

# ADR UPDATE

## A Roundtable Discussion: The Subprime Fallout



**Panelist**  
**LINDA DeBENE, ESQ.**  
Mediator/Arbitrator, JAMS  
Northern California  
[www.jamsadr.com](http://www.jamsadr.com)



**Moderator**  
**KENNETH D. GACK, ESQ.**  
Mediator/Arbitrator, JAMS  
Northern California  
[www.jamsadr.com](http://www.jamsadr.com)



How did we get into this subprime crisis? Is it a product of bad brokers or sloppy lenders? Is it a result of lying applicants or greedy sellers? And are we toward the end of the dramatic increase in foreclosed properties or just beginning to see the tip of the iceberg?

Gathered to discuss the many issues surrounding the subprime mortgage fallout were JAMS neutral **LINDA DeBENE**, who has written extensively on this subject; **VERN HANSEN** of GMAC/Pacific Union Real Estate Group; **VICKIE NAIDORF**, in-house counsel for Coldwell Banker Residential Brokerage; **DAVE HAMERSLOUGH** of Rossi, Hamerslough, Reichl, and Chuck, a law firm specializing in real estate matters; **RACHEL DOLLAR** of Smith Dollar P.C., an expert in mortgage fraud and subprime related issues; **STAN SMITH**, a partner at Niven & Smith, also specializing in real property matters; **SKIP JUSTMAN**, a partner in Fimmel, Justman & Rible and frequent expert witness in subprime related matters; and **BILL JANSEN** of Broker Risk Management. JAMS neutral **KEN GACK** moderated the lively panel discussion.

**KEN:** Let's begin by having Rachel tell us a little bit about the lenders' perspective on the subject of subprime related fraud.

**RACHEL:** From the lenders' perspective, the threshold issue is to determine how much of the subprime crisis has been caused by

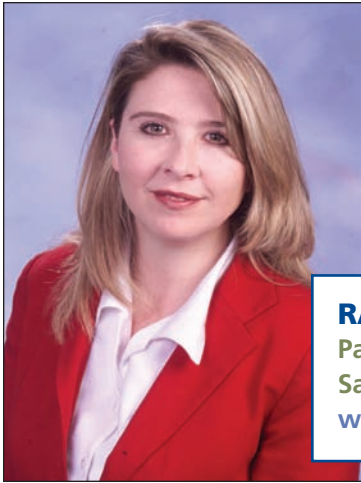
*"Mediation is a good forum since a settlement agreement will contain a statement that no one is admitting fault."  
—Linda DeBene*

mortgage fraud. We will probably never know one way or the other whether the subprime or the prime market had more fraud. Assuming a higher level of fraud in subprime

loans is dangerous, because doing so suggests a borrower who has lower credit is more likely to lie on a loan application than someone who has good credit. That is not a conclusion that I am comfortable coming to, and the statistics do not support it.

**KEN:** Tell us a little bit about the cases you are seeing.

**RACHEL:** We deal with two types of cases: defensive and offensive. On the defense side, the defendants in those cases include the lenders, servicers, and loan originators. The cases typically involve foreclosure actions, predatory lending actions, and class actions. On the other side, we represent lenders trying to recover losses caused by fraud. In those cases, we bring actions against the various parties in the origination chain under the lender, including real estate agents, mortgage brokers, property sell-



**RACHEL DOLLAR, ESQ.**  
 Partner, Smith Dollar PC  
 Santa Rosa, CA  
[www.smithdollar.com](http://www.smithdollar.com)



ers, borrowers, loan officers, and settlement agents, escrow and title companies.

**KEN:** Am I correct in assuming you are seeing on the origination side everybody from those who actually handle the paper involved in the transaction, to those substantially downstream from the transaction who repackage the debt in CMOs and related investments?

