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New Federal Law Affects Foreclosures of Residential Property with "Bona Fide" Tenants

Homeowners are not the only group feeling the effects of the unprecedented increase in foreclosures throughout the U.S. during the current economic downturn. Tenants living in residential properties are being required to vacate after foreclosure and often on very short notice.

In order to address this issue, Congress enacted the Protecting Tenants at Foreclosure Act of 2009 (PFTA) as a subpart of the Helping Families Save Their Homes Act of 2009 (Public Law 111-22) (effective May 20, 2009). The scope of the Act's provisions is very broad as it applies to "any foreclosure" on (1) a federally related mortgage loan, or (2) any dwelling or residential real property. Thus, the requirements of the Act extend to all residential property foreclosures (including commercial loans secured by residential rental property), regardless of type or entity involved in the foreclosure, and regardless of whether the tenants are recipients of any type of housing assistance.

Under the law, the immediate successor in interest at foreclosure must: (a) provide bona fide tenants with 90 days notice prior to eviction; and, (b) allow bona fide tenants with bona fide leases entered into before the notice of foreclosure to occupy the property until the end of the lease term, except the lease can be terminated on 90 days notice if the unit is sold to a purchaser who will utilize the property as his or her primary residence.

A lease or tenancy is "bona fide" if the tenant is not the mortgagor or the parent, spouse, or child of the mortgagor, the lease or tenancy is the result of an arms-length transaction, and the lease or tenancy requires rent that is not substantially lower than fair market rent or is reduced or subsidized due to a federal, state or local subsidy.

The law does not cover tenants facing eviction in a non-foreclosed property, tenants with a fraudulent lease, tenants who enter in lease agreements after a foreclosure sale, or homeowners in foreclosure. One reading of the statute is that the 90-day notice may be sent prior to the actual transfer of title to the property.

For property with a Section 8 tenant, a purchaser who intends to occupy the premises as a primary residence may terminate the Section 8 lease upon 90 days notice to the tenant. Any successor "pursuant to the foreclosure" acquires the property subject to the Section 8 lease but with the right to receive the Section 8 payments.

As a practical matter, lenders need to consider these changes when making loans that will be secured by rental property, and will also want to be sure that the parties handling their foreclosures have the necessary procedures in place to provide any required notice to protected tenants.

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No Retroactive Reading Allowed: 2006 Amendment to the Lien Release Statute Prospective Only

In Kentucky, KRS 382.365 provides a cause of action for an owner of real property to sue a lien holder that failed to release its lien within 30 days of the satisfaction of the lien. As presently drafted, a property owner is entitled to an award of attorney's fees, costs and a statutory penalty of $100 per day, *which can increase to $500 per day*, if a property owner can prove: (1) that a lien holder failed to release its lien after satisfaction; (2) after receiving written notice of this fact via personal delivery or certified mail; and (3) that there is no good cause that excuses this failure to release. The statute provides that the $100 per day penalty starts 15 days after receipt of written notice. The penalty increases to $500 per day on the 46th day after receipt of written notice. The statute also applies to the failure to record an assignment.

With the recent explosion of refinancing and bulk assignments of mortgages, the state's interest in ensuring that release and assignment fees are timely paid is obvious. The state also wants all transactions regarding real property to move smoothly and quickly without having to address unreleased mortgages from prior years and prior owners. However, the significant penalties imposed by KRS 382.365 create a substantial risk for lenders that fail to release liens in a timely manner, whether through mistake or negligence.

Previously, the statute only required "written notice" be given to the lender to start the clock on statutory penalties; however, the statute was silent on what constituted "written notice". Further, it failed to specify who had to receive the written notice. Given the size and scope of some modern lenders, this lack of specificity had the potential to cause serious problems. In 2006, the General Assembly modified the statute to state that written notice shall be properly addressed and sent via certified mail or personally delivered. Additionally, the amended statute now states who must be given written notice if the lien holder was a corporation, individual, trust or estate, or any other entity.

A recent opinion from the Kentucky Court of Appeals not only shows the necessity of the 2006 amendment, but also held that the 2006 amendment cannot be read into the statute retroactively and do not apply to causes of action that arose prior to the amendment. In *Riley v. Flagstar Bank*, FSB, —S.W.3d— (Ky.Ct.App. 2009), the Kentucky Court of Appeals heard an appeal from a decision of the Whitley Circuit Court in favor of the defendant, Flagstar Bank, on its motion for directed verdict. The Court of Appeals, however, rejected the arguments made by Flagstar in support of its motion for a directed verdict in its favor and held that the decision should have been left to the jury.

