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Inability of Borrower to Pay When Loan Originated Renders Loan "Unconscionable" and Allows Borrower to Challenge Completed Foreclosure Sale to BFP

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Just when you thought things couldn't get any crazier, they did. After the onslaught of regulatory foreclosure laws and the recent ruling from the California Supreme Court in *Yvanova v. New Century Mortgage Corp, et al., Docket No. S218973 (CA Supreme Court February 18, 2016),* now comes the *Orcilla* case.

In the *Orcilla* case the court gutted numerous longstanding foreclosure and contract principles and existing regulations and opened the door to even more chaos It is not that the result is unjust, it is the "legal bodies" that are left in the wake to get there that is of concern.

Overview of Decision: The Court allowed the borrower/appellants to assert an action to equitably rescind a foreclosure sale and held that: If the facts and circumstances surrounding the origination of the loan are unconscionable it can lead to a challenge to the enforcement of the loan including rescinding a foreclosure sale to a BFP. The greater the degree of unconscionability the greater the scrutiny into the right to enforce the loan.

> *"The implications of this case are staggering."*

Factual Background: There is no question that the borrowers got a bad loan and that the specific facts drove willingness of the Court to "trample on other areas the law." Quick Loan ("QL") was the lender and in 2006 gave the borrower (A husband and wife who spoke limited English and had limited education) a **refinance** loan secured by their residence, on standard loan documents written in English. The wife signed the note and both signed the deed of trust. The terms were: a fixed 2 year loan at 8.99 % that became variable after two years with a cap of 14.99%. The initial monthly payment was $4220.49. The borrowers' income was less than $3,000 per month. There was a default and two notices of default recorded by the same trustee and the same trustee representative ("**Trustee Representative**".) Evidence was presented that the Trustee representative was a "robosigner".

The foreclosing lender proposed a loan modification ("**Modification**") to the Borrowers. In a pre-Modification communication from the lender there were representations that the effect of the Modification would be a new loan. The borrowers signed a loan Modification agreement. The Modification capitalized arrearages, increasing the loan balance from $525,000 to $570,992.50 and increased the monthly payment to $4627.47. Approximately two years later the borrowers defaulted and the lender proceed to notice a sale **under the pre-modification NOD**. Apparently, there was a new HAMP loan modification application pending at that time. The Lender went to sale and the property was purchased by a third party purchaser. After the sale, the lender advised that it never received the HAMP application. The third party purchaser evicted the borrowers. To make the story better, QL (the originating retail lender) later lost its license because it used its trust fund monies to obtain gambling markers from Casinos.

The borrowers (who had no attorney representing them) asserted a cause of action to set aside the Trustee's Sale.[1] The borrowers asserted all the facts to show the loan was one sided, but did not show how they were harmed by the foreclosure (likely there was no equity) or that they could tender what owed. The Lender and third party purchaser demurred to the Complaint and the case was eventually dismissed. The borrowers appealed.

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HOLDING

Unconscionability: The Court in examining the requirements to equitably rescind a foreclosure sale (See footnote 1) focused primarily on illegality of the sale based on unconscionabillty. The Court differentiated between procedural unconscionability (the matter in which a contract is negotiated) and substantive unconscionability (which considers the fairness of an agreements actual terms).

The Court found that:

> "Procedural unconscionability concerns the manner in which the contract was negotiated. (*Abramson, supra,* 115 Cal.App.4th at p. 656, 9 Cal.Rptr.3d 422.) "Absent unusual circumstances, evidence that one party has overwhelming bargaining power, drafts the contract, and presents it on a take-it-or-leave-it basis is sufficient to demonstrate procedural unconscionability and require the court to reach the question of substantive unconscionability, even if the other party has market alternatives." (*Lona, supra,* 202 Cal.App.4th at p. 109, 134 Cal.Rptr.3d 622.)…
>
> …Courts use a " 'sliding scale' " approach in assessing the two elements, such that "the more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa." (*Armendariz, supra,* at p. 114, 99 Cal.Rptr.2d 745, 6 P.3d 669.). *Orcilla v. Big Sur, Inc.,* No. H040021, 2016 WL 542922, at *5 (Cal. Ct. App. Feb. 11, 2016)

Based on the facts of this case the appellate Court found an abundance of reasons that the contract was procedurally unconscionability and used the findings to overturn the dismissal of the cause of action, and allow the borrowers to challenge the sale. The Court allowed this even though the borrower did not plead harm specifically. The Court also excused the tender requirement under recognized exceptions under the law.[2]

