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March 16, 2009

Opinion No. 09-28

Requiring Lender to Negotiate with Borrower before Foreclosure

QUESTIONS

1. May the General Assembly constitutionally amend the foreclosure laws to require the lender to negotiate with a borrower in default before the lender may foreclose?

2. May the General Assembly constitutionally amend the foreclosure laws to provide that, while the borrower and lender are engaged in good faith negotiations, the borrower will not be required to pay more than thirty-one per cent of his or her gross monthly income per month toward the loan unless he or she files for bankruptcy protection?

OPINIONS

1. Current foreclosure laws do not require the lender to negotiate with a borrower before selling property at foreclosure. Any change imposing this requirement with respect to a loan agreement entered into before the effective date of the act is subject to challenge under the Contract Clauses of the United States and Tennessee Constitutions. Any change that substantially impairs an existing contractual relationship must be made pursuant to a significant and legitimate public purpose. Further, the adjustment of the rights and responsibilities of the contracting parties resulting from the change must be based upon reasonable conditions and be of a character appropriate to the public purposes justifying adoption of the change. The constitutionality of a negotiation requirement would depend on the burden it places on the lender's right to exercise the foreclosure remedy. For example, we think a court would find the requirement unconstitutional if it enables the borrower indefinitely to delay the lender's right to foreclose and sell the property. The change could be defensible if the requirement to negotiate is clearly defined and restricted, does not change the terms of the mortgage, and does not delay foreclosure.

2. Any statute reducing the amount a borrower must pay a lender while good faith negotiations are in progress is subject to the same analysis. Again, the defensibility of such a measure would depend on its particular terms. We think, however, that such a measure is vulnerable to a challenge that it violates the state and federal Contract Clauses. Such a measure imposes a heavy administrative burden on a lender to ascertain the borrower's income. Further, it changes the underlying terms of the mortgage and provides incentive for the borrower

indefinitely to delay foreclosure. For these reasons, we think a court could well conclude that this change would impair the lender's contract in violation of the Contract Clauses of the United States and Tennessee Constitutions, if applied retrospectively.

ANALYSIS

This opinion addresses whether the General Assembly may constitutionally require all lenders to conduct negotiations with a borrower before foreclosing on property pledged to secure the debt.[1] The request also asks whether legislation could constitutionally provide that, while good faith negotiations are under way, the borrower will not be required to pay more than thirty-one per cent of his or her gross monthly income per month toward the loan unless he or she files for bankruptcy protection. Foreclosure laws appear at Tenn. Code Ann. §§ 35-5-101, *et seq.* These laws do not require a lender to conduct negotiations with the borrower before exercising the right to foreclose. Under the present law, a lender may foreclose property after publishing notice three times, the first at least twenty days before the foreclosure. Tenn. Code Ann. § 35-5-101(b). The lender must also notify the debtor under Tenn. Code Ann. § 35-5-101(e).

The request indicates that it refers to pending legislation but does not specify any bill. Two bills appear to address this issue. First, House Bill 235/Senate Bill 186 would amend Tenn. Code Ann. § 35-5-101 by adding a new subsection (f). The new subsection would apply only to foreclosures on owner-occupied single family residences. It would require a lender to meet with a borrower if the lender has actual knowledge that a borrower is in default due to an illness in the family, unemployment, or any catastrophic situation beyond the debtor's control that has caused extreme financial hardship. If the borrower has sent a certified letter to the lender prior to the first foreclosure publication stating he or she is in default due to any of these circumstances, the lender would be deemed to have actual knowledge. The lender would then be required to conduct an in-person meeting with the borrower "to assess the debtor or co-debtor's financial situation, provide the debtor or co-debtor with a list of HUD-certified credit counselors in the debtor or co-debtor's geographic region, and explore options for the debtor or co-debtor to avoid foreclosure." HB 235/SB 186, § 1. The legislation also would require the lender to offer restructuring or other options "where feasible." *Id.* The meeting must take place no later than ten days after the first notice of foreclosure is published. The new subsection would not apply to mortgages entered into prior to the effective date of the act. This act, therefore, applies only prospectively. The act nowhere provides that the lender must delay foreclosure while negotiations are taking place.

