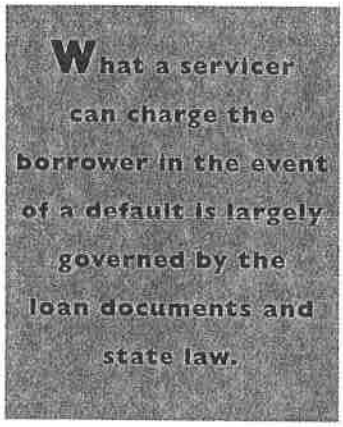
Wrong. A discharge in a Chapter 7 case does *not* mean that the loan has been discharged and no longer exists. Rather, and quite distinctly, a Chapter 7 discharge merely means that the personal liability under the debt is gone. As

a practical matter, that merely means that the mortgage lender cannot sue the borrower for a deficiency judgment. Otherwise, the loan is fully intact—even after the discharge—and collection efforts and loss mitigation can continue as long as those efforts make clear that there is no liability under the debt.

2. A mortgage servicer cannot directly charge for default-related work.

What a servicer can charge the borrower in the event of a default is largely governed by the loan documents and state law. The standard Fannie Mae/Freddie Mac documents—revised about five years ago—are carefully drafted to broadly define allowable charges in the event of default. Those documents provide that a mortgage servicer "may do and pay for whatever is reasonable or appropriate to protect the lender's interest in the property and rights under the security instrument" (Uniform Deed of Trust, section 9).

Moreover, the mortgage/deed of trust further provides that the "lender may charge borrower fees for services performed in connection with borrower's default for the purpose of protecting lender's interest in the property and rights under [the] security instrument. . . ." (Uniform Deed of Trust, Section 14). The documents are clear to provide that the allowable fees include, but are not limited to, a long laundry list of items.



To date, mortgage servicers have used this broad language for the recovery of various fees and charges incurred by outside third-party vendors. But there is no requirement in the loan documents that the costs be incurred by outside third-party vendors (i.e., the loan documents are broad enough to allow mortgage servicers to recover for their own internal costs caused by the default). Mortgage servicers need to review the language of their loan document, speak to their counsel and explore their rights to recover internal costs for loans in default.

1. A servicer cannot accept partial payments and continue to foreclose.

This is, unfortunately, an arena of considerable confusion—and yet clarity can be exceptionally helpful.

First, to avoid further disarray, address the situation of a 30-day cure letter having been sent. Assume that a borrower is three months in default at $1,000 per month, so that the letter demands that $3,000 be received no later than 30 days from the mailing of the letter. (For purposes of example, we can leave out late charges and other sums.) On the 20th day, the borrower remits $2,000. Can the lender accept it, or must it be returned?

The answer is found by inquiring as to the status of the loan at the conclusion of 30 days. Has a cure been remitted? No. Is the lender authorized to therefore begin a foreclosure because no cure was forthcoming? Yes. Therefore, accepting partial payment during the cure period is appropriate and has no deleterious consequences to the lender.

Turn now to the acceleration that comes after the 30-day cure period has expired, followed by initiation of the foreclosure action. During the course of the foreclosure the borrower remits a sum insufficient to reinstate the mortgage. What to do here is best understood by a further progression of thought.

The lender or servicer has declared due the entire balance of the mortgage and therefore need not accept anything less than that full amount. If the borrower, however, submits a sum sufficient to reinstate, and the servicer accepts it or holds it for an unduly long period of time (a question of fact that can vary from state to state), then the acceptance can be viewed as a waiver of acceleration, and there is then real danger to the foreclosure.

If, however, the remittance is *less* than the sum required to reinstate, then as a matter of law in most states, there is no issue of waiver and a lender is safe (at least as a matter of law) in accepting the money. But such a scenario opens the door for a borrower to argue that there was some agreement with the servicer about accepting this lesser sum. While the claim will typically be untrue, and while the servicer will deny any such arrangement having been made, if the record is not absolutely clear as to what occurred, it opens the door for a sympathetic court to find some question of fact or even rule that there was a waiver, thereby torpedoing the foreclosure action.

Note that where a Fannie Mae/Freddie Mac uniform instrument is used, reinstatement must be accepted at any time until the judgment (applicable in judicial foreclosure states)—but only upon payment of *all* sums then due. Thus, the analysis still applies; accepting less than all arrears does not cure the default and should not be a waiver.

In the end, then, the answer and resolution to the myth becomes a business decision rather than a legal one. Many servicers are willing to accept huge sums of money represented by partial payments across a broad portfolio, opting to have those funds in hand and take on the rare case where a borrower will try to make an issue of the partial payment and might even be successful. Other servicers, seeking to avoid any purported issue at all, will just reject any partial payment.

But the answer as a matter of law in most instances is that a partial payment can be accepted and the foreclosure can at the same time go forward. It is recommended under such circumstance that the servicer send a letter to the borrower acknowledging the receipt, confirming that it is accepted without prejudice and that the foreclosure is going forward. **MB**

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