by Thomas Brom

The Dream Deferred

LANGSTON HUGHES KNEW ABOUT DREAMS DEFERRED, and how they can fester like a sore. So do millions of California borrowers who rode the housing bubble, only to face a choice of foreclosure, bankruptcy, or walking away—called "jingle mail" for the house keys sent back to the bank.

"Home ownership is still the American dream, but it's a difficult dream to achieve," says Christopher Hanson, principal of the Hanson Law Firm in Alameda. Hanson's real estate practice represents borrowers, real estate agents, and mortgage companies—and he deals with reality rather than dreams. Reality, he says, is "at least a five-year overhang [of available inventory] that's keeping housing prices down," and lots more foreclosures to come. But so far participants in the credit chain, from loan originators and servicers to the investors in residential mortgage-backed securities (RMBS), aren't willing to share the impact of housing devaluation.

Last year's relief effort was loan modification, a second-best alternative after Congress refused to permit judges to reduce mortgage principal in bankruptcy proceedings. The banking industry termed that idea "cram-down," and killed it. With court-directed principal reduction off the table, the Treasury Department launched the Home Affordable Modification Program (HAMP), which offers negotiated terms, reduced interest, and deferred principal payments. But by the end of February, only 168,708 households nationwide had won permanent loan modifications, and another 835,194 were in trial periods. Meanwhile, more than 11 million U.S. households—about a fifth of all residential properties with mortgages—are in negative equity, or "underwater."

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Last November the Treasury Department underwrote another strategy with its Home Affordable Foreclosure Alternatives (HAFA) initiative, effective April 5. The program offers loan servicers—primarily Bank of America, Wells Fargo, JPMorgan Chase, and Citibank—a $1,500 incentive to enter a "short sale" initiated by the homeowner to sell a property at less than its outstanding mortgage. Eligible homeowners, who are provided $3,000 in moving expenses, are "preapproved"—meaning they've already been analyzed by the servicer under HAMP, but either were turned down or fell out of that program.

In March the Treasury Department announced yet another program, this time offering federally backed mortgages to refinance underwater loans held by investors if they agree to write down principal by at least 10 percent. Homeowners must be current on their loan and fully document their income.

"The problem is a practical one: to weed out borrowers who can no longer afford to live in their homes," says Mark S. Blackman, a real estate litigator who represents creditors at Alpert, Barr & Grant in Encino. "The short sale is a preferable alternative to foreclosure. But the process is bizarre, and shrouded in mystery. If the lender agrees, cash-for-keys is faster."

"Short sales are never going to work," Hanson says. He points out in his firm's newsletter that a typical short sale extinguishes the lender's security interest but not the borrower's debt. Under the One-Action Rule in California's anti-deficiency laws (C.C.P. 726(a)), lenders can either go after the lien or pursue the debtor individually, but not both. If they go after the lien, they must choose a judicial or nonjudicial proceeding. Most foreclosures are nonjudicial because they are cheaper and faster for the lender. They prevent the lender—but not junior lienholders—from pursuing the debtor for any deficiency.

A short sale usually wipes out junior lienholders, commonly including home equity lenders. But according to Hanson, these lenders may take as long as four years to file suit against the borrower for breach of contract. And despite recent special rules amending federal and state tax laws, some short sellers in California also face the potential for a big tax bill on income from cancelled debt.

"Supposedly, homeowners who do short sales take less of a hit on their credit scores," says Pamela D. Simmons, a principal in Simmons & Purdy in Santa Cruz County who represents borrowers. "But most lenders won't permit a short sale unless the borrower is in default—and there's a credit hit from that. Then there's a second hit when the short sale is reported. If there's a benefit, it's a small one."

Dan Mulligan, name partner in the San Diego office of Jenkins Mulligan & Gabriel who represents borrowers, says the HAFA program shows that the administration may not take the foreclosure crisis as seriously as it should. "Short sales are incredibly difficult to arrange," Mulligan says. "I had one going on for a year, and the bank never responded. Maybe the servicers are overwhelmed; maybe they're just screwed up. I think they're hoping to postpone taking the loss and dumping properties on the market for as long as possible."

Isaac M. Gradman, a real estate litigator at Howard Rice Nemerovski Canady Falk & Rabkin in San Francisco, says the major problem with foreclosures is the conflicts of interest between borrowers, loan servicers, and the investors in mortgage-backed securities. "Last year Congress passed a safe harbor provision that relieved servicers from bearing the cost of workouts, but that just shifted the loss to the investors," Gradman says. "Who bears the cost of principal reduction? Washington never dealt with that question."

Eventually, the courts will have to sort it out. Last year investors filed suit against Wells Fargo, alleging the bank misrepresented its RMBS loan underwriting standards, the value of the underlying real estate, and the credit ratings of the securities (*In re Wells Fargo Mortgage-Backed Certificates Litigation*, 09-1376 (N.D. Cal. filed Mar. 27, 2009)). This March the Federal Home Loan Bank of San Francisco filed two suits seeking rescission of more than $19 billion in RMBS against a laundry list of major financial institutions (*FHLB v. Credit Suisse Securities (USA) LLC*, No. CGC-10-497840 (S.F. Super. Ct. filed Mar. 15, 2010)).

Those suits followed a New York lawsuit filed in December 2008 alleging that servicer-modified home loan reductions violate securitization contracts with investors, representing a regulatory taking (*Greenwich Fin. Serv. Distressed Mortgage Fund 3, LLC v. Countrywide Fin. Corp.*, 654 F. Supp. 2d 192 (S.D.N.Y. 2009) (case remanded to state court)). Gradman writes in his Subprime Shakeout blog that the biggest challenge to plaintiffs will be getting access to loan files, which the originators are loathe to turn over because they might "reveal the depths of their depravity."

The most immediate concern for the nation's homeowners, however, is the anticipated rate spike in so-called "five-year option adjustable rate mortgages (ARMs) that were signed at the top of the bubble in 2005 and 2006. "Now upper-income people with their loans still current are coming in" for help, Mulligan says. "They're looking ahead ten to twelve months at the anticipated jump in payments, and they realize they can't make it."

The trend lines in all these developments converge in fourth-quarter 2009 Commerce Department statistics: The percentage of Americans who owned their homes fell to the lowest point, 67.3 percent, in nearly a decade. Between 2007 and 2009, nearly four million homes were lost to foreclosure.

Somewhere, the ghost of banker and former Treasury Secretary Andrew Mellon is still advising President Herbert Hoover: "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate. It will purge the rottenness out of the system. ... Values will be adjusted, and enterprising people will pick up the wrecks from less competent people."

Despite the purity of Mellon's logic, Hoover ignored him. Eighty years later all parties in the residential house of cards are dug in, refusing to liquidate or even share their losses around the table. Simmons says her practice in Santa Cruz County has never been busier. There's anger out there like I've never seen it," she says. "It's scary." CL