Second, House Bill 1443/Senate Bill 1937 would amend Tenn. Code Ann. § 35-5-101(b) to extend the advertising period before foreclosure from at least twenty days to at least ninety days previous to the sale. The act also would add a new section 35-5-117 to the statutes on foreclosure. Under this section, within one week of publishing the notice of foreclosure, the lender would be required to provide an authorized foreclosure prevention counseling agency with the borrower's name, address, and most recently known telephone number. The proposed bill

[1] Statutes use different terms to describe the foreclosing party and the owner of the foreclosed property. In this opinion, the term "lender" is intended to refer to the party conducting the foreclosure and includes the party referred to as the "mortgagee," "creditor," or "trustee" in different statutes and bills. The term "borrower" is intended to refer to the owner of foreclosed property and includes the party referred to as the "mortgagor," "debtor," or "co-debtor" in different statutes and bills.

defines "authorized foreclosure prevention counseling agency" as a nonprofit agency approved by the Tennessee Housing Development Agency or the United States Department of Housing and Urban Development to provide foreclosure prevention counseling services. An agency contacted by a borrower and providing foreclosure prevention assistance services to the borrower would be required to provide notice to the lender. The lender would be required to return a form to the agency within fifteen days of receipt of the form with the name and telephone number of the lender's agent. The legislation would require that the agent be authorized to discuss the terms of the mortgage and negotiate any resolution to the mortgagor's default. The statute would provide that nothing in the provision requires the lender to reach a resolution relating to the mortgagor's default. The act also would include the form of the preforeclosure notice that the lender must provide the borrower. Again, while it would extend the notice of foreclosure period from at least twenty days to at least ninety days, the act nowhere provides that the lender would be required to delay foreclosure while its agent is negotiating with the borrower or the foreclosure prevention counseling agency. Further, it is not clear whether these portions of the proposed legislation are intended to apply retroactively to include foreclosures initiated after the effective date of the bill that are enforcing agreements entered into before that date.

There is a strong presumption in favor of the constitutionality of acts passed by the legislature. *State v. Pickett*, 211 S.W.3d 696, 700 (Tenn. 2007), *cert. denied*, ___ U.S. ___, 128 S.Ct. 436, 169 L.Ed.2d 305 (2007). The party attacking the constitutionality of a statute must bear a heavy burden in establishing some constitutional infirmity of the act in question. *Gallaher v. Elam*, 104 S.W.3d 455 (Tenn. 2003). Article I, Section 20, of the Tennessee Constitution states "[t]hat no retrospective law, or law impairing the obligations of contracts, shall be made." Similarly, Article I, Section 10, of the United States Constitution provides that "[n]o state shall . . . pass any . . . law impairing the obligation of contracts[.]" The Tennessee Supreme Court has stated that the meaning of the federal and state constitutional provisions is identical. *First Utility District of Carter County v. Clark*, 834 S.W.2d 283, 287 (Tenn. 1992); *Paine v. Fox*, 172 Tenn. 290, 112 S.W.2d 1 (Tenn. 1938).

Article I, Section 20, of the Tennessee Constitution prohibits laws "which take away or impair vested rights acquired under existing laws or create a new obligation, impose a new duty, or attach a new disability in respect of transactions or considerations already passed." *Doe v. Sundquist*, 2 S.W.3d 919, 923 (Tenn. 1999) (quoting *Morris v. Gross*, 572 S.W.2d 902 (Tenn. 1978)). Among the main tests as to whether the obligation of a contract has been impaired are whether the value of the contract or security has been lessened, *Lake County v. Morris,* 160 Tenn. 619, 28 S.W.2d 351 (1930), or whether the right in full existing at the time the contract was executed has been diminished. *Hannum v. McInturf*, 65 Tenn. 225 (1873). The laws affecting enforcement of a contract, and existing at the time and place of its execution, enter into and form a part of that contract. *Kee v. Shelter Insurance,* 852 S.W.2d 226, 228 (Tenn. 1993). In the *Kee* case, the Tennessee Supreme Court found that an extension in the statute of limitations could not constitutionally apply to a claim that had already accrued under an insurance contract before the extension was passed.

