Will Vendors Create **New Liability For Servicers?**

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The historic $26 billion federal-state settlement with the five largest mortgage servicers is the latest evidence that we are facing a sea change in the loan servicing industry—a change that was already under way when the financial crisis hit in 2008. It is becoming apparent that this reform effort will encompass not only servicers, but their vendors as well, and the future of servicer-vendor relationships.

Vendors employed to handle foreclosures could be the source of new liability for servicers unless careful precautions are taken.

The use of outside vendors by loan servicers is not new, but their role in default servicing, and the adequacy of their work, has drawn increasing regulatory scrutiny during the mortgage crisis. The quality of services delivered by vendors has received unprecedented attention during the last 18 months, and the work of vendors has been the subject of enforcement actions at both the state and federal levels.

Third-party vendors are ubiquitous in an industry where approximately 50 million residential home loans are serviced. They include inspectors handing pre-foreclosure inspections, law firms and substitute trustees handling foreclosure matters, property preservation companies cleaning and securing abandoned homes, and real estate companies responsible for marketing and selling real estate–owned (REO) properties.

Some of these third-party vendors have important, although traditionally lesser-known, roles in the foreclosure process, but the continuing foreclosure crisis is shining a spotlight on them.

The relationships between mortgage lenders and affiliated default service companies, and conduct relating thereto, have been the subject of high-profile Federal Trade Commission (FTC) investigations and subsequent enforcement actions in the past. Of late, however, servicers have begun to face allegations that actions undertaken by vendors with whom they have arm's-length relationships are potentially unfair, deceptive or otherwise illegal, and that they, in turn, bear responsibility for ensuring that such conduct does not occur.

Continued regulatory and enforcement focus on servicer-vendor relationships suggests that more widespread derivative liability may be looming on the horizon. As enforcement actions discussed here demonstrate, servicers that implement effective processes for choosing, retaining and monitoring vendors will be best positioned to avoid this risk.

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To date, state banking regulators and attorneys general (AGs) have focused enforcement resources on the servicing practices of the very largest servicers while also pursuing direct actions against a bevy of third-party service providers involved in the foreclosure process for alleged improprieties.

Federal agencies, principally, have targeted industry-wide management of the foreclosure process by major servicers, examining both the relationship between servicers and their vendors and the specific practices of both. The recent federal-state settlement with the five largest loan servicers illustrates the level of emphasis placed on management of third-party providers, as it includes a host of provisions related to oversight of servicing vendors.

This article discusses regulation of servicers' relationships with foreclosure vendors, and recommends best practices for managing these relationships in today's regulatory environment.

State enforcement activity against vendors

State attorneys general from New York to Florida to Washington State have targeted individual foreclosure firms, trustee service companies and document management companies in actions alleging a variety of improprieties.

In April 2011, New York Attorney General Eric Schneiderman subpoenaed the state's largest foreclosure law firm, the Steven J. Baum firm, which handled an estimated 40 percent of New York foreclosures, and its related default servicing company, Pillar Processing. Judges across the state had rejected cases filed by the Baum firm based on its failure to provide necessary documentation, and at least one New York bankruptcy judge refused to accept documentation filed by Pillar Processing.

In connection with the investigation, the New York attorney general concluded that from at least 2007 through 2009, Baum attorneys verified foreclosure complaints stating that the plaintiff was "the owner and holder of the note and mortgage being foreclosed," notwithstanding their inability to provide documentary proof for these claims.

On March 22, 2012, Schneiderman announced a $4 million settlement with Baum and Pillar.

In August 2010, Florida Attorney General Bill McCollum launched investigations into the practices of eight foreclosure law firms, triggering the collapse of two firms and leaving thousands of Florida foreclosures in limbo. The consequences of the withdrawal of these two large firms from the market were immediately felt: Florida presently has among the longest foreclosure timelines in the country, with more than two years, on average, for a case to get through the foreclosure system.

In late 2011, Nevada Attorney General Catherine Cortez Masto sued a document management company, its subsidiaries and two of its title officers for allegedly falsifying foreclosure documents. The lawsuit alleged widespread "robo-signing," improper control over foreclosure attorneys and the foreclosure process, and argued the company sacrificed accuracy and integrity in the foreclosure process in the interest of speed. The 606-count indictment against the two individuals claimed they directed employees to forge their names on foreclosure documents.

At least four other states have acted against document management companies, including Michigan, Illinois, California and Missouri.

In February 2012, a Missouri grand jury indicted Alpharetta, Georgia–based DocX LLC on forgery charges, alleging DocX employees defrauded the recorder's office by filing fraudulently notarized documents.

In March 2012, servicers were under attack in Texas, North Carolina and Kentucky, with counties in those states challenging alleged fraudulently executed and notarized mortgage documents.

The practices of foreclosure trustees also have come under fire. In April 2011, the Washington attorney general's office ordered dozens of foreclosure trustees to address what it characterized as "widespread" violations of the states "physical presence" requirements for foreclosure trustees. In Washington, foreclosure trustees must maintain a physical presence in the state, with active local telephone service for consumers wishing to make last-minute payoffs or act to stop scheduled foreclosures.

