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Foreclosures of mortgage loans insured by the Federal Housing Administration (FHA) pose one of the biggest threats to stability in the American housing market.[1] Until recently, few homeowner advocates have handled many FHA-insured loans and so have not invested significant time in learning the area. FHA-insured loans, however, have dramatically increased in market share since the collapse of the housing market, and these loans are performing worse than others. Homeowner advocates must now learn FHA-insured loans' statutory and regulatory structure, which is different from the structure of conventional loans, as well as learn a different system for foreclosure alternatives. With this knowledge, advocates will be able to help many more people keep their homes.

FHA's Single Family Insured Mortgage Program and the Housing Collapse

Through its lending programs the U.S. Department of Housing and Urban Development (HUD), which includes FHA, has historically played a primary role in stabilizing and promoting homeownership for low- to moderate-income Americans. Between 1997 and 2000, before the subprime boom, FHA loans constituted between 13 percent and 14 percent of the market for purchase money home mortgages.[2] However, during the height of the housing bubble, subprime loans pushed FHA loans out of the market; at the boom's peak in 2006, FHA's purchase money market share dipped below 4 percent.[3] Now that the subprime market has collapsed, FHA's market share has more than quadrupled in some years from its low point.[4] Simply put, FHA's increased market share itself will lead to more cases for homeowner advocates.

[1]See generally Gretchen Morgenson, *In an F.H.A. Checkup, a Startling Number*, New York Times (Dec. 1, 2012), at B1.

[2]U.S. Department of Housing and Urban Development, FHA Single Family Activity in the Home-Purchase Market Through July 2012 (Oct. 19, 2012), http://1.usa.gov/VIC836.

[3]*Id.*

[4]*Id.*

Moreover, FHA loans continue to perform poorly. While delinquencies of Fannie Mae and Freddie Mac loans have stabilized, according to a recent Office of the Comptroller of the Currency's Mortgage Market Metrics Report, "[t]he quality of serviced government-guaranteed mortgages declined during the quarter. The percentage of these mortgages that were current and performing decreased to 84.9 percent from 85.9 percent in the previous quarter."[5]

The loss mitigation options for FHA-insured loans have thus far done little to help homeowners avoid foreclosure. FHA-insured loans do not operate under the Home Affordable Modification Program that is the standard for other loans, including those held by Fannie Mae and Freddie Mac.[6] Instead FHA instituted in 2009 its own, more limited program that has had much less success. While only around 16 percent of homeowners who recently received loan modifications through Fannie Mae and Freddie Mac defaulted within twelve months, over 40 percent of homeowners who recently received modifications through government-guaranteed programs default within that time.[7] While FHA has taken steps to fix some of the problems with its loan modification program, its programs' poor performance will affect advocates' caseloads.

Fortunately clients with FHA loans have strong legal arguments. FHA-insured loans are governed by an extensive regulatory scheme, and servicers must satisfy specific duties.[8] In many states, a servicer's failure to comply gives the homeowner legal arguments to avoid foreclosure.[9] Advocates working in states that have not considered the impact of servicer noncompliance with FHA regulations have the opportunity to develop the law. In doing so, they should pick cases carefully, keeping in mind the interests of both their clients and other homeowners.

With strong legal arguments available, dedicated advocates are needed, especially since homeowners are often unable to obtain FHA loss mitigation on their own. Here I review the applicable statutory and regulatory structure, the strategies that advocates have used to enforce the rules, and the current options for FHA-insured loans.

Clear, Extensive Regulations Governing FHA-Insured Loans

Unlike conventional loans, FHA-insured loans are governed by an extensive statutory and regulatory structure that is, at least in part, incorporated explicitly into the loan contracts. The FHA-insured loan program seeks "to meet the housing needs of the borrowers that the single family mortgage insurance program under this subchapter is designed to serve."[10] The program gives low- to moderate-income Americans a chance for stable housing, and it furthers the larger national housing policy, which Congress set in 1949, "of a decent home and a suitable living environment for every American family."[11]

In recognizing that low- to moderate-income homeowners may face economic hardships over the life of their loans, Congress codified a program for foreclosure alternatives in the National Housing Act: "[u]pon default or imminent default … mortgagees shall engage in loss mitigation actions for the purpose of providing an alternative to foreclosure … as provid-

[5]Office of the Comptroller of the Currency, U.S. Department of the Treasury, OCC Mortgage Metrics Report (Sept. 2012), http://1.usa.gov/11xKBJs.

