WHITE PAPER

PROPOSED ENACTMENT OF NON-JUDICIAL
FORECLOSURE PROCESS FOR COMMERCIAL REAL PROPERTY

I. SUMMARY

House Bill 799 (Draft B) and Senate Bill 1288 (together the "Bill") propose, quite simply, to eradicate 158 years of due process protections afforded by the judicial system to Florida's commercial real property owners, and others with an interest in such property. In addition, this Bill is being proposed during our nation's and the State of Florida's most pervasive economic crisis since the Great Depression. As a result, the legislature should deny passage of this Bill.

II. HISTORICAL SYNOPSIS OF FLORIDA'S MORTGAGE LAW

Florida, 158 years ago, with the passage of the Act of 1853, became a lien theory state (as opposed to a title theory state). In a lien theory state, the lender (or mortgagee) with respect to a loan made to a borrower has a security interest in the form of a lien (or mortgage) in the property; the borrower has title to the mortgaged property.

In a title theory state, the mortgagee with respect to a loan made to a borrower is vested with the legal title to the property and retains that title until the debt is paid in full. The borrower, or grantor, retains possessory rights and "equitable title," and otherwise has full use of the property for the mortgage term. When the loan is paid off, legal title is restored to the borrower.

"[T]he legal doctrines associated with the Lien Theory are of significant importance in determining the rights of the parties." *Florida Mortgages*, Hon. Thomas E. Baynes, Jr., §1-1, page 2. This is particularly true in the event of a default by the borrower on the loan. "Default, in a Title state, may allow the mortgagee private remedies. Under Florida law, if the mortgagor does not pay the mortgage or otherwise defaults, the mortgagee's remedy is to foreclose in the equity court and seek a judicial sale of the property." *Florida Mortgages*, page xii. Hand in hand with the foreclosure in the equity court, is the borrower's right to redeem the property. "It is important to know . . . that the Lien Theory states, such as Florida, recognize the mortgagor's equity of redemption much more strongly than do states accepting the Title Theory." [*Id.*]

The current law is codified at Section 697.02, Florida Statutes which states: "A mortgage shall be held to be a specific lien on the property therein described, and not a conveyance of the legal title or of the right of possession." In *Georgia Casualty Co. v. O'Donnell*, 109 Fla. 290, 147 So. 267 (Fla. 1933), the Florida Supreme Court stated the following regarding foreclosure in the state of Florida:

> At common law a mortgagee took legal title to the mortgaged property, and foreclosure was to terminate the mortgagor's right to redeem. In this state a mortgage is a mere lien,

> and does not vest title in the mortgagee. Under the statute the mortgagee has only a lien, and foreclosure is for the purpose of enforcing it.. . . Strict foreclosure in this state is not permitted, but the equitable remedy of the mortgagee is a sale of the property to pay his debt.

As noted by Judge Baynes, in his well respected treatise on Florida mortgage law, "[t]he rights of the mortgagor in his property are paramount in Florida." *Florida Mortgages*, §1-1, page 2. It is against this backdrop that the Bill must be analyzed and reviewed. Only by fully appreciating the landscape of Florida mortgage law, can one see how adversely the citizens of Florida will be affected by the procedure currently being proposed by the Bill.

III. <u>CURRENT STATE OF THE LAW</u>

The judicial foreclosure process in Florida commences with the filing of a complaint by the lender, naming all parties with an interest in the property being foreclosed. The lender is required to serve the complaint in accordance with Chapter 48, Florida Statutes (Process and Service of Process), and the Florida Rules of Civil Procedure, which generally require personal service on the defendants. The defendants have 20 days to either serve an answer and affirmative defenses, or move to dismiss the complaint. If the lender believes that there are no disputed facts, the lender can file a summary judgment motion, which requires at least 25 days' notice before the hearing on the motion. Ultimately, the court will adjudicate, either through the summary judgment process or, if there are disputed facts, a trial, the lender's entitlement to the foreclosure remedy, the priority of any other lien interests, any alleged defects in the lender's documentation and any other affirmative defenses raised by the borrower or other parties with an interest in the property.