**RACHEL:** We are not seeing a great deal of litigation on the higher secondary market side. They are not very transparent transactions for the most part, so finding those defendants can be difficult. Considering the lack of affirmative conduct in that sector, pleading viable causes of action can also be problematic.

**KEN:** Skip, tell us a little bit about your role as an expert witness in some of these matters.

**SKIP:** From my perspective as an expert witness, it is not always clear the buyers and borrowers are the victims. A lot of times they bought a house with no money down, may have gotten some cash out of the escrow, and will have lived in the property for some period of time before they stop paying the mortgage. Afterwards they live in the house for a further

rent-free period, and then walk away from the property. You start to wonder who the victims really are, and I think juries are going to have these same issues.

**KEN:** The intended characterization of Dave's topic was dirty

laundry, so I am not sure where this is headed.

**DAVE:** Where the dirty laundry comes in is in regard to loan applications with inflated incomes, falsified VOD's, and falsified secondary employment sources. Sometimes I do not even want to see the lender's file, because I

*"No lender wants another REO on their books right now, and the lenders that I have worked with are coming up with creative strategies."  
 —Rachel Dollar*

know there is going to be something there confirming what the lender wanted, but how it got there and who produced it is quite a concern. But dirty laundry makes cases more challenging.

**KEN:** I have a crossover question for Rachel and Dave, since you are on different sides of the same issue. In situations in which agent and brokers are repeat users of a mortgage broker, are there efforts to impute knowledge possessed by the agent to the mortgage side

of the case, and conversely, on the mortgage side of the case, is knowledge of the contents of the paperwork being attributed to agents and brokers?

**RACHEL:** In California, there really is no fiduciary duty to borrowers by lenders. That relationship is solely between the broker and borrower. I had a judge explain it beautifully a couple of weeks ago to a plaintiff's attorney. He said: if your client and your client's agent, the broker, got together and lied to the lender, and caused the lender to confer a benefit "loan" on your client, where is the duty?

**DAVE:** In the situation where you have a hybrid, where the one broker is actually doing sales and loans, I think that imputation may be something you can accomplish. Although there is no such thing as imputed knowledge, a decision came down in November of last year which has some very interesting language about imputed knowledge in a sales transaction context. I envision a very aggressive plaintiff's attorney using that case.

**KEN:** Rachel, tell us a little bit about bringing lenders to the bargaining table.

**RACHEL:** Lenders are definitely coming to the bargaining table on workouts and modifications. No lender wants another REO on their books right now, and the lenders that I have worked with are coming up with creative strategies. Most modification offers will be proffered only when the borrower is already in default, not when the borrower is still making payments, which I know is counter-intuitive.

**DAVE:** Is there some trick you can give us as to how to convince the lender that the borrower wants to avoid going into default

because of the impact on their credit, and yet, in fact, they are not going to be able to last more than three, five, or six months? That is a common problem I am facing.

**RACHEL:** Lenders generally will not discuss modification until there is a default. They will discuss short sales prior to default, if you go to them and can prove that the home is worth less than the amount they owe on it.

**STAN:** That is also my experience. If you have a borrower who says I can only hold out for three or six months, you are in a short sale situation as opposed to a reworking of the loan.

**BILL:** My practice deals exclusively with real estate brokers, and unfortunately the stories from the field are that many lenders will not deal with their borrower if the borrower is current. So if lenders want to work with borrowers on a short sale those lenders are forcing the borrowers to stop making payments.

**VICKIE:** I agree. Up in the Sacramento area where 30 to 50 percent of the listing inventory is REO and short sale property, you would think lenders who claim they do not want more extensive REO inventory would be far more likely to grant short sales; they are not if the borrower is current. If the lenders think they have recourse to other assets, they are not going to grant a short sale, and if there is an opportunity for them to take over the property and wipe out the second and the third, they are not discussing anything at all with the borrowers. There are a lot of short sales going on out there, but they are not as easy or as prevalent as one would think given the amount of REO inventory.

