THE REVIEW OF
BANKING & FINANCIAL SERVICES
A PERIODIC REVIEW OF SPECIAL LEGAL DEVELOPMENTS AFFECTING LENDING AND OTHER FINANCIAL INSTITUTIONS

Vol. 26 No. 6 June 2010
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MORTGAGE SERVICING UNDER FIRE

The financial crisis has heightened investigation and litigation risks for mortgage servicers, as federal and state regulators escalate enforcement activity and private litigants advance novel legal challenges to origination and servicing practices. The authors undertake a review of recent government enforcement actions and litigation, suggesting a number of strategies that servicers should employ to reduce enforcement action and litigation risks.

By Jonice Gray Tucker, Benjamin P. Saul, and Thomas A. Dowell *

Over the past decade, mortgage loan servicers have been subject to increasing scrutiny by federal and state regulators, as well as private litigants. The recent financial crisis has heightened public examination of mortgage servicing practices, with litigation and enforcement activity intensifying markedly during the past 18 months. Servicers are now facing a new frontier of legal claims based on novel theories that include attacks on previously unchallenged business practices. The absence of clear, written compliance standards has provided government regulators and private plaintiffs with wide latitude to challenge servicing practices while simultaneously hampering the ability of servicers to manage growing enforcement and litigation risks in a rapidly changing environment.

Through its advanced notice of proposed rulemaking on Mortgage Acts and Practices (the "MAP rulemaking"),[1] the Federal Trade Commission has aimed to address this dearth of regulatory guidance. The MAP rulemaking requests public comment on loan performance and default-related issues, including loss mitigation and loan modification practices. The FTC's requests suggest that it may be poised to issue regulations that codify the prohibitions and restrictions in consent decrees between the FTC and Fairbanks Capital, and more recently, EMC Mortgage Corporation.[2]

Notwithstanding the FTC's on-going rulemaking process, enforcement agencies – particularly state attorneys general, who have been emboldened by the

[1] 74 Fed Reg. 26126 (June 1, 2009).

[2] Order Preliminarily Approving Stipulated Final Judgment, *U.S. v. Fairbanks Capital Corp. Fairbanks Capital Holding, & Basmajian*, No. 03-12219 (D. Mass. Nov. 21, 2003), *modified by*, *U.S. v. Select Portfolio Serv.*, No. 03-12219-DWP (D. Mass. Sept. 4, 2007); Consent Decree, *FTC v. EMC Mortgage Corp.*, No. 4:08-cv-338 (E.D. Tex. Sept. 9, 2008).

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U.S. Supreme Court's *Cuomo*[3] decision – are aggressively pursuing enforcement actions alleging inadequate, unfair, and deceptive servicing practices, as well as actions that attack the acts and omissions of certain independent contractors that servicers employ.

Servicers also are facing an uptick in lawsuits brought by private litigants who seek to advance an expanding range of legal claims. In recent months, servicers have found themselves "caught in the crossfire," as investors sue to protect contractual rights allegedly impaired due to government-mandated workout programs. Servicing practices are being challenged in individual and class action lawsuits alleging unfair, deceptive, and, most recently, discriminatory conduct. Beyond these matters, servicers have come under fire in bankruptcy proceedings in which judges have taken unprecedented measures to analyze the propriety of servicing events across the lifespan of a given consumer's loan.

This article provides an overview of recent enforcement and litigation trends, suggesting areas where compliance resources should be focused and providing general risk-mitigation strategies for servicers to consider.

FEDERAL REGULATORY AND ENFORCEMENT ACTIVITY

The most significant federal regulatory and enforcement developments include the following:

The Department of Justice Fair Lending Unit

On January 14, 2010, the U.S. Department of Justice announced that it has formed a new fair lending enforcement unit within its Civil Rights Division.[4] The new unit is part of a policy initiative by the Obama Administration to scrutinize the lending practices of financial institutions and to enforce fair lending laws. Already, the DOJ is involved in at least 38 fair lending investigations, and the new unit, which will partner with other federal and state law enforcement agencies to develop cases, should substantially increase this figure.

Although the new unit will focus, primarily, on allegations of redlining and reverse redlining against mortgage loan originators, the DOJ has signaled its intent to examine servicing practices, particularly those relating to loan modifications. In a recent public statement, Assistant Attorney General Thomas Perez spoke to the new unit's anticipated examination of workout practices, expressing the DOJ's view that "there have been all too many instances of discriminatory practices on the [mortgage] origination side," and observing that "given that very unfortunate and discriminatory history it gives [DOJ] cause for great concern about what might be taking place in the modification context."[5] Attorney General Perez went on to state that DOJ will not "prejudge" the situation, but intends to "scrub that data with a fine tooth comb."

