Consumer Finance Monitor (Season 7, Episode 2): Foreclosing on “Zombie” Mortgages: What Lenders and Servicers Should Know

Speakers: Melanie Vartabedian and Matt Morr

Melanie Vartabedian:

Welcome to the award-winning Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer financial services and what they mean for you, your business, your customers and the industry. This is a weekly show brought to you by the Consumer Financial Services Group at Ballard Spahr. For those of you who want more information, don't forget about our blog, consumerfinancemonitor.com. We've hosted the blog since 2011, so there's a lot of relevant industry content there. We also regularly host webinars on subjects of interest to those in the industry.

So to subscribe to our blog or to get on the list for our webinars, please visit us at ballardspahr.com. If you like our podcast, let us know. You can leave a review on Apple Podcasts, Google, or wherever you get your podcasts, and please let us know if you have ideas for other topics we should consider covering or speakers that we should consider as guests on our show. I'm Melanie Vartabedian, a consumer financial services litigation partner in Ballard Spahr's Salt Lake City office. Today, Matt Morr, a consumer financial services litigation partner in our Denver office, and I will be discussing a note holder's ability to foreclose on what are called zombie mortgages.

Second mortgages where the borrower hasn't made a payment for quite some time, sometimes over a decade, and the lender hasn't taken action or sought to foreclose. But when the lender does seek to foreclose, borrowers assert various claims, including the statute of limitations has run. In other words, it's been too long, and the lender can no longer collect the debt. There's often also an intervening bankruptcy proceeding to complicate matters. So we're going to discuss how courts have addressed the statute of limitations in this situation. To start, I wanted to note that this issue has gotten the attention of the CFPB.

In April 2023, the CFPB issued guidance stating it may be illegal for debt collectors subject to the Fair Debt Collection Practices Act to use or threaten to use judicial processes such as foreclosures to collect a debt after a state statute of limitations expires. Now, here, the CFPB is focusing on piggyback mortgages generally. This piggyback mortgage product, known as the 80/20 loan, involved a first lien for 80% of the value of the home and a second lien for the remaining 20% of the home's valuation, and the CFPB characterizes the issue as follows. "Leading up to the 2008 financial crisis, many lenders relied on predatory practices to lock home buyers into mortgages they could not repay.

By and large, lenders did not pursue homeowners on second mortgages instead selling off these mortgages to debt collectors for pennies on the dollar. But now over a decade later and often without any intervening communication with homeowners who were able to save their homes, some of these debt collectors are demanding the mortgage balance, interest, and fees and threatening foreclosure on families who do not or cannot pay." The CFPB stresses that, "This prohibition applies even if the debt collector does not know that the debt is time barred.

Accordingly, any debt collector who's covered under the FDCPA and who brings or threatens to bring a state court foreclosure action to collect a time-barred mortgage debt may violate the law." The CFPB notes that, "Along with private plaintiffs, the CFPB and state attorneys general have the authority in appropriate circumstances to take action against institutions and individuals violating the FDCPA in its implementing Regulation F." So now I want to turn it over to Matt, who's going to talk about how courts have handled this issue and a little bit more background on it as well.

Matt Morr:

Thanks, Melanie. The CFPB is, as you mentioned, taking it very seriously. And part of the scary part is that they're taking the position that the bar on threatening to sue or to collect time-barred debt applies even if the debt collector does not know that the debt is time barred, which when you look at the statute of limitations, that's not always a perfectly clear-cut question

because you have to look at the accrual statute and whether the statute of limitations has been extended for any number of reasons. The zombie mortgages continue to be all over the news. Just a couple of weeks ago, 7 News in California ran a story about what they called a zombie mortgage in Carson, California, and it looks a lot like cases we see where the borrowers say, "Hey, the lender told us that the debt was charged off and we didn't think that we had to pay it anymore."