In addition, lenders have available to them another process to expedite a mortgage foreclosure. Section 702.10, Florida Statutes, commonly referred to as the "Order To Show Cause" Statute (the "<u>OTSC Statute</u>"), is an excellent and often underutilized tool for lenders to recover their real property collateral more quickly and less expensively, and can be invoked by any lender in any foreclosure case (commercial or residential). The OTSC Statute provides lenders with the potential to quickly obtain property and preserve deficiency rights. In non-residential cases, it also provides the lender the ability to request that the borrower commence making mortgage payments during the pendency of the proceedings. To invoke the OTSC Statute, the lender must file a verified complaint that contains factual allegations sworn to by the lender or lender representative, properly serve the complaint in accordance with Chapter 48 and the Florida Rules of Civil Procedure, and request that the court issue an order directing the borrower to show cause why foreclosure should be denied. This order effectively asks the borrower to come before the court and explain, given the sworn allegations of the complaint, why a final judgment of foreclosure should not be entered. The hearing on the order to show cause must be held within 60 days of the date of service of the order (but at least 20 days after service). This process is *in rem* only, as the lender may only use the OTSC Statute to obtain possession of the real property. However, the OTSC Statute leaves undisturbed the lender's ability to pursue a deficiency judgment in a separate count of the complaint.

Service on the defendant of the order to show cause may be made by mail so long as the original complaint was served in accordance with Chapter 48, *et seq*., and provides the borrower

with the requisite procedural due process as enacted by the Legislature. If the borrower cannot adequately show cause to the court why foreclosure of the lender's mortgage interest should not occur, the court will enter a final judgment in favor of the lender. Even if the borrower does show cause, the court is still required to consider whether the lender is likely to prevail in the action, and, if so, may require the borrower to make mortgage payments during the pendency of the foreclosure proceeding. The process set forth in the OTSC Statute already adequately addresses the stated concern by lenders that so many borrowers in foreclosure cases have abandoned their real property, subjecting it to vandalism, fire, theft, or destruction.

IV. ANALYSIS

Florida's constitution gives to the circuit courts jurisdiction over matters of equity.[1] As current law provides that all mortgages shall be foreclosed in equity,[2] the framers of Florida's constitution always intended the foreclosure of mortgage liens be supervised by our state's judiciary. Unlike land owners in title theory states, property owners in Florida, and other parties with an interest in the real property have enjoyed 158 years of due process protections of their real property rights by the judicial system. The Bill proposes to completely strip these due process protections away from owners of commercial property, and others with an interest in such property, by removing the judiciary from the commercial foreclosure process.

A. *The Bill Violates Florida's Due Process Requirements and Fails to Adequately Protect the Property Rights of Florida Property Owners, and Others with Interest in the property Being Foreclosed.*

As there are a number of issues regarding the Bill's violation of due process requirements and failure to protect the due process rights of land owners and others with an interest in the property being foreclosed, these issues are set forth in bullet point form below in the interests of brevity:

- Instead of filing a complaint with the court and serving that complaint and summons in accordance with Chapter 48 and the Florida Rules of Civil Procedure, the Bill proposes to allow the mortgage lender to simply appoint a private trustee. Rather than personally serving the borrower, that trustee would provide to the borrower, by certified mail, return receipt requested, notice of the trustee's intent to foreclose upon the lender's mortgage. Once the property is sold by the trustee, the lender preserves its rights in all respects to pursue the borrower for any deficiency in the amount between its remaining mortgage indebtedness and the amount for which the property could be sold, and regardless of the borrower's conduct during the term of the mortgage, or the course of the non-judicial foreclosure process.

[1] See Florida Constitution, Art. V, Sec. 20(3); "equity" has also been defined as set of legal principles, in jurisdictions following the English common law tradition, which supplement strict rules of law where their application would operate harshly *See Black's Law Dictionary*, 5th Edition.

[2] See §702.01, Fla. Stat.

- After providing the borrower with the combined notice of default and notice of foreclosure, the borrower has only 15 business days after receipt of the notice to object in writing to the trustee, using the preapproved objection form provided for in the Bill. Then, and only then, will the foreclosing creditor be required to proceed with a judicial foreclosure action, but only as to the specified default to which the borrower objects. The Bill does not provide for assertion of "affirmative defenses" or counterclaims, which the borrower, or any other party with an interest in the real property, would have the right to assert in a judicial foreclosure.

