2014 March LBA Legal Bulletin

Be Aware of New Federal Regulation Requiring Delay of Foreclosure Actions

A few bankers have asked me about a new federal regulation that requires a lender to wait 120 days after default before bringing legal action to foreclose on a mortgage loan. They are referring to the CFPB regulations that went into effect on January 10, 2014. The new regulations include changes to Regulations X under the Real Estate Settlement Procedures Act and to Regulation Z under the Truth in Lending Act Mortgage Servicing Final Rules as part of the implementation of the Dodd-Frank Act relative to mortgage loan servicing.

The 120 day foreclosure delay provision is part of a group of regulatory changes promulgated to give borrowers time to apply for federal loss mitigation assistance before foreclosure. The applicable provision is 12 CFR 1024.41(f)(1), titled "Prohibition on foreclosure referral", which provides as follows:

> *(f) Prohibition on foreclosure referral.*
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> > *(1) Pre-foreclosure review period. A servicer shall not make the first notice or filing required by applicable law for any judicial or non-judicial foreclosure process unless a borrower's mortgage loan obligation is more than 120 days delinquent.*
> >
> > *(2) Application received before foreclosure referral. If a borrower submits a complete loss mitigation application during the pre-foreclosure review period set forth in paragraph (f)(1) of this section or before a servicer has made the first notice or filing required by applicable law for any judicial or non-judicial foreclosure process, a servicer shall not make the first notice or filing required by applicable law for any judicial or non-judicial foreclosure process unless:*
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> > > *(i) The servicer has sent the borrower a notice pursuant to paragraph (c)(1)(ii) of this section that the borrower is not eligible for any loss mitigation option and the appeal process in paragraph (h) of this section is not applicable, the borrower has not requested an appeal within the applicable time period for requesting an appeal, or the borrower's appeal has been denied;*
> > >
> > > *(ii) The borrower rejects all loss mitigation options offered by the servicer; or*
> > >
> > > *(iii) The borrower fails to perform under an agreement on a loss mitigation option.*

Bankers have asked about how the 120 day delay is calculated and how it will be applied. Specifically, there are questions about whether a borrower can fail to make any installment payments for four months and then make an installment payment on day 119 after an installment is due in order to extend the delay of foreclosure for another 30 days. Unfortunately, the regulation is not clear on how it is to be interpreted and the staff commentary does not address this issue

either. In order to get some clarification, I was able to speak recently with CFPB Regulatory Attorney Andy Arculin. Mr. Arculin advised that he could not give an official interpretation or legal opinion on the regulation, but would nonetheless discuss the issue with me informally. He pointed out that the 120 day delay is part of the regulations pertaining to loss mitigation and that the foreclosure delay is designed to give the borrower time before foreclosure to apply for loss mitigation relief.

Mr. Arculin pointed out a few additional things that bankers might find helpful. He observed that the federal regulation does not address a lender's contractual right to accelerate the debt after default, which means that a bank can still invoke its acceleration clause when the borrower defaults on a payment thereby making the entire loan balance due. In addition, he observed that while there may be some Regulation Z provisions that require prompt crediting of payments, the regulations do not govern whether a bank is required to accept an installment after initial default. With a contractual acceleration clause and the ability to refuse future payments after default, it seems that a bank could avoid having a debtor manipulate or continuously extend the 120 delay. Mr. Arculin did not think that the 120 day delay was a rolling 120 day delay that would continually extend if an installment payment was made. He also observed that if a borrower defaulted and never applied for loss mitigation relief but tried to manipulate the 120 day delay, then the borrower would be asserting the delay protection outside the context for which it was intended. The informal feedback from Mr. Arculin seems to indicate that a debtor should not be permitted to manipulate the regulation by making a last minute payment on day 119 in order to continuously avoid legal foreclosure action. However, be cautioned that this was nothing more than an informal conversation with a CFPB member.

Mr. Arculin acknowledged that the CFPB is aware of the need for clarification on the issue of how 12 CFR 1024.41(f)(1) is to be interpreted and in particular how the term "120 days delinquent" is interpreted. Mr. Arculin did expect the CFPB to provide clarification relative to this issue and others through the issuance of a proposed new rule sometime this year.

