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April 28, 2008

BANKING LAW ALERT

THE RISE (AND POTENTIAL PITFALLS FOR LENDERS) OF FORECLOSURES IN TENNESSEE

According to RealtyTrac Inc., the number of foreclosures in the U.S. increased more than 57 % in March 2008 compared to March 2007. The month of March 2008 marked the 27th straight month of year-over-year growth of foreclosure-related filings. Across the nation, an average of about one out of 540 homes went into foreclosure in March 2008, which was about a 5 % increase over the totals in February 2008.

The State of Tennessee is not immune to this foreclosure dilemma. In fact, Tennessee currently has the 10th highest foreclosure rate among all states in the U.S. With the rise in foreclosures hitting so close to home, this Banking Law Alert will highlight some of the latest developments in foreclosures in Tennessee.

Notice of Sale

Most lenders are well aware that a notice of sale is required to be published in a newspaper at least twenty (20) days prior to the date of the sale. In addition to having the notice of sale published, a lender also was required to send a copy of the notice to the debtor. A recent amendment to the Tennessee Code now requires that if the debtor does not reside at the property that is to be foreclosed upon, then the lender must send a copy of the notice to both the debtor's residence and the location to be foreclosed. The notice must be sent to the debtor at least thirty (30) days prior to the date of publication -- not the date of the sale.

This is a significant change as to how much notice is to be provided to a debtor who does not reside at the property to be foreclosed upon.

The key issue on notice requirements is what is the penalty for failing to provide enough notice? It is not completely clear what the ramifications are if the lender fails to give notice as set forth in Tennessee Code Annotated § 35-5-101 *et seq.* In a Tennessee Attorney General Opinion decided earlier this year, a failure to follow the steps set forth in the foreclosure statutes in Tennessee did not make the sale void or voidable. No cases are available at this time to interpret these statutory provisions or to further expand on this Opinion; thus, it is impossible to predict how a court might handle a clear violation of one of

these statutes. We recommend following the strict notice requirements to avoid any uncertain penalties that could develop as courts are confronted with these type of cases.

A Foreclosure Sale Must Comply with the Terms of Deed of Trust

While Tennessee courts have not addressed the failure to adhere to the notice requirements as specified in the foreclosure statutes, at least one court has tackled recently the issue of failing to meet the terms as set forth in a deed of trust. In Citifinancial Mortgage Co., v. Beasley, 2007 WL 77289 (Tenn. Ct. App., Jan. 11, 2007), two debtors failed to make payments under the terms of their loan. The lender sent a notice of default and then conducted a foreclosure sale. The lender later attempted to have the debtors removed from the property via an unlawful detainer action. The debtors argued that the foreclosure was void because the lender did not have the proper authority to sell the property since the notice do not comply with the terms of the deed of trust.

Pursuant to the deed of trust, the debtors had thirty (30) days in which to cure the default. Since the foreclosure sale occurred during the 30-day cure period, the Court of Appeals held that debtors had provided a valid defense to the unlawful detainer action filed by the lender, and the Court of Appeals reversed the trial court's judgment in favor of the lender.

No Recovery of Deficiency Judgment with Low Foreclosure Sale

In Lost Mountain Development Co. v. King, 2006 WL 3740791 (Tenn. Ct. App., Dec. 19, 2006), the Tennessee Court of Appeals held that a mortgagee was precluded from being able to recover a deficiency judgment against a debtor due to the fact that the foreclosure sales price was grossly inadequate. In this case, the debtor bought a piece of land for over \$4,600,000 and had to finance a substantial portion of the purchase. After the debtor defaulted on the loan, the lender initiated foreclosure proceedings. The lender was the only bidder at the sale and obtained the property for a bid of \$1,100,000. The lender then sought a deficiency judgment, which the trial court awarded, via summary judgment, in the amount of \$4,426,135.

The Tennessee Court of Appeals reversed the lower court's judgment on the basis that the lender would be unfairly granted a windfall to be able to obtain the property for such a low value and then also recover such a large deficiency. The Court decided that the debtor had brought up a relevant issue of fact and that summary judgment was not appropriate under the circumstances. The Court stated that the goal in these type of cases is for the deficiency judgment to accurately reflect the difference in the fair market value, if it is greater than the sales price, and the amount still owed.

Notice to Insurance Company of Foreclosure

An interesting case was decided by the Tennessee Court of Appeals in the fall of 2007 with regard to the impact on a home insurance policy, in which a bank was listed as the mortgagee, where foreclosure proceedings were initiated and no notice of the foreclosure was provided to the insurer. In U.S. Bank v. Tennessee Farmers Mutual Insurance

Company, 2007 WL 4463959 (Tenn. Ct. App., Dec. 21, 2007), the bank made a home loan and took a deed of trust as security. Under the terms of the loan agreement, the homeowner was required to take out a fire insurance policy on the residence. The homeowner took out a policy that listed the bank as the mortgagee and that contained a standard mortgage clause requiring the bank to notify the insurance company of any "increase in hazard."

The homeowner later defaulted, and the bank started foreclosure proceedings. No notice was ever provided to the insurance company. Prior to the foreclosure being complete, the home was destroyed by fire. The bank notified the insurance company of the loss, but the insurance company refused to pay -- the rationale being that the failure to provide notice of the foreclosure to the insurance company was a breach of the mortgage clause in the policy.

The bank filed suit and was successful at the trial level in its claim. However, the Court of Appeals overturned the lower court's judgment. The Court's reasoning was that a foreclosure proceeding is an "increase in hazard" under the standard mortgage clause and also pursuant to a Tennessee statute. The Court held that the bank was not protected from invalidation of the protection of its interest because of its failure to give notice to the insurance company as required under the terms of the policy.

We anticipate that lenders that provide this notice to insurance companies will encounter situations in which the insurance companies will cancel the insurance. As a result, lenders will be left with the decision of whether to force place insurance to protect their security interests.

Our Advice: Due to the higher number of foreclosures and the ever-developing changes in this area of law, it is becoming more and more important that lenders follow the statutory requirements on foreclosures with strict precision. We highly suggest that you consult with an attorney before proceeding with any foreclosure actions. Please feel free to contact Laura Williams, Chuck Exum, or Adam Crider with our Business Group to discuss any issues with foreclosures that you may incur.

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