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NEW YORK’S NEW HOME EQUITY THEFT PREVENTION ACT

by
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INTRODUCTION

The mainstream media has been heralding a crisis in the sub-prime mortgage sector. Newspaper and television reports are replete with alarming news, leading viewers to believe that the current crisis developed overnight. The purpose of this paper will be to examine how this crisis is not an overnight phenomenon, but the result of a series of decisions that took place over a decade and which arose from a variety of factors that some have compared to the banking problems of the 1930’s. This paper will also examine the vast repercussions these decisions have had on the entire U.S. economy, some of which are already showing in the retail sector. Finally, we will conclude with recent New York legislation meant to stave off at least a part of this crisis by enacting consumer protection legislation for purchasers of foreclosed properties...

Overview of the Fiscal Crisis

One of the main culprits of the current financial crisis has been the lending financial institutions themselves.

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With seeming cooperation from mortgage brokers, appraisers, borrowers, government agencies, and Wall Street investors, banks stopped using the golden rule of "5 C's of credit", from capacity to character, in their lending decisions.

They made loans to borrowers who did not have sufficient income (Capacity); borrowers who did not own real estate with market values to back the mortgages (Collateral); borrowers who did not possess skills or had the education to generate future income (Conditions); borrowers who had no other assets (Capital); and/or borrowers who had poor credit scores (Character).

The willingness of many lenders to make these kinds of risky loans can be traced to the emergence of the secondary markets for mortgages. These secondary markets allowed lending institutions to sell their mortgages for a discount (the price below the principal after adjusting for the time value of money), freeing up cash quickly to make more loans.

Traditionally, most banks owned the mortgage until it was paid off and the risk of default was borne by the original lender. Once the mortgage could be sold on the secondary market, the risk of default was passed on to the buyer.

Once the lenders figured out that they could keep all the associated fees with originating the mortgages but bear absolutely no risk of default, the quick slide into today's environment became inevitable.

Government agencies such as Fannie Mae & Freddie Mac had been mandated by Congress to provide liquidity in the mortgage markets. As a result, the agencies allowed banks to sell mortgages before maturity. These agencies were the first organizations to start bundling several mortgages and stop worrying about individual defaults in their diversified portfolios. Bundling allowed the banks to create a bond-like security backed by several, instead of one, mortgage, thus making it purportedly more secure for buyers. Even the FHA (Federal Housing Authority) insured loans eventually gave in to the low standards followed by bankers & brokers.1

These low standards initiated by the lending banks by ignoring the "5 C's" of credit were eventually embraced by the FHA. Most debt experts shared the belief that even if a few mortgages went into default, the value of a security backed by several hundred loans would not be affected.

To generate more loans, the lenders began to outsource their credit evaluation decisions to brokers and the "5 C's of credit" stopped being meaningful—indeed, there is now evidence that some brokers were not only negligent, but were involved in creating fraudulent documentation. The broker's principal motivation was only on one side of the risk-reward equation: brokers could keep the fees for originating loans but did not suffer any losses if the loan they originated went into default. In short, not only did the brokers earn handsome commissions based on volume (not quality), but they did not have any responsibility if the borrower was unable to pay back the loan.2

Then bankers added another player to the mix: the appraiser. The appraiser sets the value of the home. The loan is a percentage of that value. Thus, if the appraiser came in with an inflated number, the resulting loan was out of proportion to the true value of the property. This is not a problem until the borrower defaults or wishes to sell the property. Upon default with the inflated appraisal, banks and buyers of the bundled investments were suddenly suffering losses when the defaulted properties resold.
Then another factor emerged. Given the inflated prices caused by the erroneous appraisals, many borrowers began to doubt whether they could afford the now higher monthly payments based on the newly inflated home values. But rather than shying away from such purchases, brokers and lenders figured out a way around this problem. They “came to the rescue” by offering adjustable rate mortgages (ARMs) with very low teaser rates (significantly below the standard mortgage interest rates) to sweeten the initial payments. These teaser rates typically reset to higher interest level in 1-2 years. These better rates made reluctant buyers willing to purchase, but they also flooded the market with buyers chronically on the verge of default.