In this case, the Rileys executed a mortgage in favor of Tri-County Mortgage in October 2002, which was ultimately assigned to Flagstar through Mortgage Electronic Registration Systems, Inc. (MERS). On December 1, 2003, the Rileys refinanced their mortgage through Tri-County Mortgage which, in turn, used Flagstar to fund the transaction. In June 2004, an employee of the law firm that handled the refinance discovered that the now-satisfied October 2002 mortgage had not been released. This employee testified that she called Flagstar and spoke to an employee identified as "Edwina" regarding the unreleased mortgage. The employee further testified that she faxed Flagstar regarding the unreleased mortgage using a fax number provided by "Edwina."

In its defense, Flagstar introduced evidence that it had tried to release the mortgage in March 2004, that it had no record of receiving the fax sent to "Edwina" and that the fax number used by the law firm employee was not the correct number for its lien release department. However, Flagstar's internal records showed another attempt to release the lien on June 11, 2004, which was the same date the fax from the law firm was sent. Nonetheless, the Whitley Circuit Court ruled in favor of Flagstar on a motion for a directed verdict. Its decision was based on its belief that the fax did not constitute "written notice" within the meaning of the statute and because Flagstar still held a mortgage on the Rileys' property as a result of the refinance.

On appeal, Flagstar argued that the 2006 amendment to KRS 382.265 should be read retroactively into the statute as written in 2005. In essence, Flagstar argued the legislature meant to state how and to whom written notice should be delivered when it first drafted the statute; however, it only explicitly stated this in the 2006 amendments. If the Court of Appeals read the 2006 amendments into the statute as it was drafted in 2005, then the fax would not have provided written notice within the meaning of the statute as it was not delivered via personal delivery or certified mail to the agent for service of process for Flagstar, or to an officer of Flagstar. The Court of Appeals, however, rejected any retroactive reading of the current version of the statute per KRS 446.080(3), which provides that "no statute shall be construed to be retroactive, unless expressly so declared." The Court could find no evidence that the legislature intended the 2006 amendments to be read retroactively and that to read those amendments into the 2005 version of the statute would constitute a substantive change in the law.

The Court of Appeals further found that because KRS 382.365 did not define what constituted written notice that only reasonable notice was required. Based on prior Kentucky case law hold-

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Mortgage Holders Beware: Failure to Timely Answer a Complaint Results in Loss of Interest in Property

A mortgage holder's interest in real property can be defeated by the simple failure to timely respond to a summons in a foreclosure action. If more than 20 days elapse between service of a summons on the mortgagee and its filing of a responsive pleading, the court can enter a default judgment that voids the claim under the mortgage. See, *First Horizon Loan Corp. v. Barbanel*[1].

In *First Horizon*, Roberta J. Barbanel filed a lien foreclosure action on February 4, 2005, naming First Horizon and another bank, each of which held mortgages filed prior to the lien of Barbanel, as parties to the action. The bank was served with a summons and copy of the Complaint on February 7, 2005, by certified mail, received and signed for by its registered agent for process, CSC-Lawyers Incorporating Service Company. The bank did not answer within 20 days of service and Barbanel moved for default judgment, which was granted on March 22, 2005.

To serve First Horizon, Barbanel complied with KRS 454.210 and forwarded a Summons and Complaint to the Kentucky Secretary of State naming First Horizon as a Defendant. The Secretary of State received the summons on Monday, February 7, 2005, and the Secretary of State mailed copies, via certified mail, to First Horizon at the address listed in the Complaint. First Horizon received the Complaint on February 10, 2005, and forwarded it to its in-house counsel. First Horizon then sent the Complaint to the title company, Stewart Title Guaranty Company, and its in-house counsel. Believing an answer needed to be filed by March 3, 2005, an extension of time until March 7, 2005 was requested to file an Answer. However, no Answer was filed by March 7, 2005.

Barbanel then filed a Motion for Default Judgment against First Horizon on March 8, 2005 and the Motion was granted on March 22, 2005. First Horizon filed a Motion to Set Aside the Judgment requesting the court to allow it to file an Answer, Cross-Claim and Counterclaim out of time. As the basis for the Motion, First Horizon argued that it had been improperly served, as Barbanel failed to serve First Horizon's registered agent. Furthermore, First Horizon argued that it had a valid excuse for failing to file its Answer, since in-house counsel had resigned from Stewart Title before March 7, resulting in Stewart Title failing to file an Answer within the deadline. The trial court denied First Horizon's Motion and both the bank and First Horizon appealed on the basis that they had valid explanations for their default.

Pursuant to Kentucky Rule of Civil Procedure 55.02, a trial court may set aside a default judgment if the moving party shows "good cause" pursuant to Kentucky Rule of Civil Procedure 60.02. Kentucky Rule of Civil Procedure 60.02 states that "good cause" is demonstrated if the defaulting party shows: (1) that there is a valid excuse for default; (2) that there is a meritorious defense; and (3) that there is an absence of prejudice to the non-defaulting party.[2]

The bank and First Horizon stated

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No Retroactive Reading

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ing that telegrams, printing, and typewriting all constitute "writings," the Court of Appeals held that a jury should decide whether the fax from the attorney's office to Flagstar constituted reasonable written notice within the meaning of the statute. Similarly, the Court of Appeals stated that a jury should decide whether the stamped signature of an attorney on the fax impaired the sufficiency of the notice given to Flagstar.