*“Where the dirty laundry comes in is in regard to loan applications with inflated incomes, falsified VOD’s, and falsified secondary employment sources.”*  
– Dave Hamerslough

**BILL:** I think the situation is even worse than you portray it, particularly in areas such as the Central Valley and Eastern Contra Costa County. Short sales take weeks and sometimes months. I have been told by a large number of brokers they will not show short sales or take short sale listings, but go straight to the REO’s because they sell quickly and for good prices. The lenders are creating a domino effect by not dealing with short sales in a timely manner and tripping them into REOs, and those dominos have not all fallen yet.

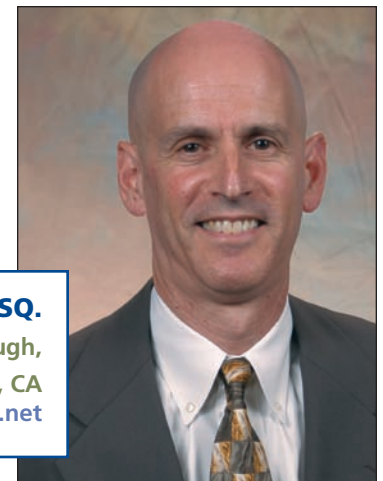
**RACHEL:** I see a couple of issues here. First, lenders are not required to do short sales. I get complaints from real estate agents across the country about lenders not accepting their short sale offers. But when a lender has a half-million-dollar loan on the table, and is looking at taking a hit of \$250,000 on it, they want to do your due diligence. You cannot believe the amount of fraud that we are seeing in the short sale

process. Second, lenders cannot accept short sales when there are second and third lien holders. The holders of the seconds and thirds will not accept the short sale and agree to walk away with nothing.

**KEN:** Linda, what impact or influence does ADR have in this subprime arena?

**LINDA:** Briefly, the cases are very difficult to resolve. If you have four parties sitting in the room, three of the four are going to tell you they do not have any money. One will be the plaintiff; one will be the mortgage broker, who says he is out of business; and one will be the lender, who is really not an institutional lender, but has been working off of a commercial line of credit making loans and never had any money. So if you can find money in the room in mediation, you can do something, but for the most part what I have seen is that you are dealing with people who are really in financial difficulties.

**LINDA:** We see cases against mortgage brokers and lenders who are bankrupt, and the next thing you see is a suit being brought against the loan servicer. Under the Truth in Lending Act, loan servicers are exempt, except if they actually come into title on the loan and own the loan. Rachel, are you seeing any unique ways plain-



**DAVID HAMERSLOUGH, ESQ.**

Partner, Rossi, Hamerslough,  
Reischl and Chuck, San Jose, CA  
[www.rhrc.net](http://www.rhrc.net)

**VERN HANSEN**

VP, CORE Risk Manager,

GMAC/Pacific Union Real Estate, San Francisco, CA

[www.pacunion.com](http://www.pacunion.com)*(photo unavailable)*

tiffs' lawyers are pleading around the exemption in TILA to bring the loan servicer into the case?

**RACHEL:** We do not see TILA pled a lot, but it is sometimes done to get around the preemption issues surrounding most of the large servicers. We also see plaintiffs' attorneys coming in and pleading non-TILA violations, and not identifying the parties in the pleadings as the servicer. I have even seen it alleged, although it may never have happened, that the servicer at one point in time came into title on the loan.

**LINDA:** I know of a couple cases in which courts have held that loan servicers, who represented they were the owner of the loan (even though they might not have been), were equitably estopped from claiming they were entitled to the exemption.

**RACHEL:** The servicer doesn't own the loan, but has the contractual right to deal with the contract issues concerning the loan. Attorneys representing servicers do not always have a complete understanding of the ownership of the loan, which has resulted in some loose representations being made in the courts. Attorneys need to be more careful about what they actually state in declarations regarding the status of the various different parties with respect to the loan.

