

B&B REVIEW

Financial Institutions and Regulation

Creditors Rights and Bankruptcy

MORTGAGE FORECLOSURES REQUIRE SPECIAL DILIGENCE

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INTRODUCTION

No one knows exactly what effect the current controversy over residential mortgage foreclosures will have on residential borrowers or lenders or on investors in mortgage-backed securities. One thing that is certain, however, is that lawyers representing delinquent borrowers will be scrutinizing the processes used by lenders to foreclose on mortgaged properties, in an effort to delay or even avoid their clients losing their homes. Banks also can expect that regulators will be looking carefully at banks' foreclosure processes for compliance with federal and state consumer protection laws, as part of their "consumer compliance" oversight duties.

This **B&B Review** will review some of the essential steps in mortgage foreclosure. Bank managers might wish to confirm with their credit recovery employees and independent contractors that they are following these steps.

TYPES OF FORECLOSURE

There are two types of foreclosure in Alabama: judicial foreclosure and non-judicial foreclosure. As the name suggests, a judicial foreclosure is conducted only after a lawsuit is commenced in which at least a part of the relief sought is foreclosure. Most lenders attempt to avoid the judicial foreclosure process because of its more cumbersome requirements and instead

include a "power of sale" in the mortgage entered into with borrowers which allows a foreclosure without judicial oversight (i.e., a non-judicial sale). Managers might wish to ask credit recovery employees and agents whether the bank's standard mortgage documents include a power of sale.

Non-Judicial Foreclosure Under a Power of Sale Clause

If the mortgage documents contain a power of sale clause, then the borrower has agreed that, in the event of a default, the lender may foreclose without going to court. Alabama law permits representatives of a lender to carry out the foreclosure process specified in the documents. Usually, the loan documents state the time (between 11:00 a.m. and 4:00 p.m.), location (in front of the main entrance of the county courthouse where the property is located) and the terms of the sale (cash).

Under Alabama law, if there is a power of sale clause in the mortgage documents, but there are no specified requirements for the time, place and terms of the sale, then a foreclosure must take place at the front or main entrance of the courthouse of the county where the property is located, after default on the mortgage or deed of trust, for cash to the highest bidder.

If a lender will rely on a power of sale clause to foreclose, the lender must publish a notice of the foreclosure sale in a

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newspaper of general circulation in the county in which the property is located for three (3) consecutive weeks prior to the sale, unless the loan documents require a longer period of time. Although it is not required under Alabama law and not always required under the loan documents, it is generally a good practice to mail the borrower written notice prior to the foreclosure sale.

After foreclosure, Alabama law gives the borrower, among other things, a "statutory right of redemption," which allows the borrower to redeem the property by making payment in full of the unpaid loan plus certain costs and interest within one (1) year after the foreclosure sale

Judicial Foreclosure

At the lender's option, it may utilize the judicial foreclosure process when there is no power of sale specified in the mortgage documents or if a compelling reason exists as to why a judicial foreclosure may be needed. For example, judicial foreclosure may be appropriate if there is an issue with the property's title or if the mortgage to be foreclosed needs to be reformed.

A lender that chooses a judicial foreclosure may also file a document known as a *lis pendens* ("lawsuit pending"), which provides public notice that the property is the subject of a judicial foreclosure action.

The same right of redemption and right to pursue a deficiency judgment are available to a borrower for this type of foreclosure.

DEEDS IN LIEU OF FORECLOSURE

As an alternative to foreclosure, many states, including Alabama, allow a lender to accept a "Deed in Lieu of Foreclosure" from a borrower. As with other deeds, a Deed in Lieu of Foreclosure transfers title of the property to the lender, permitting the lender to sell the property immediately. Because there is no foreclosure when a lender accepts a Deed in Lieu of Foreclosure, the borrower will not have any right of redemption.

Pitfalls to Avoid

Foreclosure can increase the risk of potential claims by borrowers and other parties against the foreclosing lender. Here are some issues to keep in mind during the foreclosure process:

- In order to avoid any perception of impropriety, a bank's employees and their family members should not bid at a foreclosure sale.
- Do not share information regarding the property with interested bidders (such as the amount of the debt, the status of taxes, title work or appraisals). If the information is later found to be inaccurate, the purchaser or unsuccessful bidders may claim that their reliance on the misinformation resulted in damages.
- A bank may share its opening bid price to inquiring bidders. However, the bank should not reveal its maximum bid price. Courts sometimes refer to the foreclosing lender as a "quasi trustee" of the borrower and junior lienholders. Revealing the bank's maximum bid price may be perceived as lowering the property's highest potential sale price.

Under Alabama law, the foreclosure sale price must not be so low that it "shocks the conscience of the court." The foreclosure sale price is scrutinized by courts based on its comparison to the property's fair market value, not the amount of the debt secured by the property. Therefore, consider how the foreclosure sale price compares to the property's fair market value.