Despite the unfavorable ruling for the lender, it does appear that the Court of Appeals was correct in reversing the decision of the Whitley Circuit Court. Sufficient evidence had been introduced for a jury to determine whether Flagstar received written notice and that it had failed to release its lien on the Rileys' property. There was no evidence that the General Assembly intended the 2006 amendments to be read retroactively into the text of the prior statute, which was silent on who was to receive written notice that a lien had not been released. Interestingly, the Court of Appeals also rejected a potential "no harm, no foul" defense suggested by the Circuit Court's opinion. It found that the statute provided no exemption to a lien holder that had retained a lien on the property, yet had failed to release a prior, satisfied lien after receiving written notification that the lien had not been released.

From a lender's standpoint, it might be "pennywise" not to release a satisfied mortgage when placing another lien on the property, assuming it will release both mortgages simultaneously in the future and only pay one filing fee. However, this case shows that decision may be "pound-foolish" as the owner of the property can still bring a claim against the lender for its failure to release the prior lien, even when the property is subject to an active mortgage. While the statute now clearly states who must receive written notice and what constitutes written notice, all parties who regularly encumber property with liens should instruct their employees and registered agents to pass along any document referencing an unreleased lien to the appropriate person to avoid the imposition of statutory penalties.

M. Tyler Powell

Loss of Interest

Continued from page three.

that they had "good cause" for the reasons cited *infra*. However, First Horizon's argument that it was improperly served failed because it had actual notice of the Complaint 22 days before the motion for default judgment was filed. The Court of Appeals further denied both parties' arguments regarding "good cause" in their failures in handling the Complaints because it ruled the trial court did not "abuse its discretion" by granting default judgment against First Horizon and the bank.

The Court of Appeals also denied First Horizon's argument that Barbanel's judgment, granting her first priority to the proceeds of sale, must be amended to reflect the proper priority based on the first-in-time rule. The Court of Appeals held that the failure of the bank and First Horizon to answer Barbanel's Complaint-and subsequent Motions for Default Judgment-gave Barbanel's lien priority over the prior recorded mortgages.

Banks should take away several lessons from the *First Horizon* decision. Most importantly, banks should be diligent in having an Answer or other responsive pleading filed with the Court within 20 days of service. While some may argue that it makes more sense for Kentucky to follow the Federal Rule allowing 30 days for corporate defendants to answer a Complaint, banks must comply with current state rules and not be complacent in sending proper loan documentation to their counsel in order to file a timely Answer or other responsive pleading.

Banks must analyze their procedures for service and make sure that employees know what to do when served with a Summons and Complaint. The Kentucky Rules of Civil Procedure allow for any managing agent to be served at any branch. Furthermore, service of the Summons and Complaint may even fall into the hands of tellers or an employee who opens branch mail. Consequently, procedures must be implemented to ensure that the proper action is taken upon receipt of a Summons and Complaint.

Finally, banks must pay close attention to the date of service of the Summons and Complaint. Bank officers and employees must note the date of service on the Summons, whether it is through registered mail or sheriff service, and follow through with their counsel to make sure that an Answer of record has been filed within 20 days of service.

While the implementation of such measures may seem to expend valuable resources and costs, such measures are necessary to ensure that the bank's mortgages are properly protected from being avoided in a foreclosure action.

Timothy A. Schenk

End Notes

[1] *First Horizon Loan Corp. v. Barbanel*, 2008-CA-000083-MR, 2009 WL 1884397 (Ky. App. 2008).

[2] See Ky. C.R. 60.02. *See also Perry v. Central Bank & Trust Co.*, 812 S.W.2d 166, 170 (Ky. App. 1991), citing 7 W. Bertlesman and K. Phillips, *Kentucky Practice*, CR 55.02, comment 2 (4th ed. 1984).

Firm News

M&P is pleased to announce:

Brad Salyer has joined the firm as an associate attorney. Salyer is a 2009 graduate of the University of Kentucky, College of Law where he was Vice President of the Moot Court Board. He obtained his bachelor's degree from Georgetown College in political science. Salyer intends to focus his practice on commercial litigation and bankruptcy. Salyer is located in M&P's Louisville office and can be reached at 502-560-6762 or *bss@morganandpottinger.com*.

"An American Family: Three Decades with the McGarveys" by Courier-Journal photographer Pam Spaulding, and published by National Geographic, was released on October 22, 2009.

In other news:

John McGarvey, Thurman Senn and Mindy Sunderland were presenters at the 29th Annual Conference on Legal Issues for Financial Institutions sponsored by UK College of Law.

Mindy Sunderland, Taylor Hamilton, and Eric Jensen participated as volunteer attorneys for the Legal Aid Society's Domestic Violence Advocacy Program.

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