[6]U.S. Department of Housing and Urban Development, Mortgagee Letter 2009-23, Making Home Affordable Program: FHA's Home Affordable Modification Loss Mitigation Option (July 30, 2009), http://1.usa.gov/W9Q6bf.

[7]Office of the Comptroller of the Currency, *supra* note 5, tbl.31, at 40.

[8]See, e.g., 24 C.F.R. § 203.500–.681 (2012).

[9]See, e.g., *Wells Fargo v. Phillabaum*, 950 N.E.2d 245 (Ohio Ct. App. 2011); *Lacy-McKinney v. Taylor, Bean & Whitaker Mortgage Corporation*, 937 N.E.2d 853 (Ind. Ct. App. 2010).

[10]12 U.S.C. § 1708(a)(7)(B).

[11]42 U.S.C. § 1441.

ed in regulations by the Secretary."[12] This codification of the lender's responsibility is significant. Unlike the current Home Affordable Modification Program, which is temporary by its terms, loss mitigation has long been a stable feature of FHA loans.[13]

In fact, homeowners' loan contracts further confirm lenders' obligation to consider foreclosure alternatives. According to paragraph 9 of the form mortgage, "[i]n many circumstances regulations issued by the Secretary [of HUD] will limit Lender's rights, in the case of payment defaults, to require immediate payment in full and foreclose if not paid. This Security Instrument does not authorize acceleration or foreclosure if not permitted by regulations of the Secretary."[14] The promissory note includes almost identical language.

Unlike conventional mortgages, which do not have such preconditions, the contract itself explicitly requires the lender to consider the loss mitigation requirements found in regulations before pursuing foreclosure. By the terms of the contract, lenders may not simply proceed with foreclosure based on a default in payment.

The lender must evaluate loss according to a process set forth in regulations referenced in the contracts.[15] While these regulations do not guarantee a loan modification for every homeowner who falls behind on payments, lenders must consider specific options for every homeowner before commencing foreclosure.[16]

Most of the litigation related to the regulations has centered on the requirement for a face-to-face meeting between the lender and the homeowner within three months of default.[17] Compared to the challenges of communicating with a call center, the face-to-face meeting is supposed to give the homeowner an effective way to explore foreclosure alternatives.[18] The regulations explicitly set forth the efforts that a servicer must make to arrange this meeting. An automated telephone call or standard form letter will not suffice. Instead the servicer must send a certified letter *and* visit the home to arrange the meeting.[19]

Servicers have largely failed to comply with this regulation and have relied on an exemption from the face-to-face meeting requirement for lenders that do not have a branch office within two hundred miles of the home.[20] HUD has given this position some credence through a website statement that restricts the definition of "branch office" to "servicing office," although the term "servicing office" is not found in the regulation. According to HUD's website, as long as the servicer has no "servicing office" within two hundred miles of the home, no face-to-face meeting is required.[21] Courts have consistently rejected servicer reliance on HUD's website since the website is no substitute for full rulemaking.[22]

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[12] 12 U.S.C. § 1715u(a).

[13] Mandatory loss mitigation for loans insured by the Federal Housing Administration (FHA) has been the subject of important litigation for decades (see, e.g., *Brown v. Lynn*, 385 F. Supp. 986, 999–1000 (N.D. Ill. 1974) (leading to important changes in FHA loss mitigation program).

[14] See U.S. Department of Housing and Urban Development, Lender's Guide to the Single Family Mortgage Insurance Process Handbook (4155.2), ch. 12, sec. A (March 24, 2011), http://1.usa.gov/VZx7S4.

[15] 24 C.F.R. §§ 203.501–.681.

[16] *Id*. § 203.501.

[17] *Id*. § 203.604(b).

[18] U.S. Department of Housing and Urban Development, Administration of Insured Home Mortgages (4330.1), ch. 7, sec. 7-7 [Sept. 29, 1994], http://1.usa.gov/V5nxwi.

[19] 24 C.F.R. § 203.604(d).

[20] *Id*. § 203.604(c)(2).

[21] U.S. Department of Housing and Urban Development, General Servicing Frequently Asked Questions (n.d.), http://1.usa.gov/V5oAwf.

