Litigation Update: Two California Appellate Courts Uphold

MERS Foreclosures and Clarify Important Issues of State Law.

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Two comparatively recent California appellate court decisions have clarified the California mortgage litigation landscape concerning three critical issues: (1) borrowers do not have the right to file a preemptive lawsuit challenging the standing of the party initiating foreclosure, (2) assignments of deeds of trust are not required to be recorded prior to conducting a foreclosure sale, and (3) MERS has the authority to initiate foreclosures.

In *Robinson v. Countrywide Home Loans, Inc.*, [1] the borrowers took out a loan from SBMC Mortgage secured by a deed of trust naming MERS as "nominee for Lender and Lender's successors and assigns," and stating that "MERS is the beneficiary under this Security Instrument." After the borrowers defaulted on their loan, foreclosure proceedings were initiated. The borrowers then brought claims for wrongful initiation of foreclosure and declaratory relief claiming that MERS had no legal authority to initiate the foreclosure and that California Civil Code § 2924 granted the borrowers the right to file a preemptive lawsuit challenging the standing of the party initiating the foreclosure. Specifically, the borrowers argued that their promissory note had been "sold and resold" on the securitized mortgage market, making it impossible to ascertain the actual owner of the note.

The *Robinson* court denied the borrowers claims on each ground. The court held that Civil Code § 2924 does not provide for a preemptive suit challenging a party's standing to foreclose. The court reasoned that while Civil Code § 2924 states who has authority to initiate the foreclosure

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tracking the profitability of an individual LO, provided it is mindful of a few critical facts. First, all profits (some portions of which are often referred to as "overages") belong to the mortgage banker – no exceptions. The company is free to use this money for any legitimate business purpose, subject of course, to the limitations of the Rule. Any paper trail which suggests that profits belong to, or are owned by, any LO will suggest a violation of the Rule. Moreover, any such language should be countered with a written reminder regarding ownership, control and discretion over all company-owned funds. Secondly, if bonuses are a component of your LO compensation model, they must be paid in accordance with one or more of the permitted bases set forth in the Commentary, such as volume, quality or pull through. Simply "saying" that permissible compensation metrics are the bases for bonus compensation will be insufficient. Further, those bases actually utilized, should be consistently applied to all bonuses given.

Compensation Variances between Products

The most compliant compensation structure is one wherein an LO's rate of compensation is fixed across all loans and product types, such that the LO's compensation will vary from loan to loan based solely on the principal amount financed. We are concerned that the "legitimate business expense" language in the Commentary is in an extreme state of overuse, and risks becoming the exception that eats the Rule. A decision to vary rates of compensation between brokered vs. banked products, conforming vs. jumbo, FHA vs. conventional, or between marketing channels, increases the risk of a violation. At a minimum, consult legal counsel before permitting compensation variances between products. Moreover, ensure that you have a rational, and well documented basis, to support any compensation variance.

Remember—it is the *Loan Originator* Compensation Rule

Over the past eight months, some LO's, particularly top producers, have pushed their employers to take ever riskier positions with the threat that they will otherwise go elsewhere. LO's should be reminded that, unlike much of TILA, the penalties for a Rule violation apply to LO's too. It is undoubtedly tempting to bow to competitive pressures and LO demands, particularly given the lack of further regulatory guidance and the absence of any well publicized enforcement action. Now, however – before the first signs of trouble, and before the first audit – is a good time to step back, and to take a fresh look at your compensation model to ensure that every position taken is defensible and well documented, notwithstanding those pressures and demands.

1 Truth in Lending Act ("TILA"), 15 U.S.C. §1639b., Reg. Z §226.36(d)

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process, it does not by "necessary implication" allow for a preemptive lawsuit to test whether the person initiating the foreclosure has the authority to do so. The court acknowledged that such a preemptive action "would fundamentally undermine the nonjudicial nature of the process and introduce the possibility of lawsuits filed solely for the purpose of delaying valid foreclosures." In addition, the court affirmed that MERS has the authority to initiate foreclosure proceedings.

In *Calvo v. HSBC Bank USA, N.A.*,[2] the borrower's Complaint centered entirely upon the premise that the foreclosure proceedings under her deed of trust were improper because the assignment of the deed of trust to the foreclosing party had not been recorded.[3] The borrower alleged this was a violation of California Civil Code § 2932.5, which provides "[w]here a power to sell real property is given to a mortgagee, or other encumbrancer, in an instrument intended to secure the payment of money . . . The power of sale may be exercised by the assignee if the assignment is duly acknowledged and recorded."

In rejecting the borrower's claims, the *Calvo* court reaffirmed a rule which had been part of California real property for over 100 years. Namely, that Civil Code § 2932.5 is only applicable to *mortgages*, and does not require the recordation of an assignment of a beneficial interest for a *deed of trust*. The court noted that a *mortgage* creates only a lien (with title to the property remaining in the borrower), but that a deed of trust passes title to the trustee with the power to transfer marketable title. Since the power of sale in a deed of trust vests in the trustee, the transferee of a promissory note secured by a deed of trust is not a "mortgagee" or "other encumbrancer" within the meaning of Civil Code § 2932.5. Therefore, the recording requirement of Civil Code § 2932.5 is inapplicable to deeds of trust. Further, as in *Robinson*, the *Calvo* court affirmed that MERS has authority to initiate foreclosure proceedings.

These recent decisions by the California appellate courts are important as they create binding state law precedent concerning litigated issues facing the mortgage banking industry. First, the *Robinson* decision now bars plaintiffs from bringing preemptive actions challenging a party's standing to foreclose. Second, the *Calvo* decision upholds the validity of foreclosure sales where an assignment of deed of trust has not been recorded. Third, both decisions reaffirm that MERS has authority to initiate foreclosure proceedings.

The author's firm, Houser & Allison, APC, handled the Calvo litigation at both the Trial Court and Appellate Court levels.

1 199 Cal. App. 4th 42, 130 Cal. Rptr. 3d 811 (2011)

2 130 Cal. Rptr. 3d 815 (Ct. App. 2011)

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