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AB 3088 – Tenancy: Rental Payment Default: Mortgage Forbearance: State of Emergency: COVID-19

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I. INTRODUCTION.

On August 31, 2020, Governor Newsom approved AB 3088 as an emergency measure that went into effect immediately. AB 3088 made important changes in many different California statutes. Two of those changes have an important impact on lenders holding liens on residential property of 1-4 residential units, borrowers who own such properties and tenants who occupy such properties. AB 3088 modifies California Civil Code 2924.15 and enacts California Civil Code Section 3273.01 through 3273.16.

This memorandum will focus on the changes to Civ. Code § 2924.15 and on Civ. Code §§3273.01 through 3273.16 and will discuss the requirements of the statutory enactments and the potential problem areas. It is important to note that at the time AB 3088 was being considered, there were a plethora of competing pieces of legislation all seeking to address the economic chaos created by the Covid-19 Pandemic for borrowers, lenders and tenants. There are material issues regarding AB 3088 that lenders might point out (many of which are pointed out below). However, in view of the many competing bills that were being considered, AB 3088 was perhaps the best of the lot considering the alternatives.

II. CIVIL CODE SECTION 2924.15.

A. HBOR

Section 2924.15 was originally enacted in 2012 along with the rest of the California Homeowners' Bill of Rights ("HBOR"). The HBOR (CC 2924(a), 2923.5, 2923.55, 2924.6, 2923.7, 2924.9, 2924.10, 2924.11, 2924.18) imposed certain obligations on lenders before they can conduct non-judicial foreclosures on owner-occupied residential property of 1-4 residential units that: (i) is occupied by the owner as the owner's principal residence; and (ii) is subject to a first-priority lien to secure a loan to the owner made for personal, family or household purposes (hereafter the "Specified Property").

In brief, a lender holding a defaulted consumer loan secured by 1-4 unit residential property was required to work actively with the owner to determine if the owner qualified for a "Foreclosure Prevention Alternative" offered by the lender. The lender was required to provide certain notices to the owner of the potentially available Foreclosure Prevention Alternatives and

offer the owner an opportunity to file an application for such Foreclosure Prevention Alternative. If the lender determined that the owner did not qualify for any Foreclosure Prevention Alternative, the lender was required to provide an explanation to the owner why the owner did not qualify and provide the owner an opportunity to correct any defects or errors in the owner's application and to appeal the lender's adverse determination. To protect the owner, the lender was prevented from proceeding with a foreclosure until the entire process was completed.

The entire process resulted in a lengthy delay in commencing or continuing with a non-judicial foreclosure of between 2 to 6 months in addition to the prior-existing statutory time periods. That delay often motivated lenders to agree to a Foreclosure Prevention Alternative in order to have the owner commence payments of the newly restructured loan payments.

As noted, the HBOR applied only to situation where the lender made a consumer loan and where the residential property is occupied by the owner.

B. **AB 3088.**

Under AB 3088, the scope of the HBOR is extended to apply to residential property of 1-4 residential units that are **not owner-occupied** and to loans that are **not for personal, family or household purposes** (i.e. not consumer loans).

Revised CC 2924.15 now applies to in two situations:

1. It will continue to apply to residential property of 1-4 residential units that is occupied by the owner as the owner's principal residence, which is subject to a first-priority lien to secure a loan to the owner made for personal, family or household purposes.

2. In addition it will now apply to residential property of 1-4 residential units that is occupied by a tenant under a lease as the tenant's principal residence which is subject to a first-priority lien to secure a loan to the owner provided that:

a. the lease is an "applicable lease", meaning that it (i) was entered into in good faith and (ii) for valuable consideration that reflects the fair market value of on the open market;

b. the lease was entered into before and in effect on March 4, 2020;

c. the property is owned by an individual who owns no more than three (3) residential real properties each of 1-4 residential units; and

d. the tenant occupying the property is unable to pay rent due to a reduction in income resulting from the novel coronavirus.