[22] See, e.g., *Mathews v. PHH Mortgage Corp*oration, 724 S.E.2d 196, 204 (2012) ("The term 'branch office' in the Regulation is unambiguous."); *Phillabaum*, 950 N.E.2d 245; *Kersey v. PHH Mortgage Corporation*, 682 F. Supp. 2d 588, 602 (E.D. Va. 2010) (vacated on other grounds).

While the face-to-face meeting receives most of the attention, FHA regulations contain several other specific mandates. For example, servicers must, "[b]efore four full monthly installments due on the mortgage have become unpaid, … evaluate on a monthly basis all of the loss mitigation techniques provided at § 203.501 to determine which is appropriate" and document of all these reviews.[23] Specific notice requirements apply, and the servicer must review its efforts before proceeding to foreclosure.[24] These obligations are incorporated into the loan contracts.

HUD's handbooks and Mortgagee Letters give servicers guidance beyond that in regulations. HUD's Handbook 4330.1, Administration of Insured Home Mortgages, details servicers' additional obligations, with clear language regarding HUD's expectations that run contrary to the servicer inaction that homeowners commonly face: "The professional servicer recognizes that [reasons for default] are most likely manifestations of more basic problems that are the actual causes of default. In communicating with mortgagors, the servicer should make a real effort to determine the root cause of default and work with the mortgagor…."[25]

HUD issues, as a further supplement, mortgagee letters to offer specific details on the foreclosure alternatives that servicers must consider, such as FHA's version of the Home Affordable Modification Program and the standard loan modification.[26]

Litigation Approaches for Enforcement of FHA Regulations

Although the statutes, regulations, handbooks, and mortgagee letters give loan servicers clear rules to follow, the servicers have consistently failed to comply with the regulations and have pushed homeowners into foreclosure without meeting loss mitigation requirements. In response, advocates across the country have sought, often successfully, to enforce these rules against servicers pursuing foreclosure.

In judicial foreclosure states, advocates have consistently used noncompliance to defend against foreclosures. In Indiana, Ohio, Illinois, Maryland, and other states, appellate courts have required compliance prior to foreclosure.[27]

Courts have used several legal theories to conclude that homeowners may raise noncompliance as an affirmative defense. In *Wells Fargo v. Phillabaum* the Ohio Court of Appeals recognized that language in the promissory note's acceleration clause required compliance with the applicable loss mitigation regulations before a foreclosure action could be filed.[28] From there the court concluded simply that "the dispositive issue is whether the bank complied with all pertinent HUD regulations before it initiated the foreclosure process," and the court affirmed the trial court's ruling for summary judgment in favor of the homeowner.[29] The Indiana Court of Appeals focused more on the regulations themselves and held them to establish a "HUD-imposed condition precedent to foreclosure that the lender must follow."[30] Other courts, including the Superior Court of Pennsylvania, looked to equitable principles as a basis for noncompliance with FHA regulations being an affirmative defense.[31] Note, however, that *Fleet Real Estate Funding Corporation v. Smith* relied on a now outdated version of the regulations,

[23] 24 C.F.R. § 203.605(a).

[24] *Id.* §§ 203.602, .606.

[25] U.S. Department of Housing and Urban Development, *supra* note 18, ch.7, sec. 7-3.

[26] See, e.g., U.S. Department of Housing and Urban Development, Mortgagee Letter 2012-22, Revisions to FHA'S Loss Mitigation Home Retention Options (Nov. 16, 2012), http://1.usa.gov/X8MKny.

[27] See, e.g., *Phillabaum*, 950 N.E.2d 245; *Lacy-McKinney*, 937 N.E.2d 853; *Wells Fargo Home Mortgage v. Neal*, 922 A.2d 538 (Md. 2007); *Bankers Life Company v. Denton*, 458 N.E.2d 203 (Ill. App. Ct. 1983); see also *Mathews*, 724 S.E.2d 196.

[28] *Phillabaum*, 950 N.E.2d at 246.

[29] *Id.* at 246–48.

[30] *Lacy-McKinney*, 937 N.E.2d at 863.

