New Jersey Law Journal

VOL. CXCII - NO.11 - INDEX 878 JUNE 16, 2008 ESTABLISHED 1878

Complex Litigation & E-Discovery

The Subprime Impact on the Foreclosure Defense in New Jersey

A crisis that is an occasion for alert and imaginative lawyering

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It has been about a year since the crisis in the subprime mortgage market began to engage the attention of the legal profession. This crisis is actually the leading edge of a nationwide collapse in inflated residential real estate values, concentrated in fast-growing areas of the Sunbelt, combined with the impact of a general economic downturn in the declining industrial areas of the Midwest. New Jersey has been less affected than many jurisdictions.

Subprime borrowers are by definition the least creditworthy and the most overextended. They are therefore the most vulnerable to weakening economic conditions and the most likely to default. Their capacity to pay is also the foundation on which creative financial minds erected a lattice work of speculative credit that is now in disarray. Litigation has already begun among disappointed investors and shareholders, investment bankers, loan originators, insurers, trustees and other participants in subprime mortgages. The salvage value of those securities will depend, in large part, on the ability to realize on the collateral under old-fashioned foreclosure law.

That task will be complicated by the fact that, as the New Jersey Supreme Court recently reminded us in *United States v. Scurry,* 193 N.J. 492 (2007), foreclosure is an equitable remedy, and therefore subject to the full panoply of equitable defenses. Subprime borrowers run the gamut from simple and credulous people with insufficient incomes who allowed themselves to be persuaded that they could afford a piece of the American dream, to middle-class borrowers trying to stretch into a bigger house, to disappointed speculators who bought houses for a rise that never happened. Many will try to portray themselves as the victims of fraud or sharp practice; some were. We can expect to see borrowers assert common-law fraud, unclean hands or violation of the federal Truth In Lending Act, 15 U.S.C. § 1601 *et seq,* Fair Debt Collection Practices Act, 15 U.S.C. § 1692 *et seq,* RESPA, 12 U.S.C. § 2601 *et seq.*, or the New Jersey Consumer Fraud Act, N.J.S.A. 56:8-1 *et seq,,* in defense to foreclosure.

An example of such potential defenses and counterclaims is last year's decision in *In re Curriden*, 2007 WL 4554256 (Bkrtcy.D.N.J.), a nonforeclosure plenary action in bankruptcy. The debtor, in financial distress and facing a foreclosure action, was inveigled by a mortgage broker's employee into a refinancing sale to a straw buyer that ended with her $125,000 house in other hands, $5,000 in her pocket, and the remainder of the equity dissipated in kickbacks and inflated fees and closing costs. The bankruptcy court found various individual participants in the scheme liable for compensatory and punitive damages under theories of common-law fraud, civil conspiracy, and violations of the New Jersey Consumer Fraud Act and of RESPA's anti-kickback provision. It held the mortgage brokerage company liable for compensatory damages under respondeat superior but denied punitive damages because the broker's actual knowledge or willful ignorance of its employee's scheme was not proven. Through the rubric of unclean hands, such common-law and statutory violations are likely to be raised as defenses to foreclosure and as counterclaims for damages.

We can also expect to see borrowers demand strict technical compliance with foreclosure procedures, in the hope that

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sympathetic trial courts will erect procedural roadblocks in order to keep them in their homes. It is normal for residential mortgages to be sold in the secondary market for securitzation. A well-known federal court decision in Ohio last year temporarily threw foreclosure enforcement in that state into disarray by requiring that the assignment of the mortgages, and the plaintiff's standing to foreclose, be completely and accurately documented, *See In re Foreclosure Cases,* 521 F.Supp.2d 650 (N.D. Ohio 2007).

Recent decisions in New Jersey and the Third Circuit, however, indicate that the courts are not being unduly swayed by the plight of the borrowers and remain well aware of creditors' legitimate rights. In the first place, the federal courts are not allowing borrowers to raise in separate actions defenses or counterclaims that could and therefore should have been raised in an underlying foreclosure. Last month's Third Circuit decision of *Moncrief v. Chase Manhattan Mortgage Corp.*, WL 1813161, (3rd Cir. 2008), involved a Pennsylvania homeowner who sued to enjoin her dispossession under a foreclosure judgment, alleging that she had been the victim of a fraudulent scheme and that the plaintiff lender lacked standing to foreclose. The Third Circuit affirmed dismissal of her complaint on two grounds. First, the *Rooker-Feldman* abstention doctrine barred a federal suit to review the validity of the state court final judgment. Second, the fraud claims could have been asserted as defenses to the foreclosure suit under Pennsylvania law and were therefore barred by res judicata.

