Buy Your Home Back After Foreclosure? Fannie and Freddie Announce Major Policy Shift

By Martin S. Frenkel

In mortgage litigation, there has been at least one taboo that was rarely violated: Don't allow borrowers to default on their mortgages and subsequently permit them to repurchase their former property for less than the loan balance following foreclosure.

However, on November 25, 2014, the FHFA issued a press release indicating that it is directing Fannie and Freddie (which remain under FHFA conservatorship) to sell their existing REO properties to any qualified purchaser at fair market value, including former homeowners who went through foreclosure. This is a drastic change to prior policy that may encourage borrowers (with advice of their counsel) to engage in "strategic defaults."

A strategic default may occur where a borrower owes more on his mortgage than the home is worth. Accordingly, so went the logic, if a borrower chose to default on his mortgage, the foreclosure went forward, and the borrower was permitted to repurchase the home post-foreclosure at fair market value (i.e. less than the amount of the original debt because the house was "underwater"). The net result of such a transaction is the borrower would have (in theory) stripped away the excess debt on the house (which is especially meaningful because Freddie and Fannie have rarely pursued deficiency balances from borrowers).

Prior to this significant policy change, foreclosed homeowners were required to pay their entire mortgage balance in order to repurchase REO properties from Freddie Mac and Fannie Mae's respective inventories. FHFA's directive is hot off the presses and, as of this writing; many questions remain unanswered due to the lack of additional guidance at this time.

What is clear, however, is this directive is consistent with FHFA and Freddie Mac's stated goals dating back to as early as 2012. Specifically, on August 17, 2012, Freddie Mac, acting through FHFA, as conservator, and the US Treasury entered into a third amendment to their purchase agreement to implement several

changes. One of those principal changes was an accelerated wind-down of the retained portfolio of REO properties. Thus, the “writing was on the wall” as early as 2012 and the FHFA is now becoming more aggressive in reducing REO inventories.

Indeed, the FHFA appears committed to reducing Fannie and Freddie’s inventory of REO properties, even if accomplishing this goal encourages underwater borrowers to engage in strategic defaults or litigation to strip away debt. With that said, the FHFA is close to achieving its stated goal, as Freddie Mac’s inventory of REO properties has declined from 51,000 in the third quarter of 2012 to 25,000 in the third quarter of 2014.

Yet, the concern remains whether foreclosed borrowers and their counsel will use this policy as a sword or a shield in litigation. As history has taught us, the plaintiff’s bar has repeatedly characterized various government policy guidelines as mandates. One such instance continues to occur where lawyers have painted disgruntled borrowers as third party beneficiaries of various contractual relationships between mortgage servicers and government agencies. For example, some mortgage loan servicers entered into Service Participation Agreements that required those servicers to perform loan modification reviews and engage in foreclosure prevention activities issued by the Department of Treasury. See Escobedo v. Countrywide Home Loans, Inc., 2009 U.S. Dist. LEXIS 117017, 2009 WL 4981618, at *1 (S.D.Cal.2009). To date, almost every court considering the issue has rejected the notion that a borrower is a third party beneficiary of an agreement between a mortgage loan servicer and a government entity. See, e.g. Cade v. BAC Home Loans Serv., LP, 2011 WL 2470733, at *2 n. 2 (S.D.Tex. Jun. 20, 2011)) (collecting cases in the HAMP context).

Despite an unsuccessful track record with such arguments, borrowers’ attorneys will likely assert that the FHFA’s new policy directive makes it mandatory for Freddie and Fannie to sell REO properties back to foreclosed borrowers at fair market value. While the FHFA’s original goal in changing its policy is laudable, expect that policy to become a hotly litigated issue in 2015 among servicers and borrowers’ counsel.

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