Overturning BFP Rights: To make the ruling effective, the Court needed to eliminate the effect of a BFP purchaser at sale. The Court recognized traditional protections afforded to a BFP who buys at sale without notice of the defect , but "swept away" this longstanding principle and found that allegations of unconscionability " suffice to generally defeat such claims, holding that:

> "Even assuming Big Sur is a bona fide purchaser, its status as such does not bar the Orcillas' first cause of action. "Section 2924 's conclusive presumption language for [bona fide purchasers] applies only to challenges to statutory compliance with respect to default and sales notices." (*Melendrez, supra,* 127 Cal.App.4th at p. 1256, fn. 26, 26 Cal.Rptr.3d 413.) The challenge to the trustee's sale asserted in the first cause of action "does not involve a claim concerning whether [ReconTrust, the trustee,] followed all statutory procedures with respect to the default and sales notices...." (*Id.* at p. 1256, 26 Cal. Rptr.3d 413.) Instead, it is based on the alleged unconscionability, and consequent unenforceability, of the loan agreements. We therefore hold that the conclusive presumption for bona fide purchasers under section 2924 does not apply to bar the Orcillas' first cause of action. (*Melendrez, supra,* at p. 1256, 26 Cal.Rptr.3d 413.) *Orcilla v. Big Sur, Inc.,* No. H040021, 2016 WL 542922, at *8.

This is a substantial departure from traditionally accepted law and custom and practice. It is possible that the rationale can be reconciled because the BFP in this case proceeded with eviction and obtained a judgment for possession and was not subject to the borrowers' quiet title claim (See discussion below), but if so, it only means that the BFP must race to the courthouse and get a judgment, not that its BFP status is impervious to attack because the loan was unconscionable.

Other Issues Decided/Quiet Title: The denial of almost all of the borrowers other claims was upheld on appeal. The only other claim that survived was a claim for breach the UCL against the foreclosing lender, and the Court allowed it primarily because the lender did not challenge the issue on appeal.

However, the Court's denial of the borrowers' request to quiet title against the BFP must be examined. In essence, the Court

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found that since the BFP evicted the borrowers and obtained a judgment in the unlawful detainer action that the judgment barred the borrower's suit to quiet title. The Court held:

> "Accordingly, where, as here, an unlawful detainer action is brought pursuant to Code of Civil Procedure section 1161a, subdivision (b)(3), title is at issue. "Applying the traditional rule that a judgment rendered by a court of competent jurisdiction is conclusive as to any issues necessarily determined in that action, the courts have held that subsequent fraud or quiet title suits founded upon allegations of irregularity in a trustee's sale are barred by the prior unlawful detainer judgment." (*Vella, supra,* at p. 256, 142 Cal.Rptr. 414, 572 P.2d 28; see *Bliss v. Security–First Nat. Bank* (1947) 81 Cal.App.2d 50, 58–59, 183 P.2d 312 [stipulated judgment arising from unlawful detainer action brought under Code Civ. Proc., § 1161a held to bar subsequent claim for quiet title].) *Orcilla v. Big Sur, Inc.,* No. H040021, 2016 WL 542922, at *15 ".

Although not discussed by the court, it appears that the result of this holding is to allow the BFP to take possession of the borrowers' property, and allow the borrower to sue the lender to set aside the foreclosure sale. These appear to be irreconcilable results unless it is to allow the borrowers to continue to seek prevail on their wrongful foreclosure claim and if victorious assert the rights to regain the Property from the BFP. This would be very problematic as the BFP will not be able to convey title. If the result is that the borrower can only pursue the lender on the wrongful foreclosure claim, then, the claim in essence is limited to damages only with no real ability to set aside the sale.

Note: It should also be noted that the court in *Orcilla* appears to have either misread or departed from a previous ruling it made on the BFP issue under the ruling in *Melendrez v. D & I Investment, Inc.*, 127 Cal.App.4th 1238, 26 Cal.Rptr.3d 413 (2005), which in essence held that unless the bona fide foreclosure purchaser is essentially a party to the foreclosing lender's alleged wrongdoing, the completed foreclosure sale cannot be challenged by the borrowers. Id. at pages 429-430.