Federal and state enforcement actions against major servicers

In March 2012, a combined group of federal and state agencies entered into a $26 billion settlement with the five largest residential mortgage servicers. While the settlement resolves claims underlying numerous government probes, it preserves the right of third parties to file claims arising out of the misconduct of servicers not covered by the settlement, thus allowing civil claims by individual consumers.

The settlement requires the servicers subject to its terms to adhere to a new set of servicing standards. These standards include numerous provisions relating to management of third-party service providers, including: 1) adopting policies and processes for oversight and management of providers, including procedures to review and address consumer complaints against them; 2) periodically reviewing both the performance and the adequacy of internal controls of third-party providers; 3) establishing certification processes that will ensure that law firm attorneys are licensed to practice in the relevant jurisdiction, have the requisite experience, and that firm services comply with applicable law and regulations; and 4) limiting servicing fees such as default-, foreclosure- and bankruptcy-related fees.

The provisions of this settlement are widely viewed as establishing *de facto* national servicing standards and a framework for anticipated servicing rules by federal regulators.

This landmark settlement followed a flurry of regulatory activity related to default servicing at the federal level. In April 2011, the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (FRB) and the Office of Thrift Supervision (OTS) entered into consent orders with 14 federally regulated mortgage servicers related to alleged deficiencies in their default servicing practices.

The consent decrees were the outgrowth of a horizontal review undertaken in the fourth quarter of 2010 that allegedly found myriad weaknesses in servicing practices, including deficiencies in document retention by third-party firms as well as inadequate guidance, policies, procedures and contracts between servicers and their vendors.

With respect to interactions with third-party vendors, the consent orders required the servicers to: 1) implement appropriate policies and procedures to ensure third-party provider compliance with legal requirements during foreclosure proceedings; 2) take measures to ensure proper record-keeping and filing of original documents and documents sent to third parties; and 3) implement policies to ensure periodic reviews of third-party providers.

The consent orders also required a look-back loan-file review aimed at compensating consumers who suffered "financial injury," due in some instances to noncompliance by third parties.

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Federal regulation

On June 30, 2011, the OCC issued supervisory guidance conveying its expectations for the oversight and management of foreclosures. This guidance addressed management of third-party vendors, including the need to define the roles for which third parties are hired, monitor performance and properly structure and prudently manage relationships with third-party providers. It also requires banks and thrifts under OCC supervision to conduct self-assessments and foreclosure-file reviews.

In October 2011, the Consumer Financial Protection Bureau (CFPB) issued its mortgage servicing examination procedures, specifically addressing the conduct of third-party vendors. The examination guidance focuses on the relationship between servicers and vendors, signaling an expectation that servicers will ensure that vendors effectively manage compliance with federal consumer financial laws applicable to the product or service being provided.

Most recently, in April 2012, the CFPB issued additional guidance on servicer responsibilities for third-party vendor management, reiterating the servicer's duty to ensure such business arrangements do not present unwarranted risks to consumers.

The CFPB's most recent guidance indicates that servicers should conduct thorough due diligence of their providers' compliance with law; review their providers' training materials to ensure appropriate training and oversight of employees; and take prompt action (including terminating relationships) when problems are identified through the monitoring process.

Recommendations and best practices

Regulators no longer view foreclosure as a fragmented process involving discrete elements such as pre-foreclosure default servicing, pre-judgment case management and post-judgment foreclosure sale, but rather see it as a unified process. Accordingly, servicers can no longer afford to rely exclusively on foreclosure counsel, trustees, document management companies or other vendors for assurance that foreclosures are handled in compliance with laws and guidelines.

As recent government enforcement and regulatory actions make clear, it is incumbent on loan servicers to use due diligence to select and engage foreclosure vendors, monitor the quality of their work, and identify and mitigate problems arising from these engagements. Failure to do so could lead to damaging examination reports from the federal and state agencies, exposure to potential enforcement actions and private litigation.

In this environment, adopting the following best practices may bolster servicers' compliance management systems and help them avoid liability for improper conduct by their vendors. Consider taking the following steps:

1. ***Establish written guidelines and criteria for the selection of service providers.***

While servicers may have legitimate reasons for making foreclosure referrals to a limited number of foreclosure counsel and/or trustee services (including familiarity, competency and efficiency), clearly established and documented selection criteria will reduce the appearance of impropriety in the selection process.

Moreover, established criteria provide a baseline for measuring alternative providers when making vendor retention and removal decisions.

Appropriate criteria should include the provider's qualifications, organization and management expertise, service capacity, level of complaints (and proportion of successfully resolved complaints), sophistication of information systems, existence of fully implemented quality-assurance and disaster-recovery plans, insurance coverage, financial viability, and compliance with licensing requirements and rules and regulations.