In light of these public statements, servicers should be prepared for increasing regulatory examination of

[3] *Cuomo v. The Clearing House Ass'n*, 129 S. Ct. 2710 (2009) (holding that the visitorial powers which the National Bank Act ("NBA") grants to the OCC do not preclude state attorneys general from bringing lawsuits to enforce state fair lending laws). The *Cuomo* ruling, without a doubt, has empowered state attorneys general to pursue litigation against national banks to enforce applicable state laws. In addition, many private litigants are attempting to employ the *Cuomo* decision to support the viability of their state law claims. *See, e.g., Young v. Wells Fargo & Co. & Wells Fargo Bank, N.A.*, 2009 U.S. Dist. LEXIS 100419 (S.D. Iowa Oct. 27, 2009) (holding, based in part on *Cuomo*, that the NBA and OCC regulations did not expressly preempt plaintiffs' state law claims); *but see McAnaney v. Astoria Fin. Corp., et al.*, 2009 WL 3150430 (E.D.N.Y. Sept. 29, 2009) (finding *Cuomo* inapplicable because the decision only addressed whether the OCC overstepped its regulatory authority under the NBA, not the Home Owners Loan Act); *Tombers v. F.D.I.C.*, 2009 WL 3170298 (S.D.N.Y. Sept. 30, 2009) (holding plaintiff's reliance on *Cuomo* misplaced because the decision primarily addresses issues of agency deference, not preemption).

[4] Thomas Perez, Assistant U.S. Att'y Gen., Remarks at the Rainbow PUSH Coalition Annual Wall Street Conference (Jan. 14, 2010), *available at* http://www.justice.gov/crt/speeches tp_rainbow_push.pdf.

[5] Stephen Joyce, *DOJ Launches Unit to Combat Unfair Lending, Fraudulent Modifications*, BNA BANKING REPORT, Jan. 19, 2010.

policies, procedures, and outcomes related to loan workout programs. Examination priorities likely will focus on potential disparities between consumers belonging to protected versus non-protected classes with respect to completed modifications, modification terms, and re-default rates.

The MAP Rulemaking

The FTC, in its MAP rulemaking, has expressed serious concerns that relationships between servicers and consumers are "vulnerable to abuse." In particular, the FTC has expressed its view that:

- servicers protect the interests of noteholders, not borrowers;
- consumers lack the ability to shop for or to change their servicer;
- servicing rights can be transferred frequently, causing confusion about loan-related ownership interests and payment processing; and
- servicers often have a financial incentive to impose fees on consumers.[6]

Such concerns echo many of the issues the FTC first brought to the forefront in its 2003 consent decree with Fairbanks Capital Corporation[7] and later amplified in its 2008 consent decree with EMC Mortgage Corporation.[8] The language of the MAP rulemaking seeks comment on whether the FTC should incorporate the prohibitions and restrictions of its prior settlements with servicers into MAP rules.[9] It thus appears to presage FTC efforts to convert the injunctive and declaratory relief set forth in the EMC consent decree, which is summarized below, into a definitive set of servicing industry "best practices."

The EMC Mortgage Consent Decree

On September 9, 2008, the FTC filed a Complaint against EMC and its parent The Bear Stearns Companies, Inc., alleging they had violated Section Five of the FTC Act,[10] the Fair Debt Collections Practices Act,[11] the Fair Credit Reporting Act,[12] and the Truth in Lending Act ("TILA").[13] The gravamen of the FTC's Complaint was that the defendants had (1) acquired and securitized residential mortgage loans too rapidly, (2) not taken adequate steps to ensure the accuracy of consumer loan information, and (3) not otherwise engaged in sound servicing practices.[14] Specifically, the FTC alleged that the defendants boarded loans too hastily and without proper quality control and data integrity safeguards in place, resulting in many loans being serviced based on inaccurate and incomplete loan data. According to the FTC, this inaccurate and incomplete loan data had a domino effect, ultimately causing the defendants to engage in improper collection- and default-related efforts with respect to such loans, among other things.

