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"DUAL TRACKING" CAN BE RISKY TO LENDERS AND LOAN SERVICERS

By Scott Rogers and Ted Klaassen, © 2012

A recent California case demonstrates that pursuing a loan modification and foreclosure at the same time against a borrower can lead to possible serious liability for lenders and servicers. In the residential context, at least, such "dual tracking" will be prohibited by AB 278/SB 900, which take effect on January 1, 2013. Regardless, this case provides a cautionary tale to all lenders about minding the details of the loan enforcement process. In this case, although the loan servicer never signed and returned a loan modification agreement to the borrower, the court concluded that the borrower could pursue the lender for breach of contract, breach of the implied covenant of good faith and fair dealing, and wrongful foreclosure.

The case of Barroso v. Ocwen Loan Servicing, LLC, No. B229112 (Second Dist., Div. Four, August 21, 2012), started out as so many other residential loan disputes have in recent years. After purchasing her home in 2005, Barroso encountered financial difficulties in 2008 and went into default on her loan. The loan was being serviced for the lender by Ocwen, which commenced foreclosure proceedings by recording a notice of default in January 2009 and a notice of sale in April 2009.

Barroso responded to the foreclosure proceedings by attempting to negotiate a loan modification. Ocwen notified Barroso that she qualified for a federal Home Affordable Modification Program (HAMP) modification. Ocwen sent Barroso a three-month Trial Modification Agreement that required payments in July, August and September 2009, and a longer-term Modification Agreement that required monthly payments starting in October 2009. The signature line on the Modification Agreement had the word "Seal" next to it but no other space or form for Barroso to notarize the document. Barroso signed and returned the Modification Agreement, but did not have it notarized.

Then, sometime after November 2009, Ocwen sent Barroso a Revised Modification Agreement, which reduced her monthly payments slightly. The Revised Modification Agreement had a detailed notary form on the signature page, and was accompanied by a letter expressly requiring Barroso to notarize the document and return it by a date certain. Barroso signed, but did not have notarized, and returned the Revised Modification Agreement to Ocwen, but after the date specified in the letter accompanying it.

Each of the modification documents contained provisions that Barroso's loan documents would not be modified until Ocwen signed and returned the modification agreements to Barroso. The modification documents, as well as the original deed of trust, provided that Ocwen could accept payments from Barroso without waiving its right to foreclose or pursue other remedies. Barroso did not allege that Ocwen ever signed and returned the documents to her. Nonetheless, Barroso made timely payments in accordance with the modification agreements beginning in July 2009.

To Barroso's dismay, in May 2010, she received a notice to quit and was informed that her property had been foreclosed upon in April 2010. She sued Ocwen and the lender. Ocwen and the lender asserted that they had never completed the loan modification process with Barroso. The trial court agreed and dismissed Barroso's case based upon the provisions in the modification agreements that the loan documents would not be modified unless and until Barroso received a copy of the modification agreements signed by Ocwen.

In reversing the trial court's ruling, the appellate court first considered whether notarization of Barroso's signature was required on the modification agreements. It found that notarization of Barroso's signature on the original Modification Agreement was not clearly required by the mere inclusion of the word "Seal" after the signature line. However, the appellate court did find that the notary form on the signature block of the Revised Agreement, along with express instructions to notarize the document, created a condition precedent to the Revised Agreement that Barroso did not satisfy. Thus, lack of notarization was a valid defense to the formation of the Revised Agreement but not to the Modification Agreement.

The appellate court then found that conditioning the effectiveness of the Modification Agreement upon Ocwen's return of a signed copy to Borraso would unfairly allow Ocwen to have sole control over the formation of the contract by refusing to return the same notwithstanding Barroso's full performance of her payment obligations under the Modification Agreement. The court stated that it was required to "avoid an interpretation which will make a contract extraordinary, harsh, unjust or inequitable." The appellate court concluded that Borraso could maintain an action for damages against Ocwen and the lender for breach of the Modification Agreement and, because a contract existed, the action could include damages for breach of the implied covenant of good faith and fair dealing implicit in every contract in California.

Significantly, the appellate court also affirmed Barroso's right to maintain an action for wrongful foreclo-

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sure on principles of equity. In doing so it distinguished Barroso's claim from the more typical statutory wrongful foreclosure claim which requires tender of all amounts owed in order to set aside a completed foreclosure sale. In Barroso's case, the appellate court concluded that, because Barroso was current under the Modification Agreement, in effect all defaults had been cured. Consequently, Ocwen and the lender had no right to foreclose and no tender of payment was necessary as a condition to pursuing a wrongful foreclosure claim.

Several important lessons to lenders and servicers can be gleaned from this decision:

Technical requirements for the execution of modification agreements – such as notarization – must be clearly communicated to the borrower in writing to be effective. Although not entirely clear from the opinion, more detailed notary instructions to the borrower may have been sufficient to preclude the formation of a contract in the first place, thereby completely avoiding potential liability to the lender and servicer under the Modification Agreement.

Even though express conditions to the effectiveness of modification documents may be clearly stated, where satisfaction of those conditions is within the control of the lender or servicer and the borrower signs, returns, and makes payments under the modification agreement, a court may ignore those conditions and enforce the modification agreement against the lender or servicer.

"Dual Tracking" of loan modifications and foreclosures (even when not prohibited by statute) can be potentially risky to lenders and servicers. Care must be taken to avoid potential "left hand, right hand" confusion within or among the lender and servicer, and failed borrower expectations.

This case is a pointed reminder to all players in lending and loan servicing that clear, consistent and effective communication is an effective defense against potential liability in dealing with troubled loans and borrowers. As this case demonstrates, the consequences of unclear and inconsistent communication (whether internal or external) can be confusion, unintended outcomes and potential liability. As our mothers always told us, "an ounce of prevention is worth a pound of cure".

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