In the meantime, there's multiple changes in servicers. So the borrower then claims that they're confused about what happened with the loan and will often claim, true or not, that they didn't think they owed any money on the loan any longer. So in the cases where there's a charge off, the argument very often becomes, what does it mean when you say a loan is charged off? Fortunately, there is good case law that says a charge off is an internal accounting function, but that does not mean that the debt is owed. If you get a case that's based on a charge off, sometimes it can be a little harder to succeed on a motion to dismiss because you have to look into the facts around what that charge-off means. But we find it's very often worth still bringing that motion to dismiss to try and educate the judge up front that the charge off does not mean that the money's no longer owed.

These cases can get a little bit more complicated depending on what the servicer's communication to the borrowers say about the charge off. You can run into situations where you would have what I would call a helpful letter that says, "Your loan's being charged off. This means you're no longer accruing interest. It means we're no longer charging late fees. It's an internal accounting function, but you still owe the money." Where it becomes more complicated is if the letter informing the borrower about the charge off makes some sort of indication that the money is no longer owed. And so certainly when you're preparing charge off letters, you want to leave the possibility to collect the debt in the future and say it is still owed because what happens very often as a servicer is those charged off debts get transferred to other servicers.

The zombie mortgage issue also comes up very frequently in the context of bankruptcy, especially bankruptcies that occurred in the 2008 to 2012 timeframe when property values were lower. And so you have a borrower that files for bankruptcy and that discharges their personal debt on the second mortgage. The lender or servicer was not incentivized to foreclose because the property was underwater. Very often, those borrowers will work with their first mortgage lien holder in order to stay in the house while the second mortgage loan essentially stays dormant because there's no incentive for the second lien holder to foreclose. Then, now that property values have risen, the second mortgage holders are looking at it and saying, "Well, there's now an incentive to foreclose."

So they start foreclosure proceedings, and we have seen a number of cases where the borrower sues to stop the foreclosure and says, "Hey, the statute of limitations to foreclose accrued at my discharge. And so my discharge happened in 2012. It's now 2019. You are no longer able under a six-year statute of limitation to foreclose."

Melanie Vartabedian:

Matt, could you describe what happened in the state of Washington?

Matt Morr:

They found support in this argument in a series of bad cases out of Washington State and the Ninth Circuit that held the statute of limitations accrued upon discharge. This was based on dicta in a case called Edmondson and followed by the Ninth Circuit without any meaningful analysis in another case called Jarvis. This resulted in kind of an avalanche of bad decisions where Washington courts, including Washington bankruptcy courts were saying, "This is wrong, but we're bound by the Ninth Circuit."

Unfortunately, the Colorado Court of Appeals then followed this Jarvis and Edmondson dicta and held in a Colorado case called Silvernagel that the statute of limitations accrued on discharge. The problem with this case is it really misinterpreted what it means to get a bankruptcy discharge, and then it also misinterpreted the contract, the deed of trust that controls when you may foreclose. Fortunately, the Colorado Supreme Court took up this case, this Silvernagel case, and held that the statute of limitation does not accrue on discharge. Relying on long-standing bankruptcy principles, it first explained what a discharge actually means. I think there's a common misconception, particularly in people that don't kind of run in the bankruptcy world, that a bankruptcy extinguishes the debt. It makes it disappear, and that's not true.

Fortunately, what the Colorado Supreme Court recognized is that a discharge only enjoins the collection of the debt as a personal liability of the debtor. The discharge does not affect the debtor's ability to protect against security that it has. So, in this case, the property and the deed of trust that secures the repayment of the debt. And so the Supreme Court instead in Colorado said, "You need to look at what the contract says to determine when the statute of limitation begins." So in Colorado, you are able to foreclose on the full amount based on your typical deed of trust that says everything is due on the maturity date, but it's important that you look at the actual language of the deed of trust. You could have different language if it's an installment agreement and the deed of trust does not say that all sums are due at maturity.

If that language is not there, then you would have a separate cause of action that starts from each installment payment. In the State of Washington, the Washington Supreme Court, in a case called Copper Creek, ultimately rejected the Jarvis-Edmondson cases that I talked about earlier that held that the bankruptcy accrued... the bankruptcy discharge accrued the statute of limitations. But unlike Colorado, that says that the maturity date everything is due, Washington State appears to ignore that language about the maturity date and says, "Regardless of what it says, the statute of limitations begins at each missed installment payment."

