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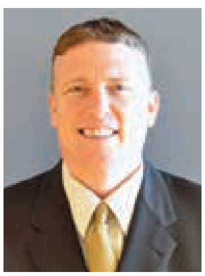
CHAIRMAN'S CORNER

CMBA Finds Success

Despite Turbulent Times

BY DENNIS SIDBURY, NORTHMARQ CAPITAL, CMBA CHAIRMAN



This will be the last article I write as Chairman of the California Mortgage Bankers Association. It has truly been my honor to represent the organization this past year.

Other pieces I've written during my tenure have been primarily forward looking. What does the legislature have in store for us in the coming year? What does the current economic situation look like and how will it affect our industry? In this article, however, I want to start by taking a look in the rear view mirror and reflecting on the strength of the association.

It may seem like ancient history but really not that long ago, the organization was struggling along with every other local, state, and national trade group, thanks to the financial crisis. Membership was down, the rainy day funds were dwindling and the future of the association was uncertain. However, with a renewed focus the group began to turn the tide and we now find ourselves in an extraordinary solid financial position.

By the time I joined the board in 2009, there was genuine momentum. But remember 2009? What a fun year that was! The mortgage industry was doing its best to navigate through the most severe downturn it had experienced since the Great Depression and we all watched as countless companies went belly up. Despite the challenges that could have set the association back for years to come, we experienced just a 3.6% decline in unrestricted reserves. That is truly remarkable.

What's even more remarkable is that the by the end of fiscal year 2010, we had already replenished that relatively minor loss as we enjoyed a 3.9% increase in unrestricted reserves year over year. We recently closed the books on fiscal 2013 and, on the

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Real Estate Lenders Relief From Serial Bankruptcies

AKA "In Rem" Relief From Stay

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Almost nothing frustrates a real estate lender more than being unable to timely enforce its deed of trust through foreclosure.When the borrower files bankruptcy, the "automatic stay" of Section 362 of the Bankruptcy Code, at least temporarily, prevents the lender from completing its foreclosure.Notwithstanding that the borrower's bankruptcy may have been filed solely for the purpose of hindering or delaying the foreclosure, to complete the foreclosure, the lender needs to make a motion to the court for relief from the automatic stay. Obtaining relief from stay can take months and cost many thousands of dollars for legal fees, appraisal costs and the like as the lender must establish its entitlement to relief from stay.However, even though the lender may be successful in obtaining relief from stay granted by the court in the borrower's bankruptcy, it still may not be clear sailing through foreclosure. All too often the borrower is unwilling to give up without a further fight.In those situations, the borrower may transfer the property, or an interest in or a lien upon the property, to a related or friendly third party (often formed for just that purpose) which in turn files another bankruptcy to gain the benefit of the automatic stay and forestall the foreclosure.

Bankruptcy courts have also observed another pattern of cases, in which a borrower, who is not a debtor in bankruptcy, attempts to stave off foreclosure by purporting to transfer an interest in his or her property to a debtor in bankruptcy.Usually, the borrower and the debtor have no connection.The original borrower, or someone working on the borrower's behalf, may have found the Debtor's name by simply searching public bankruptcy records.The borrower may have falsified and back-dated a grant deed, and the deed may have never been actually recorded.In such cases, the only party who truly benefits from this scheme is the original borrower who obtains the automatic stay in the bankruptcy case of another party without having to file a bankruptcy petition and comply with the requisite duties of a debtor in bankruptcy.(*See, e.g., In re Dorsey*, 476 B.R. 261, 266 (Bankr. C.D. Cal. 2012).

Schemes like the scenarios described above can forestall foreclosure for, in the case of some crafty borrowers, several years.Thus, in either of these scenarios, the lender is back at square one and is now truly frustrated.Fortunately, there is now some relief for lenders.

In recognition of the potential for such "serial bankruptcies," Section 362(d)(4) was added to the Bankruptcy Code in 2005 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act.Section 362(d)(4) was added to combat serial bankruptcy filings by allowing an "in rem" relief from stay order.Such an order, once a certified copy is recorded in the real estate records with regard to a specified property, makes the relief from stay order effective for 2 years in most cases regardless of any subsequent bankruptcy filing within that 2 year period.The "in rem" relief from stay is both prospective and automatic for the 2 year period. Consequently, the "automatic stay" otherwise applicable upon the filing of a bankruptcy does not take effect, and the lender is permitted to continue and complete its foreclosure notwithstanding the subsequent bankruptcy filing.To thereafter circumvent the "in rem" relief, a debtor would be required to seek the bankruptcy court's reconsideration of

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the "in rem" relief order and carry the burden of proving a material change in circumstances and/or good faith.

However, as originally enacted, Section 362(d)(4) was of little use to lenders as it required the lender to demonstrate that the bankruptcy filing was part of a scheme to delay, hinder and defraud creditors.Although delay and hinder are fairly obvious and easily demonstrated, fraud is much more difficult to prove often requiring extensive discovery and factual presentation.As all 3 elements were required to be shown, the "in rem" relief offered by Section 362(d)(4) was infrequently sought and very rarely granted.Consequently, "in rem" relief from stay had fallen off the radar of most real estate lenders and their counsel.