Bankers also have had questions about what is meant by, "first notice or filing required by applicable law for any judicial or non-judicial foreclosure process". They want to know what actions can be taken to collect within the 120 day period. There is very little guidance on this issue except for a paragraph contained in CFPB's Official Bureau Interpretations. The CFPB's Supplement I to Part 1024-Official Bureau Interpretations provide the following explanation:

> *41(f)(1) Pre-foreclosure review period.*
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> *1. First notice or filing required by applicable law. The first notice or filing required by applicable law refers to any document required to be filed with a court, entered into a land record, or provided to a borrower as a requirement for proceeding with a judicial or non-judicial foreclosure process. Such notices or filings include, for example, a foreclosure complaint, a notice of default, a notice of election and demand, or any other notice that is required by applicable law in order to pursue acceleration of a mortgage loan obligation or sale of a property securing a mortgage loan obligation.*

Louisiana law does not require that a debtor in a residential mortgage note be provided with a formal demand letter before a lawsuit to foreclose is filed. This may however be a requirement by other states. In light of the CFPB's Official Bureau Interpretations, since a demand letter is not required in Louisiana law before filing a foreclosure law suit, then this should not be something that is subject to the 120 day delay unless a lender has contractually agreed to provide a formal notice of default to the borrower. Some banks may have contractually agreed to provide a formal notice of default before filing suit to foreclose and this is something that should be considered as possibly subject to the 120 day delay.

There is also uncertainty as to whether the regulatory language providing, "first notice or filing required by applicable law…" applies to a contractually agreed to notice of default or other such

notice or delay. The Official Bureau Interpretation is not clear on this point and refers to things "required by applicable law". This would clearly cover those things that Louisiana's Civil Code, statutes and procedural articles require, but what about contractual provisions agreed to by the lender and borrower in a mortgage agreement. A mortgage agreement could be considered as the law between the parties and therefore subject to the 120 day delay. Out of an abundance of caution, lenders should review their particular loan documents, including the note and mortgage, to see whether they have contractually agreed to provide a notice of default or other notice or delay before proceeding with filing suit to foreclose. If the lender has contractually agreed to provide the borrower with a written notice or delay before accelerating the debt or filing suit then the lender may want to consider this as something subject to the 120 day delay. The conservative approach would be to refrain from providing the borrower with the contractually agreed to notice until 120 days have passed after the borrower's default. It is interesting to note that contractual provisions requiring a notice of default may be fairly common. The Fannie Mae/Freddie Mac mortgage, form 3019 available on the internet, does include in paragraph 22 a clause requiring that the lender give notice to the borrower prior to acceleration.

The bottom line is that there is much uncertainty and confusion as to how the 120 delay of foreclosure regulation relates to how and when lenders begin the legal foreclosure process for residential mortgage loans. The LBA recognizes that this is an important issue for bankers and we will continue to work with the ABA and ICBA to obtain clarification on the points discussed in this article.

Pending Legislation – Could Allow Use of Imaged Documents in Executory Process

Many banks are moving to the use of electronic records storage. As banks make the transition to electronic records, they frequently ask why the law restricts the ability of a bank to use imaged documents to foreclose on a mortgage loan through executory process. Current law requires the use of an original note in order to use executory process to foreclose, but there is legislation currently pending in the Louisiana Legislature that could remove this restriction, which would enable banks to keep more loan records electronically. House Bill 661 by Representative Price was filed, which proposes to amend La. R.S. 13:3733.1 and add language to Title 6 relative to credit unions. We have been working with some members of the LBA Bank Counsel Committee to draft amendment language that would further revise R.S. 13:3733.1 as well as amend Articles 2636 and 2637 of the Louisiana Code of Civil Procedure which govern authentic evidence for executory process. Our amendment would help banks , savings banks, and savings and loan associations. It is expected that our amendments should be added on to the bill in the coming weeks.

The draft amendments intend to allow a financial institution, as defined in R.S. 13:3733.1(A)(1), to be able to use a reproduction of a promissory note instead of having to produce the original when foreclosing on a mortgage loan through executory process. The financial institution would be required to certify that the reproduced note is a true and correct reproduction of the original in accordance with the requirements of R.S. 13:3733.1. This type of certification is already being used by financial institutions to certify other documents such as the security agreement. It is expected that the amendments will also include language clarifying in Article 2637(C) that a certified reproduction of the hand note or other evidence of the actual indebtedness may be attached to the petition to help prove the existence of the actual indebtedness. We will continue to report to you as progress is made on this important legislation.

Court Decision Upholding Reliance on Power of Attorney in Suretyship

The Louisiana Fifth Circuit Court of Appeal issued a decision earlier this month affirming the trial

court's granting of summary judgment in favor of the creditor holding that the power of attorney in question was sufficient to bind the principal in a personal suretyship agreement. The facts involved a commercial loan to an LLC that included the personal guaranties of the individual members of the LLC. The members of the LLC were a husband and wife, Mr. and Ms. Muhs. Ms. Muhs was not present at the loan closing and instead executed a power of attorney beforehand naming her husband as mandatary. Mr. Muhs executed a personal guaranty on behalf of Ms. Muhs as her agent as part of the loan documents. The borrowers subsequently defaulted on the loan and the bank brought a foreclosure suit against the LLC and Mr. and Ms. Muhs personally.