And the reason this is important is with the CFPB and the implementing Regulation F being so strict to say, "You cannot try to collect debt that's barred by the statute of limitations. You could run into a potential technical violation if you are trying to foreclose on the full amount instead of just the installment payments that were due within the past six years." And so where this could come up is when you're providing your notices to the borrower over your intent to foreclose and various requirements under different states if you say that all sums are due. That could be a technical violation and be viewed as you're trying to collect time-barred debt and put you in trouble with the CFPB and implementing Regulation F.

Now, you're still able to foreclose, but you need to make sure that you're putting the right numbers in the notices. So you're only looking... For example, most states are six years. You're only looking six years back. Now, stepping back, if you're a servicer and you get one of these cases, very often you are able to file a motion to dismiss and essentially make the argument that the maturity date has not yet happened or we’re within six years in order to foreclose. And you're able to bring in public records like the deed of trust to get around arguments that you can't bring evidence and arguments outside of the four corners of the complaint. It gets more complicated if you are six years past the maturity date or the loan has been accelerated.

If you have an issue where you're six years past the maturity date or you have a prior acceleration, that's when you need to really start looking in your files to see if there's anything in there that you can use to argue that the statute of limitations has been told. This can be difficult if you're a subsequent servicer because your files are not always complete, but the kind of evidence that you want to look for are modification agreements or evidence that the debt has somehow been affirmed. So if there's been a payment after the maturity date, you could say, "Look, they paid after the maturity date. That's a recognition of an affirmation of the debt, and they still owe it."

Melanie Vartabedian:

Aside from arguing about the statute of limitations, are there other arguments that borrowers have made?

Matt Morr:

We've seen that the plaintiff's bar has recognized that the arguments about a bankruptcy accruing the statute of limitations are dead in the water. And so they're not making those arguments as frequently anymore, but they are continuing to make arguments that the statute of limitations has accrued for various reasons. In cases where we're still within six years of the maturity date, the other argument that the plaintiffs are latching on to is a laches argument. So they are saying, "Look, even if the statute of limitations hasn't run laches bars you servicer from foreclosing because you knew about this debt. You've unreasonably delayed in trying to foreclose on this debt. And in the meantime, we've relied on your interaction to our prejudice."

Typically, in these zombie mortgage cases, the first argument is the servicer did not unreasonably delay because the property was underwater at the time of discharge. So there's no reason, no reasonable reason for that servicer to try and foreclose on an underwater property. They won't get paid. There are also good arguments that the borrower did not suffer any prejudice. During the time that there was no foreclosure, they continued to enjoy the benefits of homeownership. They got to continue

to live in the house, and even if they made improvements to the house during that timeframe, the response to that is you enjoyed the improvements, and those improvements increase the value of the house.

So if you want to continue to enjoy those improvements, you have the option to sell or refinance to get out from this debt that you clearly took out and enjoyed. The other piece is the borrowers will argue, "Well, I had to continue to ensure the house, pay taxes, and make payments on the primary mortgage." Well, that doesn't show any prejudice because those are all things that borrower would've had to do anyway. Melanie, I've been talking about what's happened in the State of Washington and in Colorado. Have you seen these issues pop up in any other states?

Melanie Vartabedian:

Yeah, thanks, Matt. Yes. We actually recently litigated this very issue in the Utah Federal Court, the Southern District of Utah. And I'm happy to share that Utah courts have come out on the right side of this issue and have followed the Colorado Supreme Court rather than Washington. In the case that we handled, the plaintiff was a borrower who brought suit against our client, the note holder, seeking a declaratory judgment that the statute of limitations enforcing the deed of trust to foreclose on a real property had run. So they sought quiet title of the property in favor of the borrower and tried to also get their attorney's fees.

So our client swiftly filed a motion to dismiss the complaint for failure to state a claim. And just quickly as far as the factual underpinnings and the amount of time that had elapsed between the various important dates are as follows. So the borrower signed a note and a trust deed in 2006, and the final payment due date, or the maturity date that you talked about earlier, Matt, was 2021. The borrower made their last payment in 2008. This borrower also had filed bankruptcy during the relevant time period and received a discharge of her debts, which included this particular debt relating to the mortgage in 2011.