This new addition remains in effect until **January 1, 2023**. At that time, the text of CC 2924.15 reverts to what it originally was.

C. **Impact of AB 3088**

AB 3088 is intended to protect small property owner borrowers who are suffering from a reduction in their rent revenue because of the adverse impact that the novel coronavirus has on the ability of the property owner's tenants to pay their rent.

Except for the change to CC 2924.15, the new law does not add any new criteria or protocols to the other provisions of the HBOR. Therefore, it should not impose many new

unfamiliar burdens on most institutional lenders who have already adopted procedures and protocols for dealing with requests under the HBOR. However, it will give rise to a large number of new requests for restructure. Moreover, the lenders must adapt their application forms to take into account new variables related to the fact that the real property is rental property (such as: rent revenue, and expenses tenant improvements and property maintenance) that are not usually relevant where the collateral is an owner-occupied residence.

Finally, there are a few points that are problematic:

(i) how is the property owner to prove that the subject real property is the principal residence of the tenant -- will a declaration by the tenant be sufficient?

(ii) how is the property owner to prove how few properties are owned -- will a declaration by the property owner be sufficient?

(iii) once the property owner's loan has been restructured, will the restructured loan remain in place if the original tenant moves and is replaced by a tenant who has a stronger financial position? (Perhaps that can be addressed in drafting the Foreclosure Prevention Alternative.)

III. **CIVIL CODE 3273.01 *ET SEQ*.**

The COVID-19 Small Landlord and Homeowner Relief Act (CC 3273.01 *et seq*.) (hereafter the "Act") is deceptively simple and non-threatening. However, it is fraught with potential risk to a lender that fails to agree to a forbearance agreement with the borrower or fails to offer the borrower a "loss mitigation" alternative.

To better understand and interpret the Act, we should consider its two predecessors: the California Homeowners' Bill of Rights ("HBOR) and the Federal CARES Act. We should also keep in mind that the drafters were sensitive to the limitations on the State's ability to mandate certain actions or results due to Federal Preemption issues. Therefore, it benefited the State not to be too specific since there was preexisting Federal legislation on the subject matter.

A. **Relevant Provisions of the Act.**

CC Section 3273.12 states, "It is the intent of the Legislature that a mortgage servicer offer a borrower a post forbearance loss mitigation option that is consistent with the mortgage servicer's contractual or other authority. Note: the statement is made as a statement of an "intent" and not as a mandatory requirement. Granted this approach in the Act will likely enable the legislation to survive a challenge of Federal preemption. However, it does open the door to litigation.

CC Section 3273.10 imposes certain obligations on mortgage servicers upon denying a "forbearance request" (a term that is not defined). If the mortgage servicer denies any forbearance request, the mortgage servicer shall provide written notice (hereafter "Notice of Denial") to the borrower that sets forth the specific reason or reasons that the forbearance was not provided if:

(i) the borrower was current on payments as of February 1, 2020 and

(ii) the borrower experienced financial hardship that prevented the borrower from making timely payment on the mortgage due, directly or indirectly, to the COVID-19 emergency.

If the Notice of Denial cites any defect in the borrower's request (including an incomplete application or missing information) the mortgage servicer shall:

(i) identify the curable defect in the Notice of Denial,

(ii) provide 21 days from the mailing date of the Notice of Denial for the borrower to cure any identified defect,

(iii) accept receipt of borrower's revised request for forbearance before said 21-day period expires.

(iv) respond to borrower's revised request within five business days of receipt.

CC 3273.10(c) provides that if the mortgage servicer denies a forbearance request and later proceeds with a non-judicial foreclosure, the declaration required under Section 2923.5(b) must include a statement whether forbearance was or was not subsequently provided. Note: this Section does not indicate whether granting the forbearance or denying the forbearance has any effect on the application of CC 2923.5(b).