[31] *Fleet Real Estate Funding Corporation v. Smith*, 530 A.2d 919, 923 (Pa. 1987).

which stated that HUD "takes no position on whether a mortgagee's failure to comply with §§ 203.650–203.662 is a legal defense to foreclosure."[32] Since *Fleet*, the regulation at issue, 24 C.F.R. § 203.500, no longer contains such equivocal language regarding defenses to foreclosure and now states, as cited in *Lacy-McKinney v. Taylor, Bean & Whitaker Mortgage Corporation*, that "[i]t is the intent of the Department that no mortgagee shall commence foreclosure or acquire title to a property until the requirements of this subpart have been followed."[33] Under any theory, courts consistently hold that noncompliance is grounds to stop foreclosure.

While using lender noncompliance defensively in response to lender lawsuits has been successful, especially in an era of mass failure by loan servicers to follow the rules, the approach has limits. First, and most important, homeowners in nonjudicial foreclosure states must bring their own lawsuit. Second, when dismissing foreclosure cases based on the homeowner's affirmative defenses, courts have generally done so without ordering lenders to take any corrective action on the account regarding the interest, costs, and other fees. In Ohio, where the affirmative defenses are well established, lenders have refiled foreclosure cases after dismissal without adjusting the account or taking steps to comply fully with the regulations, which require specific action within three months of default. This places homeowners in a terrible cycle that is hard to resolve with traditional modification options.

For this reason, advocates in both judicial and nonjudicial foreclosure states have pursued affirmative claims for servicer failure. Claims focused on a lender's failure to satisfy contract terms have proved successful because, as explained above, the HUD regulations are clearly and directly incorporated into the contract.[34] In some cases, these affirmative claims are framed as a breach of contract and in other cases as wrongful foreclosures due to the lender's failure to satisfy a necessary precondition.[35] Contrary to consistent arguments from lenders, these claims do not seek a private right of action to enforce the regulations; the private right of action is a legal theory that has been rejected.[36] Instead these claims focus on the text of the contract itself and seek to enforce it. Several significant state and federal cases have upheld these claims; however, some courts have refused to allow breach-of-contract claims.[37]

Besides using some state-specific legal arguments against homeowners' claims, such as the preexisting duty rule in Michigan, lenders have developed consistent lines of attack that they use across the board.[38] Frequently lenders argue that homeowners may not claim a breach of contract because the homeowners *caused* the first breach. Some courts have accepted this reasoning.[39] However, the Southern District of West Virginia, in *Mullins v. GMAC Mortgage*, artfully demonstrated the absurdity of this position: "[t]o hold that the first breach rule precludes such a suit would effectively render the provision of the Deed of Trust requir-

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[32]*Id.* at 922 (citing 24 C.F.R. § 203.500).

[33]24 C.F.R. § 203.500; *Lacy-McKinney*, 937 N.E.2d at 861.

[34]See, e.g., *Mathews*, 724 S.E.2d 196; *Kersey*, 682 F. Supp. 2d 588 (vacated on other grounds); *Mullins v. GMAC Mortgage Limited Liability Company*, No. 1:09-cv-00704, 2011 U.S. Dist. LEXIS 35210 (S.D. W. Va. March 31, 2011); *Sinclair v. Donovan*, No. 1:11-CV-00010, 2011 WL 5326093 (S.D. Ohio Nov. 4, 2011) (vacated by settlement agreement); *Rourk v. Bank of America National Association*, No. 4:12-CV-42 (CDL), 2012 WL 3745953 (M.D. Ga. Aug. 28, 2012); *In re Shelton*, 481 B.R. 22, 30 (Bankr. W.D. Mo. 2012); *Pfeifer v. Countrywide Home Loans*, 150 Cal. Rptr. 3d 673 (Cal. Ct. App. 2012).

[35]See *Mullins*, 2011 U.S. Dist. LEXIS 35210 (breach of contract); *Sinclair*, 2011 WL 5326093 (breach of contract); *Mathews*, 724 S.E.2d 196 (failure to satisfy preconditions); *Pfeifer*, 211 Cal. App. 4th 1250 (failure to satisfy preconditions).

[36]*In re Miller*, 124 F. App'x 152, 155–56 (4th Cir. 2005).

[37]See, e.g., *Neal*, 922 A.2d 538; *Hayes v. M & T Mortgage Corporation*, 906 N.E.2d 638 (Ill. App. Ct. 2009); *ABN AMRO Mortgage Group Incorporated v. Tullar*, No. 9-012/06-0824, 2009 Iowa App. LEXIS 320 (Iowa Ct. App. April 22, 2009).