EMC and Bear Stearns resolved the lawsuit, entering into a consent decree.[15] Under the terms of the consent decree, they agreed to pay $28 million in consumer redress and to establish a comprehensive data integrity program that would ensure the accuracy and completeness of their loan information. The consent decree also enjoins EMC from engaging in the following practices:

- representing loan terms, payment amounts due, or payment due dates without adequate substantiation; and
- misrepresenting that any payment or fee due on the loan is allowed under the loan instrument or permitted by law.

Additionally, the consent decree imposes certain preconditions on EMC's ability to initiate foreclosure actions or to charge foreclosure-related fees. Among other things, EMC must:

- review all customer records to ensure that customers are in material default;

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[6] 74 Fed Reg. at 26126.

[7] Complaint and Order, *U.S. v. Fairbanks Capital Corp. Fairbanks Capital Holding, & Basmajian*, No. 1:03-cv-12219 (D. Mass. Nov. 12, 2003).

[8] Consent Decree, *FTC v. EMC Mortgage Corp. & Bear Stearns Cos., LLC*, No. 4:08-cv-338 (E.D. Tex. Sept. 9, 2008).

[9] 74 Fed. Reg. at 26129.

[10] 15 U.S.C. § 45 (2009).

[11] 15 U.S.C. §§ 1692-1692p (2009).

[12] 15 U.S.C. §§ 1681-1681x (2009).

[13] 15 U.S.C. §§ 1601-1667f (2009).

[14] Complaint, *FTC v. EMC Mortgage Corp. & Bear Stearns Cos., LLC*, No. 4:08-cv-338 (E.D. Tex. Sept. 9, 2008).

[15] *See supra* note 8.

- confirm that customers were not victims of illegal practices; and
- investigate and resolve any customer disputes.

Finally, the consent decree requires EMC to issue new TILA disclosures on certain types of loan modifications. The FTC added this provision because it disapproved of EMC's alleged practice of adding modification fees to a consumer's unpaid principal balance without disclosing such fees to the borrower.[16]

The EMC consent decree, particularly when viewed in the context of the current MAP rulemaking, underscores for servicers the importance of establishing robust data integrity checks at loan boarding. The consent decree also suggests that servicers need to be vigilant in ensuring that internal policies and procedures, particularly those relating to the assessment of fees, are consistent with the governing loan documents and applicable state laws. Finally, the consent decree highlights the continued focus of federal regulators on the types of fundamental servicing issues initially addressed in the FTC's action against Fairbanks – including accurate payment processing and effective, efficient resolution of customer disputes.[17]

STATE ENFORCEMENT ACTIONS

Like federal regulators, state attorneys general are focusing resources on policing servicing practices – particularly those related to loss mitigation and foreclosure prevention. Attorneys General in Massachusetts and Ohio have been especially active in this area, initiating a number of lawsuits that seek to restrict servicers' ability to initiate foreclosure proceedings. The Connecticut Attorney General has also charted new territory, recently launching an investigation focused on the selection of independent contractors retained by servicers to assist with default-related matters.

Massachusetts and Ohio Attorney General Actions

In 2007, the Massachusetts and Ohio Attorneys General filed lawsuits against Fremont Mortgage and New Century Financial, respectively.[18] Both complaints alleged the defendants engaged in predatory lending and ultimately settled out of court.[19] The settlement agreements in these cases, which were substantially similar, imposed significant constraints on default-servicing. Each agreement (1) allowed the Attorney General to suspend the relevant lenders' foreclosure activities pending a review of each loan file and (2) permitted the Attorney General to stay (until the lender takes corrective action) any foreclosure proceeding that, following a review, he or she determined violated state consumer protection laws.

In November 2008, the Massachusetts Attorney General also obtained an injunction against H&R Block and its mortgage lending subsidiary, Option One, that restricted Option One's ability to foreclose on Massachusetts borrowers.[20] The Attorney General obtained the injunction based on allegations that the defendants discriminated against African-American and Latino borrowers when originating mortgage loans. Although the foreclosure restrictions in the injunction were substantially similar to the restrictions placed on Fremont a year earlier, the restrictions in the Option One injunction differed insofar as they also applied to a prior third-party purchaser of servicing rights to the relevant loans. The Option One case, therefore, very clearly shows the importance for third-party servicers of conducting thorough due diligence of the historic and current origination practices of lenders whose loans they service.

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[16] The FTC's position on the need to provide new TILA disclosures following loan modifications has been widely criticized by, among others, the Federal Reserve Board.