Now the “stew” included loaning money to unqualified borrowers; loaning too much money based on inflated assessments; loaning money not secured by sufficient underlying value of the underlying property; and loaning money with sharp payment rises that the borrower would be unable to make in futuro.

That is not to say that each of the participating members of the transaction was naive or unaware. Even though some media has chosen to paint the borrowers as the innocent bystanders, borrowers need to acknowledge their part in this debacle. When taking out any loan, the borrower’s primary responsibility is to understand if they can afford the payments and the terms of the notes they sign. Many borrowers conveniently forgot the “if it is too good to be true then it probably is” principle when securing loans with no money down and ridiculously low monthly payments. Several borrowers are now holding “upside down” loans (loans where the loan amount exceeds the fair market value of the property) with no incentive to continue making payments. It is easy for borrowers to walk away from these loans, as they have nothing more to lose, leaving Wall Street investors, and ultimately, the Federal Reserve, to hold the bag.

Wall Street investors seized upon the securitization ideas used by government agencies and introduced many new financial products, such as collateralized debt obligations (CDOs) and tranches, which not only bundled and re-bundled mortgages but also traded in the secondary markets.

When the CDO’s were being created, the investors were assured of their safety as some carried default insurance. Once again, the insurers did not foresee that several mortgages could go in to default simultaneously making it impossible for them to make insurance payments. In addition, many of these CDO’s were also blessed by the credit rating agencies with AAA ratings. Apparently, they were eager to join the band wagon to generate revenue without having a full understanding of what they were rating. Today, ownership of these types of securities is spread across several countries with no practical means of tracing the default of any particular loan. The role of bond insurers and credit rating agencies is also being investigated with plenty of blame to go around.

Our central bank, the Federal Reserve (Fed), must own up to its own share of the blame. Whether the Fed unknowingly contributed to the sub-prime woes arising out of the real estate price bubble is an open question. What is certain is the Fed’s consistent effort in keeping the interest rates low (Federal Funds Rate at 1%) starting in the year 2000 in response to the dot.com crisis until the year 2004. Such unprecedented low interest rates led to the following:

- New homebuyers who may have waited to save the money needed for down payment entered the market;
Existing homeowners engaged in additional mortgage activities either to refinance or to buy second homes; and
• Speculators started buying and flipping real estate leading to even higher home prices.

Many solutions have been proposed to manage the problems today and to avoid them in the future. One step taken in New York at the state level is the Home Equity Theft Prevention Act.

**The Home Equity Theft Prevention Act**

Effective February of 2007, the Home Equity Theft Prevention Act was passed by the New York State Legislature to prevent fraud in the real estate market. In the legislatures’ view, the increase in foreclosures left open the opportunity for unscrupulous lenders to prey on debtors. One way that creditors could take advantage of the unaware was if a homeowner defaulted or was subject to a foreclosure proceeding. Under either scenario, the homeowner was at risk of losing his or her home, and thereby ‘vulnerable.’ As such, the debtor is susceptible to a scheme in which a creditor agrees to pay off the mortgage in exchange for the deed. The creditor defaults, the bank forecloses, the debtor is homeless and the creditor absconds with the mortgage proceeds. Or, the creditor, with deed in hand, sells the property to a third party or cashes out the equity in the home, leaving the debtor in a worse position than they began with — homeless.

In effect, the Act amended three separate but interrelated New York laws: Section 265 of the New York Real Property Law by adding section 265-a, entitled “Home Equity Theft Prevention;” Section 595 of the New York Banking Law; and Section 1303 of the New York Real Property and Procedure Law, each to be discussed below.