In 2022, so about 11 years later, the lender, our client, sent notice of default and a notice of intent to foreclose. Well, plaintiff brought this suit, claiming again that the statute of limitations had run and had expired because the statute of limitations began to run in 2008 when the borrower made her last payment. Alternatively, the borrower argued the statute of limitations began to run when the bankruptcy discharged this debt in 2011. And so as a result, the trust deed could be enforced, and the borrower wanted the court to declare that she could get quiet title and her attorney's fees.

Now, obviously, those two dates, 2008, when the last payment was made in 2011, when the bankruptcy debt was discharged, those are quite a bit earlier than when we, on behalf of the note holder, argued that the statute of limitations had began to run, which was as you mentioned, Matt, when the final payment or the maturity due date was under the terms of the trust deed in 2021. Now, as far as the legal analysis here, the parties agreed that the Utah statute for a written contract had a six-year statute of limitations, but the parties disputed what triggered the running of that statute.

Now, the plaintiff was relying on the general Utah statute of limitations for written instruments to say that the statute ran on the date of her last payment. Again, that was a 2008 date. We argue that the statute didn't begin to run until the unaccelerated debt secured by the deed of trust became due, which was the 2021 date based on a more specific statute of limitations in the UCC portion of the Utah code, and the court agreed with us. The court found the more specific statute of limitations governs the enforcement of trust deeds rather than the general statute for written instruments.

And neither the last payment date nor the debtor's discharge and bankruptcy triggered the statute of limitations. The discharge only precluded actions for plaintiff's personal liability on the note and did not extinguish the trust deed that secured the obligation or the lien interest on the property, which I know you talked about a little bit earlier, Matt. And so the trust deed, the court found it remained enforceable until 2027. And based on this, the court granted our motion to dismiss was a great result for the client and great to see, at least on the lower court level in Utah, that it came out on the right side of this issue.

And then briefly, I'll just mention a more recent case that was an adversary proceeding in a bankruptcy in the District of Utah that relied on the case that I just mentioned. Here, the note holder initiated foreclosure proceedings 13 years after the debtor's last payment, and the debtor filed an adversary proceeding in their bankruptcy, asserting again the statute of limitations barred the note holder from enforcing the note and trust deed that had secured the debt. In this case, the court rejected the debtor's argument that the statute of limitations referred not only to the maturity date but also to the due date of each payment.

So in other words, the debtor was trying to argue that there was a restarting of the statute of limitations for each missed payment. The court relied on the case that I just mentioned previously, and the court had a good policy discussion underlying

its ruling. It noted that requiring a lender to accelerate a note and foreclose on a trust deed within six years of the first mispayment or to risk being barred from collecting all or part of its note isn't consistent with number one, the typical terms of a trust deed note, which are contemplated to run and typically run decades rather than a few years.

And that lenders should be allowed flexibility to determine when and under what circumstances they will accelerate a note and that benefits borrowers as well by letting them stay in their home and trying to work out a cure of mispayments for the remaining term of a loan. And with that, Matt, I will turn it back to you for any additional notes or tie-up of this topic.

Matt Morr:

Thanks, Melanie. I think the big takeaway here is when you're looking into foreclose on some of these older second mortgage loans that they are calling zombie loans, you want to make sure you do your homework upfront. So you want to understand what the statute of limitation rule is in the state where you're foreclosing. And really that's looking at whether you can foreclose the entire amount under the deed of trust definition of the maturity date or if you are limited to just going six years back from missed installment payments.

And then, from there, making sure that your notices are all correct so you don't run into any sort of technical violation. And then, if you end up in a lawsuit, you really want to be looking at can you move to dismiss? Can you move to dismiss based on the public records that show when the maturity date is? And if you don't have good arguments on a motion to dismiss based on the public records, you then need to be really looking through your files, thinking about whether there's any modification agreements, or whether there's any solid arguments that the debt has been affirmed.

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