[17] *See supra* note 8. In the Fairbanks complaint, HUD and the FTC alleged that Fairbanks violated the FTC Act, FDCPA, FCRA, and the Real Estate Settlement Procedures Act by failing to post payments timely, assessing illegal or unauthorized fees and charges, misrepresenting debt amounts, employing deceptive collection practices, reporting inaccurate information to credit bureaus, and failing to investigate written requests. The Fairbanks consent decree restricted Fairbanks' ability to initiate foreclosure actions absent thorough review and enjoined Fairbanks from misrepresenting certain fees and charges.

[18] Complaint, *Commw. of Mass. v. Fremont Inv. & Loan & Fremont Gen. Corp.*, No. 07-4373-BLS1 (Super. Ct. Oct. 4, 2007); Complaint, *State of Ohio, ex rel. v. New Century Fin. Corp., et al.*, No. CV-07-618660 (Ct. C.P. Cuyahoga Mar. 14, 2007).

[19] *Commw. of Mass. v. Fremont Inv. & Loan & Fremont Gen. Corp.*, No. 07-4373-BLS1 (Super. Ct. Jun. 9, 2009) (order granting final judgment by consent), *available at* http://www.mass.gov/Cago/docs/press/2009_06_09_fremont_consent_judgment.pdf; *State of Ohio, ex rel. v. New Century Fin. Corp., et al.*, No. CV-07-618660 (Ct. C.P. Cuyahoga Nov. 25, 2008) (order granting settlement).

[20] *Commw. of Mass. v. H&R Block, Inc., et al.*, No. 08-2474-BLS1 (Mass. Super. Ct. Nov. 10, 2008) (order granting preliminary injunction).

More recently, the Massachusetts and Ohio Attorneys General have shifted their focus from origination practices perceived to trigger defaults to mortgage servicing practices that they perceive could lead to the same result. Last year, the Massachusetts Attorney General entered into agreements with a pair of servicers to resolve claims that those servicers had engaged in unfair and deceptive loan servicing conduct and precipitated unnecessary foreclosures.[21] As part of these agreements, the servicers agreed to provide:

- loan modification options to eligible borrowers that include reducing interest rates, extending amortization periods, and, if necessary, granting principal forbearances;
- foreclosure alternatives, such as short sales, deeds-in-lieu of foreclosure, or relocation payments, to delinquent borrowers who do not qualify for loan modifications; and
- opportunities for the Attorney General's Office to object to foreclosures and denials of loan modifications, including a requirement that the companies obtain court approval to foreclose on a loan where they and the Attorney General's Office cannot resolve an objection.

Most recently, in 2009, the Ohio Attorney General and the Ohio Department of Commerce initiated lawsuits against three mortgage loan servicers challenging their loan modification practices.[22] In each of these lawsuits, all of which remain ongoing, the Attorney General has alleged that each servicer violated the Ohio Consumer Sales Practices Act by:

- providing incompetent and inadequate customer service;
- failing to investigate consumer complaints or to respond to consumers' request for assistance; and
- failing to offer timely or affordable loss mitigation options to borrowers free of unfair and deceptive loan modification terms.

The Ohio Attorney General also seeks, in each lawsuit, a permanent injunction that would enjoin the defendant servicers from initiating further "unfair and deceptive" loan modifications, consumer restitution, civil penalties, and other damages. These lawsuits further seek to require each defendant servicer to implement improved customer service processes for Ohio borrowers, such as timely responding to borrower requests for loss mitigation assistance, staying foreclosure actions during loss mitigation negotiations, and providing borrowers with copies of forbearance agreements.

The Massachusetts and Ohio actions have marked the beginning of an enforcement trend impacting servicers that is likely to continue for the foreseeable future. As origination practices continue to be challenged, there can be little doubt that there will be additional actions which are resolved with settlements that have a measureable impact on servicing. Moreover, with escalating political pressure for servicers to move rapidly to avert foreclosures, unprecedented consumer demand for workouts, novice loss mitigation staff, and scarce resources, many servicers have found themselves in the midst of a "perfect storm." Unless servicers make a concerted effort to ensure that internal processes and procedures are functioning as they should, this storm may unleash a torrent of enforcement action and private litigation.