Under New Jersey R. 4:64-5, "germane" counterclaims are allowed in response to foreclosure suits, and a counterclaim arising out of the underlying loan transaction is germane:

> Without doubt a defendant in a foreclosure action may challenge plaintiff's right to foreclose. We think it clear that any conduct of a mortgagee known to the mortgagor prior to the institution of a foreclosure that could be the basis of an independent action for damages by reason of the mortgagee having brought the foreclosure could be raised as an equitable defense in the foreclosure., *NLF Partnership v. Sasso*, 313 N.J. Super. 546 (App. Div.1998).

Borrowers who do not assert all their defenses and counterclaims in the foreclosure will not get a second chance in the federal courts, and they run the risk that damage claims that could have been asserted as counterclaims will be barred by res judicata, collateral estoppel or the entire controversy doctrine, *See Lewison Bros. v. Washington Sav. Bank*, 162 B.R. 974 (Bankr. D.N.J. 1993). Counsel for lenders or buyers of foreclosed property need to be aware of preclusion; those who counsel or represent borrowers must take care that potential defenses or counterclaims are not lost to preclusion by lack of timely assertion.

New Jersey's courts, while enforcing the procedural requirements relating to foreclosure, have been careful not to impair the lender's substantive rights. *EMC Mortgage Corp. v. Chaudri*, 2008 WL 1774991 (N.J.Super.A.D.2008), which applied the Fair Foreclosure Act ("FFA"), N.J.S.A., 2A:50-53 *et seq.*, is instructive. In *Chaudri*, the original lender sued without complying with the FFA's requirement that the borrower be given 30 days advance notice of the foreclosure suit by certified mail, with the opportunity to cure. The foreclosure complaint was dismissed without prejudice, and the loan remained in default. The original lender went into bankruptcy. The borrowers then obtained an order vacating the original lender's lis pendens and quieting title in themselves. EMC Mortgage bought the mortgage from the bankrupt estate, recorded the assignment, gave the notice to the borrower required by the FFA, sued for foreclosure, and recorded its lis pendens. After EMC's complaint was filed, borrowers sold the property to their daughter, who borrowed part of the purchase price under a mortgage from another lender.

In sorting out the resulting tangle, the Appellate Division established three principles. First, dismissal of the original lender's foreclosure for failure to comply with the FFA was without prejudice and therefore did not affect the validity of the mortgage lien. The quiet title order was invalid, and the lender or its assignee remained free to commence another foreclosure after providing presuit notice in compliance with the FFA. Second, while strict compliance with the presuit notice provisions of the FFA is required, the courts may not impose a more stringent notice requirement than the certified mail dictated by the statute. Third, the notice required by the FFA does not include notice that the mortgage has been assigned. When the recording statutes have been duly complied with, a recorded assignment is deemed to be notice to the entire world, including the borrower, of the assignment. The court noted that RESPA requires that a borrower be notified if the servicer of the mortgage is changed, *See* 12 U.S.C. § 2605(b); 24 C.F.R. § 3500.21(d), but it pointed out that "the loan servicer and the assignee of the mortgage are often not one and the same."

United States v. Scurry equally protects the creditor's substantive rights against its procedural errors. In that case, the foreclosure sale had been conducted in violation of R. 4:65-2, which requires 10 days notice to the mortgagor before a foreclosure sale. The borrower learned of the foreclosure sale only when she was served with a writ of possession. She immediately moved to vacate the sale and tendered a sufficient amount to bring her arrears current and cure the default. The Supreme Court reversed the appellate division and held that the borrower was not guilty of laches and that the balance of equities favored vacating the sale.

Having done so, however, the Court went on to hold that it would not compel the doing of a useless act. If the plaintiff could not demonstrate on remand her ability to cure the default within a reasonable time, including all arrears, the expenses of sale, and the buyer's out-of-pocket costs to maintain the property, then the sale would stand.

The teaching of *Chaudri* and *Scurry* is that a lender's procedural missteps may delay foreclosure but ultimately will not relieve the borrower of his or her obligations to the lender or to an assignee that has duly recorded the assignment. The lesson of *Moncrief* is that valid substantive defenses based on common-law fraud, consumer fraud statutes, or federal regulatory statutes may be lost for good once a foreclosure has been reduced to judgment. As recently pointed out by a bankruptcy judge in another jurisdiction, "The Court finds, however, that all too often counsel rely upon the tragedy of a situation to circumvent the diligence required to actually prove violations of the myriad federal and state consumer protection statutes" that might offer a defense, *In re Noyes,* 382 B.R. 561, (Bankr. D. Mass. 2008). The subprime crisis is an occasion for alert, imaginative lawyering, not an exemption from it. ■