- The notice to be provided by the trustee shall be by certified mail, commercial delivery service, or delivery service permitted by the agreement between the borrower and the lender, return receipt requested, and by first-class mail or permitted delivery service, postage prepaid. If the trustee does not perfect service within 30 days of the sending of the notice, then the trustee is required to perform a diligent search and inquiry to obtain a different address for the borrower or junior interest holders. If that inquiry produces an address different from the original notice address, the trustee is required to mail a copy of the second notice by certified mail, registered mail, or permitted delivery service, return receipt requested, and by first-class mail or permitted delivery service, postage prepaid, to the new address. Notice is considered perfected under the Bill upon the trustee's receiving the return receipt bearing the signature of the borrower or junior interest holder within 30 calendar days after the trustee sent the notice. If notice is not perfected after a diligent search and inquiry and the notice is not returned as undeliverable, the trustee may perfect notice by publication in a newspaper of general circulation in the county or counties in which the commercial real property is located.

- Because of the Bill's expansive definition of commercial real property [Lines 51ff of Senate Bill 1288], the proposed statute could apply to residences, including homestead. The Bill states that it applies to property used by the owner for "other than for personal, family or household purposes." Some owners operate a home-based business out of their homestead. As well, some property that is likely intended to be subject to non-judicial foreclosure might be deemed to be excluded by that definition. Consider, for example, a "family business" or a "family counseling center" or a "family physician's practice operated out of what would otherwise be residential real property. The ambiguity of the Bill causes it to fail due to its Constitutional vagueness.

- The term "interest holder" [Line 62-65 of Senate Bill 1288.] does not include certain parties such as a short-term possessory interest holders (a tenant for less than 1 year), an heir of a decedent owner, beneficiary of a trust, etc. Unlike a judicial foreclosure process, those persons receive no notice and have no rights under the Bill. This deprivation violates their due process rights. . Alternatively, if by their exclusion those interests are left undisturbed, then a purchaser does not acquire title free and clear of those interests, an infirmity that could lead to title

challenges. The present Bill is, at best, entirely unclear on the method of notice, or even requirement of notice, on a variety of junior, and other, interest holders in the real property to be foreclosed.

- Moreover, junior lienors, who do receive notice of the non-judicial foreclosure, are not provided an objection form [Line 287 of Senate Bill 1288]; hence, arguably they cannot object to the foreclosure. It is not unusual for a "second mortgagee" to contest the priority of the "first," particularly after a refinance. Presently, in a judicial foreclosure, the court determines who really is "first." That cannot happen under the Bill. The "second" mortgagee would have to sue for an injunction to stop the foreclosure. Similarly, *bona fide* defenses, such as "marshalling of assets" are eliminated. A construction lienor, who worked on a portion of the property (an outparcel, for example), may now ask the court to "marshal the assets" so the lender can foreclose all of the property except the outparcel (if the value is sufficient) and the outparcel will be left for the construction lienor to foreclose. That cannot happen under the Bill—the construction lienor would have to file for an injunction to stop the non-judicial foreclosure.

- The trustee provided for in Lines 116-121 of Senate Bill 1288 need not be disinterested; she may be a bank employee or lawyer. No independent third party reviews the procedure, the amounts requested, the nature and validity of the default, etc for fairness and due process, as would be the case in a judicial foreclosure process.

- If within 15 business days, the obligor objects to the use of the foreclosure procedure for a "specific default," the creditor must proceed to judicial foreclosure for the specified default. The Bill does not provide for assertion of "affirmative defenses" or counterclaims, which the borrower, or any other party with an interest in the real property, would have the right to assert in a judicial foreclosure process.

- Although the explicit requirement that the borrower must initiate an injunction proceeding to stop the non-judicial foreclosure has been removed from the Bill, if a dispute arises as to whether a particular objection is sufficient to stop the non-judicial foreclosure, the borrower's only recourse would be to file for emergency injunctive relief. In other words, even though the requirement to seek injunctive relief was removed from the bill, in fact, it still exists in practice.