Connecticut Attorney General Investigation

The relationship between servicers and independent contractors is one of the newest areas of focus for state attorneys general. In a first of its kind action, on June 4, 2009, the Connecticut Attorney General launched an investigation into the default servicing practices of Freddie Mac, Fannie Mae, and Lender Processing Services. As part of the inquiry, the Attorney General sent letters to the servicers asking them to describe the processes they use to select law firms and marshals for

[21] Press Release, Massachusetts Office of the Attorney General, *Attorney General Martha Coakley Enters into Affordable Loan Modification and Foreclosure Prevention Agreement with Purchaser of Fremont Servicing Rights* (Oct. 15, 2009), *available at* http://www.mass.gov/?pageID=cagopressrelease&L=1&L0=Home&sid=Cago&b=pressrelease&f=2009_10_15_carrington_fremont_loan_mod&csid=Cago; Press Release, Massachusetts Office of the Attorney General, *Attorney General Coakley's Office Reaches Affordable Loan Modification and Foreclosure Prevention Agreement with Mortgage Servicer* (Nov. 10, 2009), *available at* http://www.mass.gov/?pageID=cagopressrelease&L=1&L0=Home&sid=Cago&b=pressrelease&f=2009_11_10_ahmsi_agreement&csid=Cago.

[22] Complaint, *State of Ohio, ex rel. v. Carrington Mortgage Servs., et al.*, CV-09-711433 (Ct. C.P. Franklin Jul. 31, 2009); Complaint, *State of Ohio, ex rel. v. Am. Home Mortgage Serv., et al.*, No. CV-09-708888 (Ct. C.P. Cuyahoga Nov. 5, 2009);. Complaint, *State of Ohio, ex rel. v. Barclays Capital Real Estate, Inc., dba HomEq Serv.*, No. CV-09-10136 (Ct. C.P. Montgomery Dec. 16, 2009).

their foreclosure work.[23] Additionally, the letters requested that the servicers provide copies of any procedures, policies, or agreements governing their relationship with Connecticut law firms or marshals and a description of the fees charged by each party.

In public statements, the Connecticut Attorney General has indicated that the investigation was motivated by a concern that a select group of law firms and marshals had come to dominate the Connecticut market for foreclosure services, charging uncompetitive fees and engaging in improper or illegal practices, such as forging documents, failing to serve notices, allocating work to non-marshals, and providing kickbacks.[24]

Although the Connecticut Attorney General's investigation has yet to result in any formal enforcement action, it portends further enforcement focus by states on servicers' relationships with default-related contractors, including, among others, bankruptcy firms, marshals, debt counselors, property inspectors, providers of broker price opinions, and door-knockers.[25]

Office of the United States Trustee's Working Group

In addition to the significant regulatory and enforcement activities discussed above, the DOJ's Office of the United States Trustee ("UST") has created an informal working group to investigate complaints regarding the accuracy of filings made by mortgage servicers before bankruptcy courts.[26] Often, the UST's investigations prompt it to intervene on behalf of debtors or to commence its own actions. For example, in *In re Stewart*, discussed below, the UST submitted an amicus brief in support of the debtor, asking the district court to uphold the bankruptcy court's imposition of sanctions against a lender that systematically filed false proofs of claim.[27]

TRENDS IN PRIVATE LITIGATION

Much of the significant private litigation against servicers has consisted of consumer class actions. Generally, these lawsuits have focused on practices raising issues such as fee assessment, payment posting and application, the forced placement of insurance, customer service (*e.g.*, dispute resolution), and billing. Examples of such lawsuits include: *In re Ocwen Federal Bank FSB Mortgage Servicing Litigation*, in which plaintiffs sued Ocwen Federal Bank, alleging that the thrift charged borrowers improper or unnecessary fees, failed to post or misapplied payments, and improperly claimed borrowers were in default;[28] *Ogbin v. CitiFinancial Mortg. Co., Inc.*, in which the court dismissed class action claims challenging additional fees and costs charged by a servicer providing loan modifications because the plaintiffs failed to raise such claims during their foreclosure actions as required to satisfy the "entire controversy" doctrine;[29] *Schaffer et al v. Litton*, in which plaintiffs alleged that Litton violated the Real Estate Settlement Procedures Act by wrongfully assessing late fees within the first 60 days of it assuming servicing rights;[30] *Pestana et al. v. Washington Mutual*, in which plaintiffs sued Washington Mutual, alleging that the thrift failed to respond to their repeated phone calls and applications for loss mitigation;[31] and *Lauricella et al. v. Countrywide Home Loans Servicing*

[23] *See e.g.*, Letter from Richard Blumenthal, Connecticut Attorney General, to Timothy J. Mayopoulos, Executive Vice President and General Counsel, Federal National Mortgage Association (Jun. 4, 2009), *available at* http://www.ct.gov/ag/lib/ag/consumers/ctdefaultservicing.pdf; *see also* Press Release, Connecticut Attorney General's Office, *Attorney General Investigates Selection Process for Law Firms, Marshals Handling Foreclosures* (Jun. 4, 2009)[hereinafter Blumenthal Press Release], *available at* http://www.ct.gov/ag/cwp/view.asp?A=367 3&Q=441316.