The trial court granted summary judgment in favor of the creditor. Ms. Muhs unsuccessfully opposed the motion for summary judgment by arguing that Ms. Muhs was not personally liable for the LLC's debt because she had not validly authorized Mr. Muhs to bind her as a personal surety on the loan. Ms. Muhs made the same argument on appeal.

On appeal, the Fifth Circuit affirmed the trial court's holding and concluded that the power of attorney at issue here did expressly authorize this act. The Court recognized that Louisiana Civil Code article 2997 required that a POA grant express authority to the mandatary to contract a loan, acknowledge or make remission of a debt, or become a surety. The POA at issue, the Court noted, expressly gave Mr. Muhs authority to act as Ms. Muhs' agent in connection with a "loan transaction" with the Bank "and to execute any and all documents necessary to consummate said loan transaction." Mr. Muhs was also authorized to act "as fully" as she could as "if she were personally present and acting for herself." The Court interpreted this to mean that Mr. Muhs was authorized to bind Ms. Muhs personally.

The Court also pointed to La. CC art. 3021 and explained that Ms. Muhs' act of executing this particular POA caused the bank to believe the Mr. Muhs was her mandatary for this purpose and to contract with him as such.

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Gulf Coast Bank and Trust Co. v. Montoli &Pitre, LLC, 2014 WL 970155, 13-784 (La.App. 5 Cir. 3/12/14).

Recent UCC-9 Court Decision Upholding Bank's Security Interest in Equipment Collateral That Was Moved To Another State

The Louisiana Third Circuit Court of Appeal recently issued a creditor favorable decision in a case involving the lender's rights to movable collateral under Chapter 9 of the UCC. The facts involved a bank that had made multiple loans to a business to purchase equipment, including a Franklin flange unit. The bank, Farmers-Merchants Bank and Trust Company ("FM Bank"), held a purchase money security interest in the flange unit. Two years later, the borrower business, Southern Structures, sold the flange unit to Nucor. Nucor then had the flange unit shipped to South Carolina. Southern Structures defaulted on its loan with FM Bank, and the bank attempted to inventory its collateral and discovered that the flange unit was gone.

FM Bank sued to enforce it security interest and to recover damages and named Southern Structures, MH Precision, and Nucor as defendants. Nucor asserted that it purchased the equipment from MH Precision in good faith pursuant to La. R.S. 10:1-201(9) and as such was not liable to FM Bank. The trial court after a trial on the merits rendered a judgment against all three companies, jointly, severally, and in solido, in the amount of $276,000.00 together with legal interest from the date of judgment and all court costs.

Nucor appealed the judgment contending that (1) it should not have been held personally liable for damages and should not have been held to be in bad faith regarding the purchase of the flange unit; (2) the court did not have in rem or quasi in rem jurisdiction over the flange unit because it was not located in Louisiana; and (3) Nucor should have been considered a buyer in the ordinary course and entitled to keep the flange unit free and clear of FM Bank's security interest, further contending that MH Precision was the seller of the flange unit and MH Precision was acting in the ordinary course of business when it sold the flange unit. The Third Circuit was not persuaded by Southern Structures arguments and affirmed the trial court's holding in favor of FM Bank.

The Third Circuit addressed each of Southern Structures assignments of error. As to assignment number one, the Court found that the trial court did not err in finding that La. R.S. 10:9-315(a)(3) created a statutory avenue for a secured party to hold a third-party purchaser personally liable for damages. The Court explained that it interpreted an amendment to 9-315(a)(3) deleting the requirement of conspiracy to mean that the legislature intended to reduce the burden of proof required to impose personal liability on the buyer. The Court opined that based on the evidence, the trial court reasonably concluded that Nucor knew about a lien and acted to deprive FM Bank of its security interest.

The Court addressed assignment of error number two as to jurisdiction by pointing out that the real issue was whether the trial court had jurisdiction over the flange unit for the purpose of recognizing a lien, which is governed by the UCC. The bank loaned Southern Structures money to purchase equipment in 2005, which was located in Louisiana and was subject to a commercial security agreement. The Court explained that the subsequent relocation of the flange unit from Louisiana to South Carolina does not affect the bank's security interest as Louisiana courts have the authority to recognize a lien on property that was in the state when a valid security interest was created.

Nucor's assignment of error number three, contending that it purchased the flange unit in the ordinary course of business, was also unsuccessful. The Court in reviewing the evidence concluded that it was reasonable to believe that Southern Structures was the seller and Nucor was the buyer. The Court's analysis included referring to the definition of buyer in the ordinary course, La. R.S. 10:9-201(9), Section 9-320 defining buyer of goods, and the definitions of inventory and equipment, 9-102(48) and 9-102(33) respectively. The Court looked to testimony in the record and found that it indicated that the flange unit was not inventory used in the ordinary course of business of Southern Structures. Instead, the flange unit was a specialty piece of equipment used in the manufacturing process that was subject to FM Bank's lien. It concluded that the trial court was correct in finding that the transaction between Southern Structures and Nucor did not occur in the ordinary course of business.