[38]*Houston v. U.S. Bank Home Mortgage Wisconsin Servicing*, No. 11-2444, 2012 WL 5869918 (6th Cir. Nov. 20, 2012).

[39]*Baker v. Countrywide Home Loans Incorporated*, NO. 3:08-CV-0916-B, 2009 U.S. Dist. LEXIS 53704 (N.D. Tex. June 24, 2009).

ing [lender] to abide by HUD regulations ineffective and unenforceable."[40] Several courts have followed the *Mullins* logic.[41]

Lenders consistently focus on whether the homeowner has suffered any damages, especially if the homeowner is still living in the home "for free."[42] In these cases, pleading compensatory damages, including emotional distress damages, where available, is critical.[43] Homeowner advocates must also explain that the lenders' continued addition of interest, fees, and costs to the account prevents loss mitigation. Appropriate judicial relief should at least restore the homeowner to a point where the lender can restart the loss mitigation process and follow the rules. For example, a lender that has failed to take proper loss mitigation action within three months of default—e.g., failed to hold the face-to-face meeting—should swallow any additional months of interest added after that failure, or the lender will never be able to comply fully with the regulation.

Because case law regarding the contract theory is still unsettled, attorneys should pick cases where lender noncompliance truly deprived homeowners of the chance to save their homes. In those cases, failure to follow the statutory and regulatory mandates not simply is technical but imposes a real cost.[44]

FHA's Limited, but Improved, Options for Resolving Loans

The ultimate goal for most homeowners is not necessarily a victorious decision in court but rather a sustainable and affordable loan modification. Unfortunately FHA's loss mitigation program has major flaws. A recent Government Accountability Office report on federal agency performance in helping homeowners pointed out that FHA loan modifications typically lead to less payment relief for borrowers than do other types of modifications.[45] The report further showed that FHA failed to analyze whether its mitigation program is effective in creating sustainable loan modification plans.[46]

As a practical matter, advocates who represent FHA homeowners must recognize the unique options that the insured loan program offers to homeowners seeking assistance. Since March 2009, the federal government, through the U.S. Treasury, has used the Home Affordable Modification Program as its flagship program for most mortgage loans. Through the program, qualifying homeowners can get their interest rates reduced to as low as 2 percent, loan terms extended to 480 months, and even principal forbearance.[47]

In July 2009 FHA issued its Home Affordable Modification Program version, which had significant limitations compared to the Treasury's program.[48] The FHA program did not endorse interest rate reductions to 2 percent or allow 480-month-term extensions, and it sought to achieve principal forbearance through an expanded version of HUD's partial claim program, a long-standing option for FHA-insured homeowners in default. Through a partial claim, "the Lender will advance funds

[40]*Mullins*, 2011 WL 1298777, at *4.

[41]See *In re Shelton*, 481 B.R. at 29–30; *Sinclair*, 2011 WL 5326093, at *7–8.

[42]This characterization not only ignores the lender's noncompliance but also fails to recognize that the lender has accelerated the loan and will refuse to accept monthly payments.

[43]See *Sinclair*, 2011 WL 5326093, at *9.

[44]Note also that homeowners have had some success with tort claims when they allege that the lender violated duties to process loss mitigation (see *Sinclair*, 2011 WL 5326903, at*9–10; *Ponder v. Bank of America National Association*, No. 1:10-CV-00081, 2011 WL 8307207, *4–5 (S.D. Ohio March 8, 2011)).

[45]U.S. Government Accountability Office, GAO-12-296, Foreclosure Mitigation: Agencies Could Improve Effectiveness of Federal Efforts with Additional Data Collection and Analysis 54 (June 2012), http://1.usa.gov/YajvYi.

[46]*Id*. at 58–59.

[47]See Making Home Affordable Program: Handbook for Servicers of Non-GSE Mortgages 6.3 (Aug. 17, 2012), http://bit.ly/U2eCwl.