[24] *See* Blumenthal Press Release, *supra* note 23.

[25] Door-knockers are third parties that servicers hire to visit a property to determine (i) if the property is still occupied or (ii) whether the borrower is willing to enter into a deed in lieu of foreclosure. In Connecticut, marshals are special agents vested with the authority to serve process.

[26] *See Policing Lenders and Protecting Homeowners: Hearing Before the Judiciary Subcommittee on Administrative Oversight and the Courts United States Senate*, 110th Cong. 5-6 (2008) (statement of Clifford J. White, Director, Executive Office for

footnote continued from previous column...

United States Trustees), *available at* http://www.justice.gov/ust/eo/public_affairs/testimony/docs/testimony20080506.pdf.

[27] Brief for the U.S. Trustee, *In re Stewart*, 2009 WL 2448054 (E.D. La. 2009) (No. 208-cv-03225).

[28] *In re Ocwen Fed. Bank FSB Mortgage Serv. Litig.*, No. MDL 1604, 04-C-2714 (N.D. Ill. Mar. 22, 2006), *aff'd*, 491 F.3d 638 (7th Cir. 2009).

[29] *Ogbin v. CitiFinancial Mortg. Co., Inc.*, 2009 WL 4250036 (D.N.J. Nov. 19, 2009).

[30] Complaint, *Schaffer, et al. v. Litton Loan Serv., LP, et al.*, No. 2:05-cv-7673 (C.D. Cal. Oct. 26, 2005) (parties filing a motion for settlement May 1, 2009).

[31] Complaint, *Pestana et al. v. Washington Mutual*, 1:2008cv11593 (Mass. September 17, 2008).

LP, in which plaintiffs sued Countrywide, alleging that it failed to return excess per diem interest to them after they paid the balance of their mortgages early.[32]

With regulators yet to establish clear compliance standards for servicers, these types of consumer class actions likely will grow in prevalence. Moreover, in addition to these types of actions, plaintiffs are advancing lawsuits predicated on an ever-increasing range of new theories – including suits based on alleged contractual breaches, "fair servicing" violations, and bankruptcy-related infractions.

Modification Suits

As politicians and regulators implement plans for systemic loan modifications, investors have brought a number of lawsuits challenging such modifications and seeking damages for breach of contract. Servicers, including those that did not originate the mortgages at issue, have been forced to defend these actions.

In December 2008, Countrywide bondholders filed the first major case to challenge systemic loan modification provisions.[33] In their complaint, the bondholders contest the validity of loan modification provisions contained in a multi-state settlement agreement between Countrywide and various state attorneys general. Specifically, the bondholders argue that, under their investor contracts, Countrywide is not permitted to modify the terms of any loan unless it repurchases the notes out of the securitized trust at par value (even loans in default). Under the bondholders' theory, given the number of modifications at issue, Countrywide would be liable for a staggering $80 billion in payments to trusts.

In this matter, which has been remanded to the Supreme Court of the State of New York for lack of federal question jurisdiction,[34] there are a number of issues worthy of continued monitoring. For example, open questions remain as to whether repurchase provisions in the bondholders' investor contracts apply to loans modified pursuant to settlements with regulators or, more generally, to loans in default. In any event, in the current regulatory and market environment, the issues this lawsuit spotlights seem likely to recur in subsequent litigation.

Discrimination Claims

Another significant new trend are efforts by private litigants to advance "fair servicing" claims alleging that mortgage servicers have engaged in discriminatory treatment of members of protected classes.

As an early example of this trend, in 2007, a putative nationwide class of borrowers filed a complaint against defendants, Bear Stearns and EMC, alleging that they intentionally discriminated against minority borrowers in violation of sections 1981 and 1982 of the Civil Rights Act[35] and that they engaged in practices that had an adverse disparate impact on minority borrowers in violation of the Fair Housing Act ("FHA").[36] Specifically, the plaintiffs claimed that the defendants' intentionally acquired non-prime loan portfolios with high proportions of minority borrowers because they believed such borrowers were less sophisticated and, thus, less likely to resist predatory loan servicing practices.[37]

The case ultimately was dismissed,[38] but the theory underlying it is one that private plaintiffs will continue to advance in subsequent litigation. In addition, given that the DOJ has indicated that its new fair lending unit will examine servicers' loan workout and modification data, servicers should anticipate new class action lawsuits alleging discriminatory treatment of protected classes with respect to loan modifications offered, including their terms, conditions, and sustainability.