- The assumption that underlies this non-judicial foreclosure procedure is the lender always is correct as to the amount of default, the nature of the default and the calculations of payments, interest, etc. Recent history has confirmed that lenders are often wrong about the amount and nature of defaults in mortgage documents, especially in light of secondary market transactions, servicing agent sloppiness, etc. No effective means is provided to challenge these matters.

- The notice provisions in the Bill are inadequate. If the debtor does not pick up the "return receipt requested" notice, the Bill allows the lender/trustee to publish notice in a newspaper that is not actually widely circulated. In short, the property owner never may receive actual notice of the foreclosure, and property can be taken without notice… a major due process problem.

- The lender can set its own costs, fees, interest, etc. unilaterally without judicial review or third party oversight.

- After the foreclosure, the lender may seek a deficiency judgment (or arguably judgment on a guaranty) in court. [Line 474 of Senate Bill 1288] The only defense the debtor may raise is the "adequacy of the price obtained at the foreclosure sale," and the debtor has the burden of proof regarding its inadequacy. Most sales are accomplished for a nominal sum "credit bid" by the lender. The non-judicial foreclosure Bill does not provide a means to challenge the lender's unilaterally calculated judgment amount, including attorneys fees and costs which could be significant, given the lack of checks and balances, as well as the calculation of late charges and post-default interest. A potential for abuse exists any time one party has unilateral, unchecked power; this Bill provides lenders just that kind of unbridled power.

- The only recourse for a lender's wrongful or material violation of the proposed statute is damages. The owner loses her property even if the lender was absolutely wrong. [Line 583 of Senate Bill 1288] Also, trustees are only liable for intentional violations, which are difficult to prove given the intent element, making trustees virtually free of any responsibility for their own negligence. [Line 589 of Senate Bill 1288.].

- This Bill may have other, unintended consequences if allowed to pass in its present state. For example, and as referenced above, the Florida Constitution provides the circuit courts with the exclusive jurisdiction over matters of equity. Section §702.01, Florida Statues, provides that all mortgages shall be foreclosed in equity, imbuing the circuit courts of our state with the exclusive jurisdiction over the foreclosure process. Among other problematic provisions, the Bill proposes that, in the instance of a conflict between the provisions of the Bill and Chapter 702, Florida Statutes, or other applicable law, the provisions of the proposed Bill, if enacted into law, would prevail. This would appear to fly in the face of existing statutory law and Florida's Constitution.

B. *The Bill Violates Several Public Policies*

As there are a number of public policies being violated by the Bill, these issues are set forth in bullet point form below in the interests of brevity:

- Although it is a colloquialism, Florida legislation generally follows the mantra of, "If it isn't broken, don't fix it." The commercial foreclosure process in Florida is not

"broken," and it does not need a wholesale "fix." Indeed, no one has suggested anything about the process that is broken.

- Several years ago, as a result of discussions among Legislators, the Bar and the Bankers Association, Section 702.10, Florida Statutesthe OTSC Statute, was enacted. It provides an expedited foreclosure procedure, described above, while maintaining Florida's historic judicial process, which is predicated on the basic notion that a mortgage is a **lien on property** and must be foreclosed in Court. While any Statute may be improved, the Bill "throws the baby out" entirely with the bath water, and with it, hundreds of years of Florida history. No rationale or excuse for such a major policy shift even is suggested by the proponents. In addition, the legislature seeks to enact yet another law that essentially provides lenders with the expedited relief, but without the proper, procedural due process requirements the citizens of Florida currently have, and deserve.

- The current Bill leaves undisturbed the lenders right to seek a deficiency judgment in a court action, without providing the borrowers with judicial oversight of the process by which the foreclosure judgment is obtained.