**KEN:** Let's turn to another aspect of this whole problem, which is how do brokers and agents handle the myriad list of problems they face when it becomes time to

try to move this REO or short sale property? Vickie, tell us a little bit about how to sell without buying too much risk.

**VICKIE:** Listing REO properties is obviously not the oldest profession. It has been around for a long time, but it is like Tom Cruise's movie, because it is now far more of a "risky business," at least for real estate brokers, because of the hidden traps the lenders are creating. The listing agreements lenders are generating shift absolutely every aspect of liability the lender ever has or ever will have onto the real estate broker. The brokers have to take care of all of the utilities, repairs, and in many instances ensure code compliance. If a broker takes on the maintenance and repair responsibilities, they are now in possession of a wealth of information and knowledge about the condition of the property that a normal listing agent would not have. Think about this from a litigation standpoint. If anything goes wrong later on regarding the property, the buyer's attorney does not have to be too adept at figuring out how to find liability on the part of the broker.

**KEN:** Vern, tell us a little about your perspective on this subject.

**VERN:** Just to go along with what Vickie is saying, none of us have E&O for this unless you have coverage for property management activities, and a real concern is that a lot of these activities make the brokers into property managers. But the biggest problem I see is the short sale right

before the REO, because if people are not making the payments, they are not making the repairs. I blame most of this on the lenders. The urge to make money far outweighed their ability to review the applications and make good loans. Also, on some of the REOs at the very lower end of the market we are beginning to see a feeding frenzy, and as soon as you get into multiple offers, buyers quit inspecting.

**VICKIE:** I think we all get the same kinds of calls from our broker clients, regarding the so-called victim we have talked about who, following foreclosure, kicks holes in every wall and door as they leave, breaks all the windows, leaves the faucets running, and

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– Vern Hansen*

does unmentionable things with the toilets. What happens when the agent has to go in and fix all this damage?

**VERN:** The agents then become responsible for the repairs. Most agents are like me, without any kind of construction background, and so are not going to know if the repairs are done properly.

**VICKIE:** Do the listing agreements require them to do this?

**VERN:** The listing agreements require it and the brokers are signing them. From the broker's

perspective, the amount of liability on these sales is unbelievable.

**SKIP:** Given the fact that lenders are trying to ignore their disclosure obligations, would it be prudent for the brokers to insist the lender and buyer agree to binding arbitration?

**VERN:** You know as well as I do, as soon as the lender and buyer go to arbitration, a separate action will be filed against the broker, and the broker is going to be right back into it.

**SKIP:** In a lot of litigation, the split forum works to the advantage of the broker, because the buyer is faced with having to arbitrate with the seller, and if they want to pursue the broker, go to a jury trial. You can split the buyer into two forums. You double the work, and you cannot get attorneys' fees against the broker.

**LINDA:** The property manager/broker is required to warrant that the repairs have been done in compliance with building codes, as well as make sure the property has been vacated. Stan, do they have insurance for all that?

**STAN:** This is an important topic for everybody, regardless of what side you happen to be on. I looked at the Countrywide listing agreement (among others) and it puts some onerous insurance requirements on the broker. A lot of small brokers are not going to be able to comply with these requirements. The typical broker E&O policy has no coverage for property management, although you can buy a rider or an endorsement. But if you do not have the endorsement for property management, and the E&O carrier faces a claim based on the maintenance obligations you took on behalf of

*"The next round of mortgage fraud cases are in short sales. Some unscrupulous buyers are conspiring with sellers."  
– Bill Jansen*

the lender, you may well have no coverage.

**DAVE:** And if you are taking on an eviction role, do you think that creates any duty of inquiry into that eviction process on the part of the broker?

**STAN:** I do. Everything you learn in doing your job as a broker on a REO property, to the extent you fail to disclose it, presents a horrendous problem. All these contracts require periodic reports to the lender, and when a listing broker on a REO property does not turn over the report, or only turns over part of it, you have created an easy road map for a plaintiff's lawyer to follow.