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[32] Complaint, *Lauricella et al. v. Countrywide Home Loans Serv., LP*, 4:2007-cv-00516 (E.D. Tex. Nov. 13, 2007) (dismissed with prejudice Jan. 8, 2008).

[33] Complaint, *Greenwich Fin. Servs. Distressed Mortg. Fund 3, LLC & QED, LLC v. Countrywide Fin. Corp.*, No. 650474-2008 (N.Y. Sup. Dec. 1, 2008).

[34] *Greenwich Fin. Servs. Distressed Mortg. Fund 3, LLC & QED, LLC v. Countrywide Fin. Corp.*, 654 F.Supp.2d 192 (S.D.N.Y. 2009).

[35] 42 U.S.C. §§ 1981-1982 (2009).

[36] 42 U.S.C. §§ 3601-3631 (2009).

[37] Complaint, *Rodriguez, et al. v. Bear Stearns Cos., Inc., et al.*, No. 07-cv-1816-JCH (D. Conn. Dec. 10, 2007).

[38] On April 14, 2009, the court dismissed the plaintiffs' Civil Rights Act claims for failure to state a claim under Fed. R. Civ. P. 12(b)(6). *Id.*, slip op. (D. Conn. Apr. 14, 2009). On December 22, 2009, the court granted the EMC's motion for summary judgment on the plaintiffs' remaining FHA claim, finding the plaintiffs had not established a genuine issue of material fact as to whether EMC employed practices that had a disparate impact on racial minorities. *Id.*, slip op. (D. Conn. Dec. 22, 2009).

Bankruptcy Actions

In many jurisdictions, bankruptcy courts have begun to challenge allegedly improper, undisclosed, or otherwise questionable fees servicers have charged borrowers in default. Additionally, bankruptcy courts have started to scrutinize servicers' foreclosure procedures.

For example, in *In re Stewart,* the U.S. Bankruptcy Court for the Eastern District of Louisiana found that a servicer failed to take sufficient remedial action and was negligent when it imposed abusive, unwarranted, and improperly calculated fees on a debtor and failed to notify her when it assessed these charges on her account.[39] As a result, the court awarded $22,350 in damages. In addition, the court sanctioned the servicer an additional $5,000 for presenting erroneous proofs of claim and an inaccurate consent protection order.

Similarly, in *In re Watson*, the U.S. Bankruptcy Court for the District of Delaware considered whether a Chapter 13 plan awarding creditors, including a servicer, fees, costs and/or other charges in a set amount operated as a bar to the ability of those parties to recover additional post-confirmation fees and costs.[40] The court concluded such a bar existed, because such fees, when undisclosed and unapproved by a court, hinder the debtor's ability to obtain a fresh start after emerging from bankruptcy.

In re Schuessler, brought in the U.S. Bankruptcy Court for the Southern District of New York, provides a final illustrative example of this growing trend of bankruptcy court scrutiny. In *Schuessler,* the servicer had filed a motion requesting a relief from an automatic bankruptcy stay, claiming that the debtors had become two months delinquent on their mortgage. During a hearing on the motion, the court discovered that the debtors had attempted to make a timely payment at one of the underlying lender's branches, but that the payment was refused. Despite having accepted payments from the debtor made at the lender's branches previously, in this instance, the servicer opted to enforce contractual rights requiring the debtor to make payments by mail. The court determined that the servicer's actions were an abuse of discretion because they were undertaken without notice and unnecessarily prejudiced the borrower. In addition, the court found that the servicer filed its motion for relief without sufficient cause because the property in question contained an equity cushion that provided the servicer with adequate protection. After the court took these two factors into consideration, it determined that the servicer's motion was an unwarranted, abuse of process that merited Rule 9011 sanctions.[41]

[39] *In re Stewart*, 391 B.R. 327 (Bkrtcy. E.D. La. 2008), *aff'd*, 2009 WL 2448054 (E.D. La. 2009).

[40] *In re Watson*, No. 07-11294 (Bkrtcy Del. Apr. 7, 2008).