Most writers on the topic agree that the New York Legislature’s intent was well-meaning, as evidenced by the following language setting forth the purpose of the Act:

The intent and purposes of this section are to provide a homeowner with information necessary to make an informed and intelligent decision regarding the sale or transfer of his or her home to an equity purchaser; to require that the sales agreement be expressed in writing; to safeguard equity sellers against deceit and financial hardship; to ensure, foster and encourage fair dealing in the sale and purchase of homes in foreclosure or default; to prohibit representations that tend to mislead; to prohibit or restrict unfair contract terms; to provide a cooling off period for equity sellers who enter into covered contracts; to afford equity sellers a reasonable and meaningful opportunity to rescind sales to equity purchasers; and to preserve and protect home equity for the homeowners of this state.

By amending the law, the New York Legislature did not prevent the transaction from occurring, but instead, structured the arrangement so that the debtor receives more protection. While such an arrangement protects debtors, it also provides numerous traps for unknowledgeable purchasers of the property as well as title companies trying to comply with the minutiae of the statute.

**A. To Whom Does The Law Apply?**
The new law now designates the parties as the “equity seller” and “equity purchaser.” An equity seller is defined as a natural person who is a property owner or homeowner at the time of the equity sale. An equity purchaser may be a person who acquires title to a residence that is in foreclosure or default, but there are numerous buyers who do not qualify. These include: a purchaser who will occupy the property as a residence; a purchaser from a referee in a foreclosure; a purchaser taking the property by statute; a purchaser taking the title by a court order or judgment; or a purchaser taking title from a spouse, parent, grandparent, grandchild, or sibling. Therefore, one could reasonably conclude that most transactions are excluded from the statute. The situation that attorneys must be wary of is a seller in default or foreclosure selling to a buyer who is not going to occupy the property, but rather is purchasing it as an investment.

The Act defines foreclosure as “when a notice of pendency is filed in an action under RPAPL Article 13 or the Residence is on an active tax lien sale list,” and default means that the equity seller is two months or more behind in his or her mortgage payments.

B. How Does One Comply With The Statute?

Once the purchase and sale transaction is deemed covered by the Act, the parties must commit their agreement to writing called a “covered contract.” A writing, after all, “ensures, fosters and encourages fair dealing; prohibits misleading representations; and provides a cooling off period.” The writing however, is not in compliance with the statute unless it consists of eight required components. In addition to including the usual provisions like names and addresses, the covered contract must also include the terms by which the reconveyance will be made, a component rarely if ever seen in purchase offers; and a notice of cancellation in a particular format.

With the notice of cancellation requirement, one should recognize that the “picky details” of the Act begin. This is a good place to point out, in fact, just how rigid the legislation is, and remind the reader that failure to comply may mean the entire sale is voidable. The notice tells the equity seller that they may cancel the contract by midnight of the fifth business day following the execution of the covered contract, and has a provision allowing the seller to sign off right on the form to effect the provision. In order to legally cancel the transaction, a cancellation form must be filled out by the equity seller and returned to the buyer; if Spanish is the equity seller’s primary language, the equity seller has the right to have a copy of the contract and all attached documents provided in Spanish. Strict delivery rules also apply.

During the five day rescission period, the equity purchaser is prohibited from:
- accepting any instrument of conveyance;
- recording any instrument executed by the equity seller;
- transferring or encumbering an interest in the residence;
- paying consideration to the equity seller;
- making false or misleading statements.

The covered contract must also be accompanied by yet another form on which the seller can cancel the contract, so not only does the covered contract have to include the notice of the right to cancel, but the form to effectuate the cancellation as well. The Notice of Cancellation set out in the statute is another example of a hole through which the unwary can fail to be in compliance, again making the contract voidable.
C. Real Property Actions and Proceedings Law Section 1303

As noted above, the Home Equity Theft Prevention Act also amended two other laws. Under McKinney's RPAPL § 1303 — "Action to Foreclose a Mortgage" — another notice is required that must be delivered with the summons and complaint in a foreclosure action. Perhaps the most onerous of the requirements in terms of the detail required, this statute mandates that:

The notice required by this section shall be in bold, fourteen-point type and shall be printed on colored paper that is other than the color of the summons and complaint, and the title of the notice shall be in bold, twenty-point type. The notice shall be on its own page.33

This law was expanded in the summer of 2008 to include more specific language as follows:

You are in danger of losing your home. If you fail to respond to the summons and complaint in this foreclosure action, you may lose your home. Please read the summons and complaint carefully. You should immediately contact an attorney or your local legal aid office to obtain advice on how to protect yourself.34

And in an effort to warn sellers in understandable language, the warning must also include the following:

Be careful of people who approach you with offers to "save" your home. There are individuals who watch for notices of foreclosure actions in order to unfairly profit from a

homeowner's distress. You should be extremely careful about any such promises and any suggestions that you pay them a fee or sign over your deed. State law requires anyone offering such services for profit to enter into a contract which fully describes the services they will perform and fees they will charge, and which prohibit them from taking any money from you until they have completed all such promised services.35

In his article on the Home Equity Theft Prevention Act, Bruce Bergman questions the efficacy of this legislation stating, "There seems little reason to believe that someone unsophisticated enough to need the protection of the Act will understand the warning of the additional notice or if understood, derive any benefit over and above what the Act so assiduously applies through its myriad protections."36

The statute also includes new required notices going to debtors of foreclosed subprime mortgages.35 The amendments also amended N.Y. C.P.L.R. § 3408, which now mandates a mandatory settlement conference to determine "whether the parties can reach a mutually agreeable resolution to help the defendant avoid losing his or her home."36

D. Section 595 of the New York Banking Law

The Act also incorporates Section 595-a, which proscribes penalties for failure to comply with Section 265-a of the Real Property Law.

Two cases have interpreted the law to date. First, in Countrywide Home Loans, Inc. v. Taylor, the plaintiff failed to show that the proper 1303 notice was given.37 Specifically, the
plaintiff failed to show in its summons or complaint that he had given the proper notice, including the content of the notice, type size, and paper color. The court stated:

[T]he plaintiff must submit proper evidentiary proof to establish full compliance with the substantive and procedural requirements of RPAPL § 1303. Merely annexing a copy of a purportedly compliant notice does not provide a sufficient basis upon which the Court may conclude as a matter of law that the plaintiff has complied with the statute.

And in Washington Mut. Bank v. Sholomov, a number of requirements under that statute would be triggered, requirements which clearly were not followed. Because these mandates were not met, the defendant owners might be entitled to rescind within two years of the transaction, a period that has not yet passed. “Obviously, this places the plaintiff’s mortgage at risk, in that ownership would revert to parties who were not the mortgagors.”

II. PROBLEMS FOR THE PRACTITIONER

If the equity seller does in fact convey the property under the statute and the equity purchaser conveys to a bona fide purchaser, who prevails if the seller seeks redemption? The answer gives real estate attorneys and title companies pause. The statute allows an equity seller a two-year redemption period following the transference of the property. If the parties fail to comply with any part of the statute, then the equity seller can file a notice of rescission by “giving written notice to the equity purchaser . . . if the purchaser is not a bona fide purchaser for value and filing a notice of rescission with the county clerk.” Then, the equity purchaser has twenty days to reconvey the property back to the seller. Additionally the purchaser has to return any consideration received from the equity purchaser. Sellers may also recover costs and attorneys’ fees as well as suing for damages. If the purchaser is found to have been involved in fraud or deceit, then there is an added provision for a class E felony and fines up to $25,000.00. Although the intent of the law serves a “public good” the law actually raises many issues as yet untested. What is title insurers worried about? Given the detail of the statute, how can a title company possibly ensure that the various details of the statute were in fact complied with? For example, the title agent would be insuring that the proper notices were given to the seller; that if the seller was in foreclosure, another notice was given; that all of the notices were in the correct form. How will a title company know if the correct notices were given?