**VICKIE:** What about the problem Vern and I touched on, which is the broker who effectively becomes a general contractor in terms of taking over the repairs? Is this an insurance problem?

**STAN:** Absolutely. I know of an arbitration held in San Mateo County about a year ago in which a broker hired a contractor using a seller's funds from a trust account. The broker was found liable for acting as a general contractor

without a license. The broker had hired the subs and directed the subs as to what work to do.

**VICKIE:** This is exactly what the property managers are doing, especially on the distressed properties, where the buyer who has been foreclosed upon literally destroys the property on their way out. To the extent the repairs and maintenance to be done on the property requires getting permits and getting contractors in, the brokers are overseeing the project as unlicensed contractors.

**KEN:** Have any of the defaulting borrowers' attorneys, or perhaps the agents trying to work short sales, talked with the defaulting borrowers about the possibility of a phantom income issue?

**STAN:** In the last few months I have developed a forum for sellers engaging in short sales, and that is one of the topics. You have to understand, if you have forgiveness of debt, you have income. You are going to get a 1099 from the lender for that forgiveness.

**BILL:** In counseling real estate brokers, any time this question comes up, I recommend sending them to their legal and tax advisors, because forgiveness of indebtedness is a complex federal issue, and still unresolved at the state level.

**KEN:** Bill, give us a preview of coming attractions.

**BILL:** The next round of mortgage fraud cases are in short sales. Some unscrupulous buyers are conspiring with sellers. They tell the seller they will buy their

**WILLIAM L. JANSEN**

President, Broker Risk Management, Corte Madera, CA

[www.brokerriskmanagement.com](http://www.brokerriskmanagement.com)

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**HAROLD "SKIP" JUSTMAN, ESQ.**

Partner, Fimmel, Justman and Rible  
San Mateo, CA

property on a short sale, negotiate with the lender, and after the close of escrow, sell it back to the seller and split the difference. Lenders are doing what is called a "compromise short sale," which is when the lender takes a short payoff on the loan, and the buyer gives the lender a note for the rest of the cash owing, or if the buyer has other property, a note secured by a deed of trust on the other investment property. Another situation I am seeing is the homeowner who bought their property for \$500,000, is still current and so still has good credit, but is starting to go underwater. The REOs down the street are selling for \$300,000. The property owner then concludes: "Why not buy the house down the street for \$300,000 while I still have good credit, and then just walk away from my present home?" Another issue is the short sale addendum created by the California Association of Realtors, which states the listing agent will continue to market the property. I think that listing brokers are obligated to do that, but many listing agents do not do so. My final comment concerns a mortgage loan provision that most agents who have come into the market in the last 10 years have never heard of: the due on sale clause. We are seeing

a resurgence of the "subject to" sale, where a buyer closes escrow taking the property "subject to" the existing loan in favor of the seller without notifying the lender. As soon as the lender finds out

the property is transferred they call the loan, the buyer with nothing to lose walks, and the seller may not find out about it because they have no notice of default or delinquency. So this is what is probably going to be the next round of cases in this mortgage mess.

**KEN:** Skip, one minute on the topic of bankruptcy.

**SKIP:** I have used bankruptcy law as a defense to a civil action. The way it evolves is the borrower/homeowner starts to have financial problems, and ends up doing a bankruptcy, perhaps a Chapter 7, but maybe a Chapter 11, to get rid of their unsecured debt. After the bankruptcy proceeding concludes, they obtain a lawyer to sue the seller and/or the brokers claiming concealment and fraud. The impact of the Chapter 7, or even a Chapter 11, is if the homeowner

*"A massive failure to employ reasoned risk management by all the participants in the financial crisis will be the resounding imprint left for the future."*

– Ken Gack

*"You start to wonder who the victims really are, and I think juries are going to have these same issues."*

– Skip Justman

did not disclose the potential claim against the seller or the brokers in the bankruptcy proceeding, they are judicially estopped from bringing the action after the bankruptcy. So if your homeowner takes a bankruptcy approach and then wants to sue you, you have got a very powerful defense under the judicial estoppel rules.