In determining whether a particular state regulatory measure is constitutionally valid under the federal Contract Clause, courts generally apply a three-pronged test. *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 410-13, 103 S.Ct. 697, 704-05, 74

L.Ed.2d 569, 580-81 (1983). The threshold inquiry is "whether the state law has, in fact, operated as a substantial impairment of a contractual relationship." *Allied Structural Steel Co. v. Spannaus*, 428 U.S. 234, 244, 98 S.Ct. 2716, 2722, 57 L.Ed.2d 727 (1978). In determining the extent of the impairment, the courts are to consider whether the industry the complaining party has entered into has been regulated in the past. *Id*. at 242 n. 13, 98 S.Ct. at 2721 n. 13. Where, in light of all facts and circumstances, including past regulation and the terms of the agreement, a change in state law is foreseeable, the change does not impair the parties' reasonable expectations. *Energy Reserves Group*, 103 S.Ct. at 707. The Tennessee Supreme Court relied on similar factors to determine whether a change in the process of accessing adoption records impaired a "vested right" in violation of Article I, Section 20, of the Tennessee Constitution. *Doe v. Sundquist*, 2 S.W.3d 919, 924 (Tenn.1999). The Court inquired, first, whether the public interest is advanced or retarded; second, whether the retroactive provision gives effect to or defeats the *bona fide* intentions or reasonable expectations of the affected persons; third, whether the statute surprises persons who have long relied on a contrary state of the law; and finally, the extent to which a statute appears to be procedural or remedial.

The first question, then, is whether, in light of all the facts and circumstances, a requirement to negotiate would be a substantial impairment of a contractual relationship between the lender and the borrower. The answer to this question would depend on the burden that the requirement places on the lender and its effect on the value of the contract. If the requirement to negotiate is clearly defined and does not impair the value of the contract, we think it can be argued that a negotiation requirement is procedural in nature, affecting a statutory remedy rather than underlying contractual obligations. Further, to the extent that the change protects owners, it can be argued that it advances the public interest. But if the requirement places a heavy administrative burden on the lender and allows the borrower indefinitely to delay foreclosure, we think a court would conclude that the requirement would substantially affect the value of the contract to the lender.[2] Further, we think a court would conclude that lenders in Tennessee could not foresee such a retroactive change in the law. Our research indicates that no such condition has ever been placed on the right to foreclose mortgaged property. For this reason, we think a court would conclude that extending the term would retroactively impair mortgage contracts entered into before the effective date of the change.

Under the federal Contract Clause, if the challenged regulatory measure does impair a contract, then the second inquiry is whether the regulatory measure came into being pursuant to a significant and legitimate public purpose, *United States Trust Co. v. New Jersey*, 431 U.S. 1, 22, 97 S.Ct. 1505, 1517, 52 L.Ed.2d 92 (1977), *rehearing denied*, 431 U.S. 975, 97 S.Ct. 2492, 53 L.Ed.2d 1073 (1977), such as the remedying of a broad and general social or economic problem. *Allied Structural Steel Co.*, 428 U.S. at 247, 249, 98 S.Ct. at 2723-25. Once a legitimate public purpose has been identified, the next inquiry is whether the adjustment of "the rights and responsibilities of contracting parties [is based] upon reasonable conditions and [is] of a

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[2] Under regulations promulgated by the Office of the Comptroller of the Currency, state laws that obstruct, impair, or condition a national bank's ability to fully exercise its federally authorized real estate lending powers do not apply to national banks. 12 C.F.R. § 34.4(a). Under (b)(6) of this regulation, state laws on acquisition and transfer of real property apply to national banks to the extent that they "only incidentally affect the exercise of national banks' real estate lending powers[.]" A serious burden on a lender's right to foreclose could, arguably, be found inapplicable to national banks if it more than incidentally affects the exercise of their real estate lending powers.

character appropriate to the public purposes justifying [the legislation's] adoption." *United States Trust Co.*, 431 U.S. at 22, 97 S.Ct. at 1518. Furthermore, "as is customary in reviewing economic and social regulation, . . . courts properly defer to legislative judgment as to the necessity and reasonableness of a particular measure." *Energy Reserves Group, Inc*., 459 U.S. at 412-13, 103 S.Ct. at 704-05, 74 L.Ed.2d at 581.