ISSUES AND QUESTIONS TO PONDER FROM THIS CASE ON LONG WINTER NIGHTS

The *Orcilla* case appears to be a continuation of more restrictive laws governing loan origination and servicing. Limitations on exercising default remedies was certainly understood in the context of the "mortgage meltdown" in 2007, but the playing field has been leveled substantially since then. It is if all the California Appellate justices recently went on retreat and saw the movie ***The Big Short*** (Adam McCay 2015), got "fired up" and decided to do even more.

The implications of this case are staggering. Some issues that come to mind are:

Is there now a Fiduciary Duty to Borrowers on Loans? This case appears to "cut away" at the long accepted concept that there is no fiduciary duty owed by a lender to the borrower in traditional lending activities, absent fraud or management of the borrower (See generally *Nymark v. Heart Fed. Sav. & Loan Assn.,* 231 Cal. App. 3d 1089, 283 Cal. Rptr. 53 (Ct. App. 1991). The Court in *Orcilla* did not allow claims for fraud to proceed, so the ruling appears to be the imposition of a quasi-fiduciary duty. This ruling paves the way for many more borrowers in default to assert that they are the victims of an "unconscionable loan" and leaves the answer to each judge to look at each loan and the terms and determine if they were unfair. It looks to be a "moving target", with only QM loans seemingly immune.

What impact does this Case have on Existing Statutory Law Governing Translation of Loan Documents, Origination of, High Cost loans and Foreclosure Regulation? There are already statutory schemes in place to govern the rights of borrowers who do not read English (See e.g. Civ. Code §1632). There are already state and federal laws governing obligations to ensure borrowers can repay and allowing rights for borrowers to rescind and seek damages for violations of high costs loans that exceed established fee and interest rate thresholds and trigger liability (See e.g. 12 CFR 1026.43, 12 CFR 1026.35 and 12 CFR 1026.35). There are already extensive state and federal regulations of the foreclosure process and the right to assert damages (See e.g. 12 CFR 102441, Civ. Code. §2923.5 et. seq.)

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Is the *Orcilla* case a "catch all" or an "add on" the other borrower rights under these statues? Will the holding be used to obviate rescission and tender obligations in TILA? Will the holding allow additional post-foreclosure remedies beyond that allowed in the HOBR which now limits claims to damage claims?

Tender Requirements: The requirement that a borrower "pay to play" has always been a balance to deter frivolous litigation. The *Yvonava* ruling just put a big limitation on tender obligations (not required when a sale alleged to be void). *Orcilla* has extended the limitatations to: may not be required when loan deemed unconscionable. This certainly will remove a check on frivolous lawsuits (tender requirement) and may result in a flood of pre and post-foreclosure sale challenges.

What the impact on Foreclosure Sales? If BFP status is not assured, it should drive down the prices bid at foreclosure and will certainly impact title companies and their willingness to insure sales. Will this put greater pressure on lenders to judicially foreclose?

This author can't answer these questions but you can be sure that they will have to be answered unless *Orcilla* is limited by the California Supreme Court. Stay tuned.

1 The Court found that the following elements had to be satisfied:"[T]he elements of an equitable cause of action to set aside a foreclosure sale are: (1) the trustee ... caused an illegal, fraudulent, or willfully oppressive sale of real property pursuant to a power of sale in a ... deed of trust; (2) the party attacking the sale ... was prejudiced or harmed; and (3) in cases where the trustor ... challenges the sale, the trustor ... tendered the amount of the secured indebtedness or was excused from tendering." (*Lona, supra*, 202 Cal.App.4th at p. 104, 134 Cal.Rptr.3d 622.) *Orcilla v. Big Sur, Inc.*, No. H040021, 2016 WL 542922, at *5 (Cal. Ct. App. Feb. 11, 2016).

2 Holding that: "Case law has recognized four exceptions to the tender requirement in actions to set aside a foreclosure sale: (1) the borrower attacks the validity of the debt (e.g., based on fraud); (2) the borrower has a counter-claim or set-off sufficient to cover the amount due; (3) it would be inequitable as to a party not liable for the debt; or (4) the trustee's deed is void on its face (e.g., because the trustee lacked power to convey property). (Id. at pp. 112–113, 134 Cal.Rptr.3d 622". *Orcilla v. Big Sur, Inc.*, No. H040021, 2016 WL 542922, at *7 (Cal. Ct. App. Feb. 11, 2016).

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