**KEN:** Linda, we heard a lot about new areas of conflict coming from the subprime situation. How can ADR help with the actions predicted to come?

**LINDA:** Most of the new areas of conflict we discussed at the Roundtable have yet to season. But ADR will come into play as most federal and state courts have ADR programs to help courts lighten case loads.

**KEN:** Some parties will not be able to afford ADR and others may be reticent about setting precedent by settlement. How do you see those hurdles surmounted?

**LINDA:** For those truly not able to afford formal ADR, such as mediation, arbitration, private judging, there are help hotlines, neighborhood support groups, legal aid services and local community groups that actually intervene between borrowers and lenders to control foreclosure situations. Even on the most minimal level, such forms of ADR are available at no-cost or affordable rates.

**KEN:** What about the reluctance of lenders or brokerages to settle because they do not want to commit to one party when so many more are in the litigation stream?

**LINDA:** We are going to need to be more creative in what we call ADR in these subprime cases. Lenders and other institutional parties will be looking not just at lawsuits, but also at SEC or other governmental regulatory (maybe criminal) actions. They do not want to admit to anything. This could present a good market for early neutral evaluations which are not binding. Or maybe non-

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– Vickie Naidorf

binding references where a neutral does some fact-finding on proffered testimony rather than sworn testimony.

**KEN:** What other strategies might ADR neutrals employ to encourage the non-borrower parties to participate?



**VICKIE NAIDORF, ESQ.**  
In-House Counsel, Coldwell Banker  
Residential Brokerage, Santa Rosa, CA  
[www.californiamoves.com](http://www.californiamoves.com)

**LINDA:** Mediation is a good forum since a settlement agreement will contain a statement that no one is admitting fault.

**KEN:** What new processes might be on the horizon?

**STAN SMITH, ESQ.**

Partner, Niven and Smith  
San Francisco  
[www.nivensmith.com](http://www.nivensmith.com)



**LINDA:** Early neutral evaluation is not new, but could be used more. Partnering an ENE with a mediation is an effective method. The neutral listens to the proffered case, then makes an assessment of the case and defenses. Depending on that evaluation, the parties can decide to go forward with the same neutral (or another one) as mediator. All non-binding, and no admissions to be argued as precedent in other cases.

**KEN:** Similar to an informal ruling on a summary judgment motion?

**LINDA:** Very similar. I liken it more to a non-binding reference in which the neutral takes proffered testimony and argument on all issues, not specifically on facts on one or several causes of action. It is broader in scope. In this arena I also see the benefit of non-binding motion practice. The institutional party may have legal issues to determine, rather than factual. If they can obtain a ruling on how this may come out in court, they may decide to proceed to mediation or another ADR process to resolve a case, or many similar

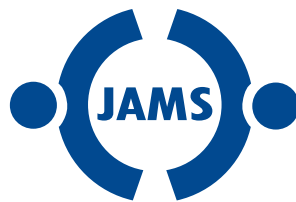
cases, based on that one decision. Like a mock jury trial.

**KEN:** Have you been involved in such type of matters?

**LINDA:** Yes. Over the years I have done numerous stand alone ENE's. I recently did an ENE with mediation. There was pre-briefing on issues, a morning of arguments and rebuttal, then a non-binding confidential decision by the neutral. After that the mediation

*“This is an important topic for everybody, regardless of what side you happen to be on.”*  
– Stan Smith

commenced upon agreement of the parties, fully elective. The case settled that day. The process was efficient, dispositive, yet not binding. I calculate that the trial costs saved were in excess of \$100,000 per side, with no attorneys' fees clause in any contract to provide recovery. ■



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