Periodic review of foreclosure documentation prepared by third-party providers is essential.

As with all organizations, situations change over time. A foreclosure firm may gain (or lose) expertise, personnel or financial resources from one year to the next. Essential operating systems may fail or become obsolete. Stronger or more creative vendors may become available.

Revisiting vendors periodically helps ensure that the criterion on which the initial selection rests still pertains. Documents such as vendor liability insurance policies, occupational or professional licenses and their regulatory examination reports should be obtained annually and reviewed.

Where services provided by a third party involve interfacing with consumers, face-to-face meetings with the service provider's management and key employees also can reveal a wealth of useful information.

2. ***Establish written record-keeping guidelines and protocols for service providers, and monitor their implementation.***

To ensure immediate access to key documents that reside primarily with vendors, servicers should adopt and enforce clear document-retention protocols. Such protocols should outline in detail the specific documents to be retained, as well as the retention period, retention method, anticipated time frames for delivery and/or uploading, and naming conventions for the documents in question.

In crafting these guidelines, servicers should be aware of differences in document nomenclature among the states and recognize that even among providers within a single state, documents may be referred to inconsistently.

Servicers' contracts with vendors should include the parties' expectations for vendor compliance with record-keeping and document-transmission guidelines. Document-transmission guidelines should contain safeguards against inadvertent disclosure or misdirection of documents, particularly for those that contain non-public personal or financial information about consumers. Servicers should establish contractual rights to audit providers for compliance with required record-keeping, rights to terminate or sanction non-compliance, and ensure adequate indemnities to cover financial losses in case of inadvertent disclosure, loss of documents or other problems.

3. ***Establish state-by-state foreclosure-compliance review checklists.***

Because foreclosure processes are created by state law, foreclosure service providers should be monitored regularly for compliance with applicable state law. Servicers should select providers with robust procedures for keeping abreast of statutory changes.

State-by-state foreclosure checklists can be useful for servicer personnel education and training, as well as for quality-control monitoring of vendors. Checklists should identify the steps in the foreclosure process and the documentation appropriate to each step, such as service of process and posting or publication of notice.

Because foreclosure procedures vary considerably from state to state, one-size-fits-all solutions are not ideal for the creation of such checklists. Servicers' in-house legal staffs, outside counsel distinct from foreclosure counsel, title companies and consultants are useful in this effort.

As with other compliance-related tools, the information checklists should be updated regularly because state foreclosure laws are being constantly amended. For example, a number of states added mandatory mediation to the foreclosure process as a result of the financial crisis, and others placed temporary moratoria on foreclosures. Failure of a servicer or vendor to update state-by-state foreclosure information to include these requirements could result in costly and ineffective foreclosure filings with potential risk of suit by injured consumers as well as negative examination findings, investigations or enforcement actions by federal and/or state regulators.

4. ***Conduct periodic review of foreclosure-related documentation prepared by service providers.***

Periodic review of foreclosure documentation prepared by third-party providers is essential. The quality and accuracy of documentation provided to consumers and courts has been at the heart of many of the enforcement actions described here, and of late, inadequate documentation has often resulted in dismissal of the lender's complaint in foreclosure.

Vendors also should be reviewed frequently for compliance with prescribed document formats, control over document completion and execution formalities, and implementation of quality-control processes for determining whether required documents were provided to all necessary parties. On-site reviews at the vendors' facility are often effective, with reviews conducted with minimal advance notice having maximum evaluative impact. On-site reviews also permit evaluation of documentary compliance and simultaneous evaluation of vendor personnel.

5. ***Identify trends in customer complaints.***

The seeds of significant regulatory enforcement matters are often sown by a series of uncoordinated customer complaints. Identifying trends in customer complaints may alert servicers to existing or budding compliance or customer service issues. Such patterns can provide early warnings and opportunities to craft solutions before problems escalate. While much of the foreclosure process is not customer-facing, keeping an ear tuned to customer feedback is invaluable when crafting compliance strategies.

6. ***Quality control and quality assurance***

Even the most carefully crafted compliance procedures, up-to-date process checklists and scrupulously enforced vendor reporting can fail in revealing whether procedures are actually being followed in practice. Quality-assurance testing lies at the heart of every operational process whose success (and its corollary, risk reduction) depends on compliance.

Quality-assurance testing and exception reporting should be a mandatory part of servicer-vendor relationships. Unsatisfactory results on key metrics can serve as red flags to warn servicers of impending risk. If the servicer does not have the in-house staff to conduct these reviews, engaging quality-assurance experts is a step in the right direction, and one that demonstrates the servicer's commitment to quality of outsourced services.

Turning obligation into opportunity

Without doubt, the mortgage industry is facing a crisis of consumer and regulatory confidence in the wake of foreclosure practices uncovered during the mortgage crisis. With respect to vendor management, by taking appropriate steps to monitor vendors involved in foreclosures, the recent surge in regulatory activity can be turned into an opportunity for the mortgage industry to showcase its commitment to service and compliance. **MB**

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