[48]U.S. Department of Housing and Urban Development, *supra* note 6.

on behalf of the Borrower in an amount necessary to reinstate the delinquent loan."[49] After this advance, the borrower executes, to HUD, a promissory note and second mortgage that is not due until sale or foreclosure.[50] While FHA's Home Affordable Modification Program allowed homeowners to include more than just an arrearage in the partial claim, it still limited the partial claim to only twelve months of arrearage payments. The practical effect was to disqualify homeowners whose payments were more than twelve months past due; this is troubling simply because of rampant servicer delays in evaluating homeowners for loss mitigation options. FHA's program totally excluded homeowners with significant nonmortgage debts instead of requiring credit counseling, and it required servicers to use the FHA Home Affordable Modification Program only as the final option.[51]

Because of these limits, the FHA program has been little help to FHA-insured homeowners over the past three years. Every month the Treasury releases the Making Home Affordable program performance report that outlines the progress made in helping homeowners. While the Treasury's program has assisted over a million people, the FHA program has had much less impact. Through the September 2012 performance report, only 15,227 FHA Home Affordable Modification Program trial modifications had been started and only 9,089 completed.[52] Similarly, over two years starting in January 2009, the Government Accountability Office reported almost a million Home Affordable Modification Program modifications but only 13,000 modifications through the FHA program.[53] In light of FHA's increased role in the mortgage market, its market share cannot alone explain the vast disparity in modifications between the Treasury's program and FHA's Home Affordable Modification Program.

On November 16, 2012, FHA revised its program through Mortgagee Letter 2012-22.[54] While it did not change the policy on interest rates and term extensions, the new mortgagee letter did amend the twelve-month rule for partial claims and eliminate the exclusion for homeowners with too much nonmortgage debt. Furthermore, the new mortgage letter gave guidance on how servicers should evaluate FHA's Home Affordable Modification Program and how their standard mortgage fits with the revised FHA program. The helpful revisions went into effect in March 2013.[55]

For homeowners who do not qualify for FHA's Home Affordable Modification Program, FHA loans offer a standard loan modification option under Mortgagee Letter 2009-35.[56] Under this program, servicers add arrears to the principal balance, reduce the interest rate to one based on the Primary Mortgage Market Survey, and extend the loan to 360 months. While this modification seldom offers significant payment relief, it can help some homeowners, especially those who have regained income.

That FHA should "conduct periodic analyses of the effectiveness and the

[49]U.S. Department of Housing and Urban Development, Partial Claim Frequently Asked Questions (n.d.), http://1.usa.gov/SMum99.

[50]*Id*.

[51]U.S. Department of Housing and Urban Development, *supra* note 6.

[52]U.S. Department of the Treasury, Making Home Affordable: Program Performance Report Through September 2012, at 4 (n.d.), http://1.usa.gov/W9WrWx.

[53]U.S. Government Accountability Office, *supra* note 45, at 23.

[54]U.S. Department of Housing and Urban Development, Mortgagee Letter 2012-22, Revisions to FHA's Loss Mitigation Home Retention Options (Nov. 16, 2012), http://1.usa.gov/13Wsvzw.

[55]U.S. Department of Housing and Urban Development, Mortgagee Letter 2013-03, Extension of Implementation Date for Mortgagee Letter 2012-22, Revisions to FHA's Loss Mitigation Home Retention Options (Jan. 31, 2013), http://1.usa.gov/11k2lsT.

[56]U.S. Department of Housing and Urban Development, Mortgagee Letter 2009-35, Loan Modification (Sept. 23, 2009), http://1.usa.gov/W9Q6bf.

long-term costs and benefits of their loss mitigation strategies and actions" in order to help homeowners seems obvious.[57] Mortgagee Letter 2012-22 seems to respond to some of these issues by making FHA's Home Affordable Modification Program more available, and homeowner advocates should watch for future changes.

■ ■ ■

Even with recent revisions, FHA loss mitigation options are more limited than conventional options. As a result, FHA-insured homeowners are more vulnerable to foreclosure unless they have legal assistance from trained homeowner advocates. In response to foreclosure these homeowners are fortunate to have strong legal arguments that are grounded not only in the regulations but also in the explicit terms of their contracts. With the help of experienced attorneys, FHA-insured homeowners can overcome problems with a menu of foreclosure alternatives. Such key help should give lawyers and law offices clear incentives to expand their work with FHA cases and advance the law in their jurisdictions.

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[57]U.S. Government Accountability Office, *supra* note 45, at 72.

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