As discussed above, neither House Bill 235/Senate Bill 186 nor House Bill 1443/Senate Bill 1937 would change the terms of the underlying contract. Further, they clearly define the lender's obligations regarding notice to and meetings with the borrower. For these reasons, we think the renegotiation requirements in these bills would be defensible against a claim that they violate the Contract Clauses. Whether any other negotiation requirement is defensible against such a claim would depend on its terms, particularly the burden it places on the lender and whether it enables the borrower indefinitely to delay foreclosure. For example, the Minnesota Court of Appeals upheld the Farmer-Lender Mediation Act of 1987, a temporary act requiring a lender on farm property to participate in mediation and delaying foreclosure proceedings until ninety days after mediation was concluded or a mediation agreement was reached. *Laue v. Production Credit Association of Blooming Prairie,* 390 N.W.2d 823 (Minn.Ct.App. 1986). The Court found the act did not unconstitutionally impair the lender's contract because it limited the time for mediation, imposed obligations of good faith on lenders and borrowers, and repealed the act effective July 1, 1988. The Court found, therefore, that the act was carefully tailored to protect farmers during an economic crisis without unreasonably burdening lenders. *See also First National Bank in Lenox v. Heimke,* 407 N.W.2d 344 (Iowa 1987) (upholding a farm mediation statute against a Contract Clause challenge).

Similarly, in *Home Building & Loan Association v. Blaisdell,* 290 U.S. 398, 54 S.Ct. 231, 78 L.Ed. 413 (1934), the United States Supreme Court upheld a temporary law authorizing a court to delay a lender's right to take possession of foreclosed property. The Court emphasized, however, that the act did not change the underlying terms of the mortgage and required the property owner to pay a fair market value rent during the delay. But "[n]ot even changes of the remedy may be pressed so far as to cut down the security of a mortgage without moderation or reason or in a sprit of oppression." *W.B. Worthon Co. ex rel Board of Commissioners of Street Improvement District No. 513 of Little Rock, Ark. v. Kavanaugh,* 259 U.S. 56, 55 S.Ct. 555, 557, 79 L.Ed. 1298 (1935). In that case, an improvement district had issued bonds payable out of assessments against property owners in the district. Any property on which the assessments were delinquent was subject to foreclosure. After the bonds were issued, the state legislature amended the statutes governing enforcement of assessments. These changes increased the time for payment after notice from thirty days to ninety days; greatly reduced the penalty for late payment; eliminated recovery of costs or attorneys' fees; greatly extended the period of redemption after foreclosure; reduced the rate of interest accruing during the period of redemption from ten or twenty per cent to six per cent; and denied a purchaser at a foreclosure sale the right to occupy the property during the period of redemption. The Court found that, while each of the changes affected a remedy, their cumulative effect was "an oppressive and unnecessary destruction of nearly all the incidents that give attractiveness and value to security." 55 S. Ct. at 556. The Court remanded the case, ordering the lower courts to issue a foreclosure decree including the terms of the statutes in effect when the bonds were issued.

Any statute reducing the amount a borrower must pay a lender while good faith negotiations are in progress is subject to the same analysis. Again, the defensibility of such a measure would depend on its particular terms. We think, however, that such a measure is vulnerable to a challenge that it violates the state and federal Contract Clauses. Such a measure imposes a heavy administrative burden on a lender to ascertain the borrower's income. Further, it changes the underlying terms of the mortgage and provides incentive for the borrower indefinitely to delay foreclosure. For these reasons, we think a court could well conclude that this change would impair the lender's contract in violation of the Contract Clauses of the United States and Tennessee Constitutions, if applied retrospectively.

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