CC 3273.11 and CC 3273.10(d) provide in essence that if the lender complies with various Federal statutes which provide for COVID-19 related forbearance, such compliance will be deemed to be compliance with the Act.

CC 3273.16 provides that any waiver of the provisions of this Act shall be void. Note: presumably, this section refers to any **advance** waiver; and does not refer to any waiver after a cause of action has accrued.

CC 3273.15 provides that "any borrower who is harmed by a material violation [of the Act] may bring an action to obtain injunctive relief, damages, restitution, and any other remedy to redress the violation." Such relief shall include borrower's attorneys' fees: (i) in any action in which injunctive relief (including a temporary restraining order) is granted against a sale [presumably where the borrower is the moving party] and (ii) in any action for violation of the Act in which the borrower is the prevailing party even if injunctive relief against a sale is not granted.

CC 3273.1(b) provides a cryptic indirect reference to the termination date of the Act. The definition of the term "Effective time period" (used elsewhere in the Act) is stated as 'the time period between the operation date of this title and April 1, 2021. Note: presumably, **April 1, 2021** is the termination date of the Act.

CC 3273.1 and 3273.2 define the scope of the Act. However, the language of these two sections requires careful examination.

1. <u>Borrower.</u>

The term "'Borrower" **will** include:

a. A **natural person** who is the mortgagor, trustor under a deed of trust or mortgage or any confirmed successor in interest to such mortgagor or trustor.

b. An **entity** only if the encumbered property contains no more than four dwelling units and is currently occupied by one or more residential tenants.

c. Any **person** who holds a power of attorney for any of the foregoing.

The term "Borrower" **will not** include:

a. An **individual** [a natural person? Or an entity?] who has surrendered the encumbered property as evidenced by a letter [any written document?] or by delivery of the property's keys to the mortgagee, trustee, beneficiary or their authorized agent. (This provision is similar to that included in CC 2920.5 of the HBOR.)

b. Unless the property encumbered contains one or more deed-restricted housing units subject to regulatory restriction limiting rental rates contained in an agreement with a governmental agency,

(i) A real estate investment trust;

(ii) A corporation;

(iii) A limited liability company in which at least one member is a corporation.

2. Mortgage Servicer/Lienholder.

The term Mortgage Servicer and Lienholder is very broadly defined and includes the current owner of the note, or the current owner's authorized agent, or the person or entity that directly services the loan or interacts with the borrower, manages the loan account on a daily basis, manages any escrow account, enforces the note of the security instrument. Also included is any subservicing agent under a master servicing agreement. Note: Presumably, the term also **includes** the beneficiary under a deed of trust or mortgagee under a mortgage. (This provision is similar to that included in CC 2920.5 of the HBOR.)

The term **does not include** a trustee or a trustee's authorized agent acting under a power of sale.

3. The Deed of Trust or Mortgage.

The Act will apply to any mortgage or deed of trust that encumbers residential property consisting of 1-4 residential units (including condominiums, cooperatives) and that was in effect as of the effective date of the Act.

4. Lenders Covered.

The Act applies to virtually all lenders licensed or chartered under federal or state law and to virtually all persons licensed under state non-bank lending statutes. (This scope is similar to that provided for in CC 2923.7 and 2924.18 of the HBOR.)

B. **Comments.**

1. Confusing Language and Provisions.

The Act is confusing in many aspects.

a. Terminology. Some of the terminology of the Act is confusing. There are references to "natural persons", "persons", "individuals", "entities". However, it is unclear whether these terms are separate and distinct or are overlapping to any degree.

b. Forbearance Request. The Act uses language similar to that in the federal CARES Act. The concepts of "forbearance" and "default" appear to apply to failure of the borrower to pay regular contractual payments.