- If legislation is intended to remedy a problem or enhance the quality of life of the affected citizens of our state, then the Bill is unnecessary. There is no crisis confronting the courts where commercial foreclosures are concerned because such cases make up a very small part of all foreclosure cases. Based upon statistical information set forth in the below table, and maintained by the Office of State Courts Administrator, commercial foreclosures filings, as a percentage of all foreclosure filings, represent a small fraction of foreclosure cases working their way through Florida's courts. This Bill, which represents a sharp departure from over a century and a half of judicially supervised foreclosures, is a remedy to a problem that simply does not exist. The Bill would do very little to address judicial overload, which generally is the result of residential foreclosures that are not addressed in the Bill. The State Courts' Administrator compiled the following statistics in 2010:

FY 2010/11 YTD

	Commercial Filings	Total Filings	% of Filings
0 -$50K	237	10,247	2.3%
$50K - 250K	909	63,882	1.4%
$250K +	2,418	23,730	10.2%
Total	3,564	97,859	3.6%[3]

In short, out of almost 100,000 foreclosure filings, less than 4,000 (3.6%) were commercial foreclosures. Moreover, the Bill will not eliminate most of those 4,000 cases because, in most instances, the lender will wish to pursue the guarantor or seek a deficiency and that must be done in court. Also, the objection procedures built into

3 Percentage supplied by drafters of this paper.

the Bill will mean some foreclosures will be directed to the courts in any event. Beyond that, given the inability to assert defenses and the lack of standing given to junior lienors to object, an increase in emergency injunction suits can be expected.

- According to several title insurance underwriters, the Bill will create uncertainty in Florida real estate titles.

- Recent history (such as the "robo-signing" scandals) has demonstrated lenders' records are not always pristine and abuses can occur. Indeed, several major lenders halted foreclosures to conduct internal investigations into their own foreclosure practices. In short, the Bill places unilateral control of the process in the hands of lenders at a time when lenders are under intense scrutiny and criticism.

- The Bill may lead to more delays, pressure, and uncertainty in the already-burdened judicial system because the Bill eliminates many safeguards currently available to borrowers and junior lienors, who may feel compelled to institute emergency proceedings to stop/enjoin non-judicial foreclosure so they can assert certain rights and defenses.

- The Bill eliminates the historic right of redemption after issuance of a certificate of sale [Line 207]. While the right of redemption has been part of Florida foreclosure law for many generations, with one stroke of the pen, that long-standing right could be eliminated. Again, this basic property owners' right is being eliminated as to commercial property without even a suggestion of justification.

- The text of HB 799 presumes to take precedence over judicial foreclosure proceedings as set forth in Florida's Constitution and Chapter 702, Florida Statutes, making the timing of the introduction of this current Bill inexplicable. To pass this Bill would subject our state and its lawmakers to much unwanted and national scrutiny at a time of recession and anemic economic recovery, and would constitute very bad public policy, at a very bad time.

- Even if this Bill became law, implementation will be problematic. This is because at present, many if not most of existing mortgage documents in Florida provide for a judicial foreclosure process after default. Therefore, unless the borrower and lender agree to a non-judicial process by way of a novation or other amendment to the mortgage document, the non-judicial foreclosure process envisioned by the current Bill will likely be unavailable to most lenders. Therefore, based on the absolute lack of any urgency or need to address what is by any objective measure a light commercial foreclosure caseload, and the likely inability of lenders to avail themselves of the non-judicial process in the event of passage, there is no need for the current legislation.

IV. FISCAL IMPACT ON STATE AND LOCAL GOVERNMENTS

Although not addressed directly in the Bill, if passed, this legislation could have significant, negative fiscal impact on our state government. The current downturn in the economy has created significant funding issues for Florida's courts. In an attempt to alleviate the situation, the legislature enacted Section 28.241, Florida Statutes, which increased the filing fee to $1,900 for all cases in which the value of the claim is $250,000 or more, and in which there are not more than five defendants. As the table above sets forth, there were 2,418 commercial foreclosure cases filed last year where the amount in dispute was in excess of $250,000.00. If most or all of those cases were handled outside the supervision of the court system, our already strapped court system would be deprived of $4,594,200.00 of revenue it can ill afford to do without. Passage of this Bill will deprive Florida's court system of very badly needed revenue.

V. DIRECT IMPACT ON PRIVATE SECTOR

The proposal will have a direct impact on all commercial property owners who may default on their loans with the lender, as well as other junior lienors or others with an interest in the property being foreclosed (such as tenants).

VI. CONSTITUTIONAL ISSUES

There are certain constitutional issues looming in the proposed Bill, including, but not limited to, due process issues.

VII. OTHER INTERESTED PARTIES

Other interested parties in the proposed Bill include the Real Property and Trust and Probate Section of The Florida Bar.