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Minnesota Legislature Reacts to Record Number of Mortgage Foreclosures

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As the downturn in the residential real estate market continues, the 2007 Minnesota Legislature enacted a number of new laws designed to curb certain practices which have led to a record number of mortgage foreclosures in Minnesota.

Historically, conventional mortgage financing (such as 30-year fixed-rate mortgages) have been used to finance new home purchases. The requirements to qualify for such mortgages, however, precluded many from entry into the ranks of homeownership.

During the most recent real estate boom, a number of unconventional mortgage financing options, such as adjustable rate mortgages (ARMs), zero down mortgages and subprime loans, appeared on the scene and facilitated home purchases by people for whom homeownership would ordinarily be out of reach. In addition, the ever increasing home values combined with these programs spurred a record number of mortgage refinances, many of which had as their primary purpose the consolidation of credit card debt.

With the bursting of the residential real estate bubble, many homeowners found themselves overextended on their mortgages, only to have "teaser" rates (such as a fixed rate under an ARM) come to an end. Unable to keep up with the increased payments in the face of stagnating and/or declining home values, many homeowners saw their homes lost in foreclosure.

Two bills were passed by the 2007 Minnesota Legislature that, together, are designed to form a comprehensive package of protection and enforcement tools to protect homeowners from so-called "predatory mortgage lending" practices.

In addition, the Legislature made substantive amendments to Minnesota's first of its kind "foreclosure reconveyance" act, Minn. Stat. Chapter 325N, enacted in 2004, in order to clarify issues raised in the first cases litigated under the statutes.

HF 1004

The first bill, HF 1004, contains five significant provisions:

- **Lenders and Brokers Must Verify the Borrower's Ability to Repay.** Lenders and mortgage brokers must make sure that borrowers can afford the payment when the teaser rate expires. For example, if the borrower is applying for an ARM, the broker or lender must verify the borrower's ability to pay the increased "variable" rate, not simply the borrower's ability to make the monthly payment during the fixed rate period. In addition, lenders and mortgage brokers must verify a borrower's income through means other than the borrower's statement of income, effectively eliminating "no document" or "stated income loans"
- **Lenders and Brokers Now Have a "Duty of Agency."** Lenders and mortgage brokers are now considered agents of the borrower, meaning, among other things, the lender or broker must always act in the borrower's best interests.
- **Kickbacks from the Lender to the Broker Counted as Lender Fees.** A mortgage broker can receive a side payment from a lender, often for getting the borrower to agree to a higher interest rate than the rate for which the borrower qualifies. The lender pays this compensation, also known as a "Yield Spread Premium", directly to the broker, but the borrower is the one who bears the ultimate cost through the higher interest rate they're paying. Prior to the new law, a lender can finance loan costs (fees and charges) into the loan, but only up to a maximum of 5 percent of the loan. Currently, however, Yield Spread Premiums are not considered "costs" and are not part of the 5 percent cap. Yield Spread Premiums may be helpful to borrowers in limited circumstances where the borrower knowingly agrees to pay a higher interest rate in exchange for lower upfront costs. However, in the case of subprime loans, the borrower receives no benefit; just a higher interest rate. Payments from the lender to the broker, as well as other closing costs, are now counted toward the 5 percent cap that the law places on fees that can be financed into the loan.

- **"Churning" is Prohibited.** SF 1004 also prohibits "churning." "Churning" is repeated refinancings that do not benefit the borrower. Under the new law a mortgage broker or lender can't provide a loan to a borrower that refinances an existing loan unless the new loan provides a "net reasonable tangible benefit" to the borrower considering all of the circumstances. The new law, however, provides no guidelines for how this determination is to be made.
- **"Negative Amortization" Prohibited.** A loan cannot be made to a borrower if the monthly payments do not at least cover the interest payments. This prohibits "negatively amortizing loans" in which the amount of the loan increases even after the monthly payment is made.

HF 988

The second bill, HF 988, contains four significant provisions:

- **Prepayment Penalties Banned.** A subprime loan cannot be made to a borrower if it contains a prepayment penalty, which requires the borrower to pay substantial amount of money if the borrower pays the loan off early (within a specified number of years after the initiation of the loan).
- **Refinancing "Special Mortgages" Without Counseling Prohibited.** Loans such as those provided by a nonprofit or government agency with especially favorable terms (i.e., the interest rate is 2 percent or less, the loan is forgivable, the loan is a no interest loan, or it is only repayable when the house is sold) cannot be refinanced unless the borrower receives certification from a certified housing counseling agency that the borrower has discussed the refinancing with a housing counselor.
- **Provides a Private Right of Action.** A borrower now has the right to sue a mortgage broker or originator who violates any of the provisions of Minn. Stat. § 58.13. The borrower who wins in court is entitled to: (1) actual, incidental, and consequential damages; (2) statutory damages of no less than \$1,000 nor more than \$2,000; (3) punitive damages if the court allows; and (4) court costs and reasonable attorneys' fees.
- **Criminal Penalties.** Lenders or brokers who give loans that are based on fraud or that contain information the broker or lender knew was false can be criminally prosecuted and go to jail for up to two years.

Amendments to Foreclosure Reconveyance Statutes, SF 1553

Minnesota Statutes Chapter 325N, enacted in 2004 (a model law which has been replicated in other states) to address the problem of "equity stripping," has driven the worst offenders out of business, allowed legitimate transactions to go forward, and gave homeowners the tools to combat those remaining unscrupulous industry actors. The 2007 amendments, contained in SF 1553, addressed certain loopholes in the law and legislatively overruled the Minnesota Court of Appeals decision. The bill also makes additional changes. The bill, which has been signed into law by Governor Pawlenty and takes effect August 1, 2008: • Provides that any property in which an equity investor has an interest is covered by the law, not just the foreclosed home. This is meant to close a loophole by which the scammers were able to evade the law simply by using a different property but being able to engage in otherwise volatile practices with impunity. • Removes an ambiguity in current law, clarifying that the law ONLY applies to someone who is in the business of foreclosure rescue and who DOES NOT HAVE a prior personal relationship with the homeowner (e.g., a friend or relative). • Prohibits the required closing of one of these deals to be conducted by an independent closing agent (i.e., one who DOES NOT have a business relationship with the foreclosure rescuer). • Requires the housing court to grant an automatic stay of eviction if the defendant (the foreclosed homeowner) raises a claim or defense that there has been a violation of the equity stripping law (Chapter 325N). This prevents the victim from being displaced from his or her home while the court sorts out the claim or, worse, prevents the home from being sold to an innocent third party while the claim is pending. • Repeals a 2009 sunset. *Jeffrey C. O'Brien is an associate attorney practicing in the areas of business transactions, real estate law, estate planning and probate. He has significant experience with commercial and residential real estate loan transactions and regularly lectures on the subject. He can be reached at jobrien@mansfieldtanick.com*



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