LITIGATION AVOIDANCE STRATEGIES FOR SERVICERS

With federal and state agencies intensifying their enforcement efforts and private litigants pursuing a widening array of theories in individual and class action lawsuits, servicers face significant legal risks. Servicers and related parties should consider the following risk-mitigation strategies in order to reduce the likelihood of litigation and/or enforcement action:

- **Quality Controls and Data Integrity Checks.** Servicers should institute adequate procedures for boarding loans and processing customer account information. Failing to implement such measures can lead to servicing based on inaccurate or incomplete data, which, in turn, can cause servicers to misrepresent important loan terms, such as amounts due, payment due dates, and permissible fees. Often such misrepresentations can serve as the basis for consumer class actions and government enforcement actions.

- **Monitoring Workout Practices**. With mounting pressure to complete rapid workouts for record numbers of borrowers with limited resources, servicers have been placed in a position that could compromise the overall quality of their servicing and the sustainability of their foreclosure prevention solutions. With internal processes and procedures evolving to meet growing needs, it is important for servicers to test such policies and procedures before implementing them, to monitor them after implementation to ensure such policies and procedures continue to function properly, and to amend such policies and procedures based on their findings. Servicers who fail to put such quality control measures in place could face significant legal exposure.

- **Self-Assessments of Loan Modification Data**. An important aspect of being able to address potential discrimination claims related to loan modifications is to understand that data. As in the fair lending

[41] *In re Schuessler*, 386 B.R. 458 (Bkrtcy S.D. N.Y. Apr. 10, 2008).

context, companies should consider conducting privileged analyses of their modification data to ensure they understand and address the root causes of any issues.

- **Due Diligence**. Comprehensive due diligence of lender relationships has become critical for servicers because, when regulators challenge a lender's origination practices, such challenges often have significant consequences for servicers. For example, in Massachusetts' action against Option One, the state accused the lender of steering minorities toward predatory loan products. However, many of the state's remedies for the lender's violations restricted the ability of its third-party servicer to service loans in default. Therefore, when establishing new business relationships with lenders, servicers should ensure that they adequately investigate the lender's current and historic origination practices.

- **Contractual Terms**. When lenders securitize mortgage-backed securities, their agreements (including pooling and servicing agreements) should address which parties bear the risk of loss associated with loan modifications relating to loans in default or subject to government mandates. Establishing which parties bear this risk in advance could potentially save on costly litigation and better align the incentives of the contracting parties.

- **Bankruptcy Practices**. Regulators and bankruptcy judges alike are scrutinizing the servicing of loans to borrowers in bankruptcy and are focused on:

    - fee assessment and collection practices;

    - filing proofs of claim (or other pleadings) without adequate substantiation; and

    - failing to apply property tax payments in bankruptcy to pre-petition/post-petition categories of consumer's debts.

  These developments underscore the need for servicers to ensure fee issues – particularly those at issue in the EMC Consent Decree discussed above – are handled properly and to ensure any bankruptcy pleadings are well-researched and supported.

- **Third-Party Relationships**. Servicers should have in place adequate procedures for conducting due diligence and compliance review of third-party partners, such as call centers, property inspectors, and IT providers, hired to assist with default-related activities. Exemplar due diligence efforts could include an examination of: the qualifications, backgrounds, and reputations of company principals (including criminal background checks when appropriate); references; corporate financial status; delivery capability, and effectiveness; the internal controls environment; and the legal and regulatory compliance record (including any litigation, complaints, or regulatory actions) of such providers. Compliance reviews should be focused on whether third-party partners have adhered to applicable legal standards as well as emerging industry best practices.

- **Comprehensive Internal Practices for Monitoring Legal Compliance**. The legal and regulatory environment surrounding the servicing industry is changing rapidly, as policy makers at the federal and state level take action to enhance consumer protections. Servicers should establish comprehensive processes to actively monitor regulatory changes, on both the federal and state level, and put in place mechanisms which will facilitate timely modification of internal procedures. In the absence of such measures, servicers face significant exposure to lapses in compliance, which carry with them risks of enforcement action and private litigation.

CONCLUSION

The increased enforcement and litigation focus on mortgage servicers, a growing trend throughout the past decade, will continue apace. Federal and state enforcement authorities will continue to use investigations and litigation as a means to restrict foreclosures and otherwise scrutinize servicer workout practices. Private litigants likewise are poised to pursue claims against servicers (and, in the case of investors, perhaps in spite of them) based on both old and new theories, including many of those detailed above. In this challenging legal landscape, servicers should make enforcement and litigation risk management a top priority. ■