The Court also addressed an alternative assignment of error raised by Nucor since the Court found that Nucor acted in bad faith. Nucor contended that there is no supportable finding of any type of intentional tort or willful action on the part of Nucor. The Third Circuit agreed with the trial court's finding that Nucor's purchase, while the bank was being kept at bay, was not a negligent act. According to the decision, the Court concluded that it was intentional. The Court noted that the unlawful act was a sale of equipment with knowledge of a lien against it and without any notification to the bank holding the lien in violation of La. R.S. 14:72.4. The Court agreed with the trial court's finding of solidary liability.

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Farmers-Merchants Bank & Trust Company, et al. v. Southern Structures, LLC, et al., 2014 WL 8525584, 2013-926 (La.App. 3 Cir. 3/5/14)

Private Works Act Case Upholds Validity of Subcontractor's Lien

A case was decided earlier this month by the Louisiana Third Circuit Court of Appeal affirming the trial court's judgment upholding the validity of a subcontractor's lien under the Private Works Act. A lien was filed by a subcontractor, Delta Development, LLC, for labor and materials utilized in remodeling a house. The property owner, Ms. Dermon, asserted at trial that the invoices referenced in the lien affidavit filed by Delta were not attached to the lien affidavit and that the invoices supporting the lien affidavit were not sufficiently descriptive of the work done and not properly filed in the Beauregard Parish mortgage records. At the trial, a representative of Delta testified that he executed the affidavit at issue. Delta also introduced into evidence the lien affidavit and accompanying invoices, along with recording data showing that the lien affidavit and invoices had been properly filed. Ms. Dermon did not offer any further evidence and relied on her previous argument contained in exceptions and motion for summary judgment that the invoices were not properly attached to the lien affidavit and were not sufficiently descriptive of the work done. The trial court found that the lien was timely filed, and the invoices for the work were properly itemized and attached to the lien affidavit filed in the Beauregard Parish mortgage records.

Ms. Dermon appealed the trial court's judgment based on the validity of the attachments to the lien affidavit. The Third Circuit affirmed the lower court's holding, finding that the trial court's specific finding that the invoices attached to the lien affidavit were legally sufficient to support the lien. The Court cited the decision of *Hibernia National Development Bank v. Belleville Historic Dev., L.L.C.*, 01-657, p.7 (La.App. 4 Cir. 3/27/02), 815 So.2d 301, 306 *writ denied*, 02-1177 (La. 6/14/02), 818 So.2d 785, in which the Fourth Circuit explained that the legislative intent of the Private Works Act was "to protect materialmen, laborers, and subcontractors who engage in construction and repair projects." In *Hibernia*, the court found that a technical objection to the lien, including the amount in dispute, was not sufficient to defeat the purpose of the Act.

UNPUBLISHED OPINION. CHECK COURT RULES BEFORE CITING. NOT DESIGNATED FOR PUBLCATION.

Delta Development, LLC, v. Rapid Response Restoration, LLC, 2014 WL 879202, 2013-1077 (La.App. 3 Cir. 3/5/14).

Appeals Court Rejects Retailer Challenge to Interchange Rule

The D.C. Circuit Court of Appeals recently overturned a lower court decision that would have required even lower debit interchange fee caps than the Federal Reserve's rule calls for. In a decision last July, District Court Judge Richard Leon said that the Fed's rule violated congressional intent in the Dodd-Frank Act by setting the interchange fee cap too high and failing to allow merchants to choose multiple unaffiliated PIN and signature networks for each card transaction they process. The matter was appealed to the U.S. Court of Appeals for the D.C. Circuit, and a three-judge panel rejected arguments from the retail industry and reversed the ruling of the district court that granted summary judgment to the merchants concluding that the rules violated the statute's plain language.

The Circuit Court disagreed with the district court's finding and explained in its opinion that by applying traditional tools of statutory interpretation, and held that the Board's rules generally rest on reasonable constructions of the statute and found that the Fed's rule "generally rests on a reasonable interpretation of the statute." Specifically, the appeals court upheld the Fed's use of fixed costs, network processing fees and fraud loss costs in the interchange fee cap calculation, although it said the Fed would need to provide further justification for its inclusion of transaction

monitoring costs. The court also found that the Fed followed the Durbin Amendment in its "anti-exclusivity" provision on network choice.

NACS, Formerly Known As National Association Of Convenience Stores, et al., v. Board Of Governors Of The Federal Reserve System, No. 13-5270, (D.C. Cir. 3/21/2014).
Read the D.C. Circuit opinion.

Note: The information contained in this LBA Legal Bulletin is not intended to constitute, and should not be received as, legal advice. Please consult with your counsel for more detailed information applicable to your institution.

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