At this point, the only recommendation to avoid potential liability is to have the sellers execute an affidavit at closing verifying that the house is not in default; not the subject of a foreclosure proceeding; and the buyer is purchasing the property for a private residence. If all of these statements are true, then the statute does not apply. Nevertheless, the statute still defeats part of its purpose by making title insurance more difficult to obtain, which may result in buyers unable to obtain financing for the transaction. Making foreclosed homes more difficult to buy will only escalate the current mortgage crisis.

CONCLUSION

While a few states are now enacting legislation to protect homeowners who are defaulting on their loans, or being foreclosed against, the legislation is unwieldy and complicated. Most debtors will find the protections arduous. States cannot be faulted for trying to protect their citizens, but the foreclosure
crisis will not succumb to a quick fix. While this legislation might be a small step toward debtor protection, it will be up to the courts to determine how effective a protection it will really turn out to be.

ENDNOTES


4 Tyler Cowen, Economic View, So We Thought, But Then Again . . . , THE NEW YORK TIMES, January 13, 2008.

5 Basically, “a CDO is a way of creating securities with widely different risk characteristics from a portfolio of debt instruments.” John C. Hull, Fundamentals of Futures and Options Markets, Pearson/Prentice Hall (6th ed.)

6 A tranche is the name given to a newly created investment. Usually, a tranche is retained by the institution which put together these mortgages.


13 N.Y. R.P.L. § 265-a(1)(d) (McKinney’s ______).

14 As a result, the “intend and purposes of this section are to provide a homeowner with information necessary to make an informed and intelligent decision regarding the sale or transfer of his or her home to an equity purchase; to require that sales agreement be expressed in writing; to safeguard equity sellers against deceit and financial hardship; to ensure, foster and encourage fair dealing in the sale and purchase of homes in foreclosure or default; to prohibit representation that tend to mislead; to prohibit or restrict unfair contract terms; to provide cooling off period for equity sellers who enter into covered contracts; to afford equity sellers a reasonable and meaningful opportunities to rescind sales to equity purchasers; and to preserve and protect home equity for the homeowners of this state.” Id.


17 N.Y. R.P.L. § 265(a)(2)(e)

18 Id.


21 A “covered contract” is defined by the Act as:

any contract, agreement or arrangement, or any term thereof, between an equity purchaser and an equity seller which: 1. is incident to the sale of a residence in
foreclosure or default where such contract, agreement or arrangement included a reconveyance arrangement.


23 The Act requires information such as: The name, business address, and telephone number of the buyer; The address of the house that is being sold (i.e., your home); The total value of the house that is being sold, plus any other fees or payments the equity seller must make to the buyer; A complete description of the terms of payment that will be given to the equity seller in exchange for the house. N.Y. R.P.L. § 265-a(4).

24 Id.

25 Specifically, section 265-a(6)(a) states:

The covered contract shall be accompanied by a form completed by the equity purchaser in duplicate, captioned “notice of cancellation” in at least twelve-point bold type if the covered contract is printed or in capital letters if the covered contract is typed. This form shall be attached to the covered contract, shall be easily detachable, and shall contain in type of at least twelve-point if the covered contract is printed or in capital letters if the covered contract is typed, the following statement written in the same language as used in the covered contract:

“NOTICE OF CANCELLATION

This contract was entered into on ________________________ (Enter date covered contract signed)

You may cancel this contract for the sale of your house, without any penalty or obligation, at any time before midnight of ________________________ (Enter date)

To cancel this transaction, personally deliver a signed and dated copy of this cancellation notice, or send it by facsimile, United States mail, or an established commercial letter delivery service, indicating cancellation to

__________________________ (Name of purchaser)

__________________________ (Street address of purchaser's place of business and facsimile number if any)

NOT LATER THAN midnight of ________________________ (Enter date)

If you wish to cancel this contract, sign and date both copies and return one copy immediately to the purchaser. I hereby cancel this transaction.