However, there are many different events which can constitute events of default under a loan secured by residential real property, besides the failure to maintain contractually obligated payments. Some are monetary defaults (failure to pay the note, failure to

pay taxes); some are breaches of covenants that are related to failure to pay certain obligations to third parties (failure to maintain insurance, failure to pay taxes, failure to keep the property free of liens); some are defaults in performance (waste on the subject property, sale or leasing of the property); some are financial covenants (maintaining certain net worth). Moreover, some home construction loans include covenants requiring obtaining permits and compliance with local ordinances.

The question then is raised how should such defaults be treated. Perhaps, the Cares Act and decisions thereunder might provide some guidance. One logical conclusion is that a monetary default might be treated differently than a non-monetary default and could be considered a legitimate reason for not granting any forbearance. However, a monetary default arising from a COVID-related cause should be seriously considered for a forbearance under the Act.

c. Intent of the Legislature. Section 3273.12 contains a general statement that certain results are the "intent of the Legislature". Such language might be interpreted to mean that if those results are not achieved the lenders are in violation of the statute. How is a lender to determine what precise actions are sufficient to satisfy this generalized statement of the intent of the Legislature?

d. Limited Partnerships. It is clear that under Section 3273.1 the definition of "borrower" is meant to apply as much as possible to natural persons and associations of natural persons. This appears to be the case since corporations are excluded from qualifying as a "borrower" and so are LLC's in which a corporation is a member. However, that definition fails to exclude limited partnerships. This leaves a large gap since many limited partnerships have as their general partner corporations or LLC's in which the managing member is a corporation. This situation then raises the question whether Section 3273.1 intentionally omitted limited partnerships from the exclusion or whether this omission was an oversight.

e. HBOR. It appears that the Act was enacted to provide an incentive for a lender to agree to a forbearance period to a borrower who is not in compliance with the payment provisions of a residential loan (and to provide a post-forbearance "loss mitigation" option as stated in CC 3273.12). This appears to overlap to some extent with the purpose of the HBOR which prevents a lender from foreclosing and encourages the lender to provide the lender a "Foreclosure Prevention Alternative". One might assume that the Act and the HBOR were two sides of the same coin, and that compliance with HBOR should satisfy all obligations under the Act.

However, the reference in Section 3273.10(c) to CC Section 2923.5 makes it appear that the Act and the HBOR impose separate burdens on lenders. If so, it would appear that a lender would have to: (i) provide a forbearance to the borrower, (ii) then explore the borrower's loss mitigation options under the Act, (iii) thereafter explore the Foreclosure Prevention Alternatives for the borrower under the HBOR.

This confusion is perhaps unavoidable since earlier versions of the Act attempted to mesh the requirements of the Act with the requirements of the HBOR but were unsuccessful in that attempt. The current language in the Act is probably the best case result.

f. Stay of Foreclosure. The HBOR contains provisions which expressly prevent a lender from commencing or continuing with a non-judicial foreclosure while the parties comply with the requirements of the HBOR. The Act does **not** contain any such prohibition. However, a lender should tread lightly in this area. The HBOR imposes certain requirements on the lender before it can commence foreclosure.

2. Potential Liability for Lenders.

The HBOR contains many provisions similar to those in the Act allowing the borrower to sue lenders for violation of the HBOR, to recover damages for that violation, to recover attorneys' fees if the borrower is successful in obtaining any injunctive relief (including a TRO) and to recover attorneys' fees if the borrower is the prevailing party in the litigation. Such provisions in the Act are not new.

However, these provisions in the Act present more risk and danger to lenders because of the uncertainty and lack of precision in the Act as described above. That uncertainty allows greater leeway for a jury to impose liability on a lender by concluding: (i) that a lender should have known either not to take certain action or to have taken certain other action; and (ii) therefore the lender violated the requirements of the Act.

3. Recommendation.

In view of the potential risk, there is one safe harbor for lenders which is for a lender to comply with any applicable federal COVID-19 related forbearance and borrower options.

If a lender has no such applicable safe harbor available, the lender should grant the borrower a forbearance and comply with the HBOR in order to get past the termination date of the Act, which appears to be April 1, 2021.