Subsequently, as part of the Bankruptcy Technical Corrections Act of 2010, "and" was replaced by "or" in Section 362(d)(4) thus paving the way for much broader application of the "in rem" relief from stay provision.The burden of proof on the lender seeking "in rem" relief is now substantially reduced.All the lender need show is that there was a scheme to delay, hinder or defraud, and if that scheme involves the transfer of an ownership interest in real property without the secured creditor's consent, then the secured creditor may obtain relief under § 362(d)(4).The debtor's involvement in the scheme is not required.This post-2010 interpretation thus covers the second scenario described above in which the actual borrower is not actually the debtor in bankruptcy.

In summary, real estate lenders have a powerful but little known tool for combating actual or potential serial bankruptcy filings. By obtaining "in rem" relief from stay under the appropriate circumstances, the lender can avoid the need for costly and repetitive visits to the bankruptcy court in the process of enforcing its loan through foreclosure.

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11,050 square feet, and was stated in public record information provided to Cortazzo by the MLS Service as having 9,434 square feet of living area. In that prior transaction, Cortazzo had provided a handwritten note to the buyers to hire a qualified specialist to verify the square footage.

After the prior transaction failed, Cortazzo deleted any reference to square footage from the MLS listing. However, when showing the property to Horiike, Cortazzo gave Horiike a copy of the flyer prepared for the prior transaction. Cortazzo also sent a copy of the building permit to Namba, who in turn provided it to Horiike, with other documents. Cortazzo did not, however, highlight the differences in square footage for Namba or Horiike, nor did he add a handwritten note to Horiike, as he had in the prior transaction, advising the buyer to hire a qualified specialist to verify the square footage of the home.

After purchasing the property, Horiike sued CB and Cortazzo for, among other claims, intentional and negligent misrepresentation and breach of fiduciary duty. The trial court determined that Cortazzo had no fiduciary duty to Horiike. The jury found that Cortazzo was not liable for intentional misrepresentation because he had not made a false representation of a material fact and that, although he had made a false representation of a material fact, he was not liable for negligent misrepresentation because he honestly and reasonably believed his square footage representation was true. The trial court entered judgment for the defendants.

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The Court of Appeal reversed, stating that "Salespersons commonly believe that there is no dual representation if one salesperson 'represents' one party to the transaction and another salesperson employed by the same broker 'represents' another party to the transaction. The real estate industry has sought to establish salespersons as 'independent contractors' for tax purposes…, and this concept has enhanced the misunderstanding of salespersons that they can deal independently in the transaction even though they are negotiating with a different salesperson employed by the same broker who is representing the other party to the transaction."[1] The Court then stated that "Cortazzo, as an associate licensee acting on behalf of CB, had the same fiduciary duty to Horiike as CB."[2] The Court stated, "[A] broker's fiduciary duty to his client requires the highest good faith and undivided service and loyalty. …The broker as a fiduciary has a duty to learn the material facts that may affect the principal's decision. He is hired for his professional knowledge and skill; he is expected to perform the necessary research and investigation in order to know those important matters that will affect the principal's decision, and he has a duty to counsel and advise the principal regarding the propriety and ramifications of the decision. The agent's duty to disclose material information to the principal includes the duty to disclose reasonably obtainable material information."[3]

The Court then noted, "Constructive fraud is a unique species of fraud applicable only to a fiduciary or confidential relationship. …Most acts by an agent in breach of his fiduciary duties constitute constructive fraud. The failure of the fiduciary to disclose a material fact to his principal which might affect the fiduciary's motives or the principal's decision, which is known (or should be known) to the fiduciary, may constitute constructive fraud. Also, a careless misstatement may constitute constructive fraud even though there is no fraudulent intent."[4]

Based on the foregoing, the court determined that Cortazzo could be liable for constructive fraud where "he did not explain to Mr. Horiike that contradictory square footage measurements existed."[5] The court continued, "A trier of fact could conclude that although Cortazzo did not intentionally conceal the information, Cortazzo breached his fiduciary duty by failing to communicate all of the material information he knew about the square footage. He did not even provide the handwritten advice to other potential purchasers to hire a specialist to verify the square footage."[6]

This case should serve as a major wakeup call to real estate or mortgage brokers representing the parties on both ends of a transaction, as the case holds that the broker cannot satisfy fiduciary obligations simply by providing conflicting information to a party without highlighting the material concerns raised by such conflicting information. Rather, as a fiduciary, the broker "has a duty to counsel and advise the principal regarding the propriety and the ramifications of the [principal's] decision."[7] When a broker represents both buyer and seller or both borrower and lender, as applicable, these fiduciary obligations can result in additional burdens and exposure to constructive fraud claims.

1 *Horiike*, 2014 WL 1384226 at 4, quoting 2 Miller & Starr, Cal. Real Estate (3d ed. 2011) § 3:12, Comment, pp. 68-69.)

2 *Id.* at 4-5.

3 *Id.* at 5 (emphasis added, citations and internal punctuation omitted).

4 *Id.* (emphasis added, citations and internal punctuation omitted).

5 *Id.*

6 *Id.*

7 *Id.* (emphasis added).