__________________________ (Seller's signature)  ________________________ (Date)


26 N.Y. R.P.L. § 265(5)(b). Specifically, Section 5(b) states:

Cancellation occurs when the equity seller, or a representative of the equity seller, personally delivers written notice of cancellation to the address specified in the covered contract or sends a letter via facsimile or other means of written communication, United States mail, or through an established commercial letter delivery service, indicating cancellation to the business address of the equity purchaser listed on the covered contract. Proof of facsimile delivery or proof of mailing creates a presumption that the notice of cancellation has been delivered.

Id.

27 N.Y. R.P.L. § 265-a(3).

28 N.Y. R.P.L. § 265-a(5)(d). Specifically, Section 265-a(5)(d) states:
Within ten days following receipt of a notice of cancellation given in accordance with this subdivision, the equity purchaser shall return without condition any original covered contract and any other documents signed by the equity seller as well as any fee or other consideration received by the equity purchaser from the equity seller. Cancellation of the contract shall release the equity seller of all obligations to pay fees to the equity purchaser.

Id.

29 N.Y. R.P.L. § 265-a(7).

30 The Notice of Cancellation states:

You may cancel this contract for the sale of your house, without any penalty or obligation, at any time before midnight of __________ (Enter date)

To cancel this transaction, personally deliver a signed and dated copy of this cancellation notice, or send it by facsimile, United States mail, or an established commercial delivery service, indicating cancellation to

N.Y. R.P.L. § 265(a).


33 Id.


35 Specifically, the 2008 Session Laws amended Section 1304 of the Real Property Actions and Proceedings Law as follows:

1. Notwithstanding any other provision of law, with regard to a high-cost home loan, as such term is defined in section six-l of the banking law, a subprime home loan or a non-traditional home loan, at least ninety days before a lender or a mortgage loan servicer commences legal action against the borrower, including mortgage foreclosure, the lender or mortgage loan servicer shall give notice to the borrower in at least fourteen-point type which shall include the following:

"YOU COULD LOSE YOUR HOME.
PLEASE READ THE FOLLOWING NOTICE CAREFULLY"

"As of ..., your home loan is ... days in default. Under New York State Law, we are required to send you this notice to inform you that you are at risk of losing your home. You can cure this default by making the payment of ..... dollars by ....

If you are experiencing financial difficulty, you should know that there are several options available to you that may help you keep your home. Attached to this notice is a list of government approved housing counseling agencies in your area which provide free or very low-cost counseling. You should consider contacting one of these agencies immediately. These agencies specialize in helping homeowners who are facing financial difficulty. Housing counselors can help you assess your financial condition and work with us to explore the possibility of modifying your loan, establishing an easier payment plan for you, or even working out a period of loan forbearance. If you wish, you may
also contact us directly at .......... and ask to discuss possible options.
While we cannot assure that a mutually agreeable resolution is possible, we encourage you to take immediate steps to try to achieve a resolution. The longer you wait, the fewer options you may have.
If this matter is not resolved within 90 days from the date this notice was mailed, we may commence legal action against you (or sooner if you cease to live in the dwelling as your primary residence.)
If you need further information, please call the New York State Banking Department's toll-free helpline at 1-877-BANK-NYS (1-877-226-5697) or visit the Department's website at http://www.banking.state.ny.us.

2. Such notice shall be sent by the lender or mortgage loan servicer to the borrower, by registered or certified mail and also by first-class mail to the last known address of the borrower, and if different, to the residence which is the subject of the mortgage. Notice is considered given as of the date it is mailed. The notice shall contain a list of at least five United States department of housing and urban development approved housing counseling agencies, or other housing counseling agencies as designated by the division of housing and community renewal, that serve the region where the borrower resides. The list shall include the counseling agencies' last known addresses and telephone numbers. The banking department and/or the division of housing and community renewal shall make available a listing, by region, of such agencies which the lender or mortgage loan servicer may use to meet the requirements of this section.


38 Id.
39 Id.
41 Id.
42 Id.
43 N.Y. R.P.L § 265-a(8)(b).
44 Id.