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Your Foreclosure Hearing Just Got More Crowded

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On August 30, 2017, an amendment to North Carolina's foreclosure statutes took immediate effect. The amended statute, Section 45-10, concerns substitute trustees under a deed of trust. As amended, Section 45-10 now prohibits an attorney who serves as trustee or substitute trustee from representing the noteholder or the borrower while "initiating" a foreclosure proceeding. Before the amendment, a lender often could rely on its counsel simultaneously to conduct the foreclosure and represent its interests. With the new amendment, the takeaway for lenders is that non-judicial foreclosure under the power-of-sale provision in a deed of trust now requires two parties—a substitute trustee and lender's counsel—and this may increase the time and expense of foreclosure.

Non-Judicial Foreclosure and Substitute Trustees

There are three parties to a deed of trust: (1) grantor (borrower), (2) trustee, and (3) beneficiary (lender). Typically, the first step in foreclosure is to replace, or substitute, the trustee under the deed of trust. The substitute trustee initiates the foreclosure through a special proceeding before the clerk of court.

Although the lender may hire and pay the substitute trustee, the substitute trustee is a fiduciary to the lender and the borrower. The substitute trustee may not advocate for either side during the foreclosure hearing and must use diligence and fairness in conducting the sale. The substitute trustee need not be an attorney, but non-attorney substitute trustees also have a fiduciary responsibility to the borrower and lender.

When a lender directs counsel to initiate foreclosure under the power-of-sale provision in a deed of trust, it engages in a non-judicial foreclosure. Chapter 45 of the North Carolina General Statutes governs non-judicial foreclosures and requires the clerk to authorize a foreclosure sale if the lender establishes the existence of (1) a valid debt, (2) default, (3) the creditor's right to foreclose (including that creditor is the "holder" of the loan documents), (4) notice, (5) "home loan" classification and applicable pre-foreclosure notice, and (6) that the sale is not barred by the debtor's military status. If the borrower contests any of these matters, the substitute trustee must remain neutral. It is the job of lender's counsel to advocate for the lender.

The Impact of Amended Section 45-10

Before the recent amendment to Section 45-10, counsel often wore two hats during foreclosure—counsel for the substitute trustee and lender's counsel. Some law firms used an "in-house" corporation or limited liability company to serve as the substitute trustee. For example, the law firm formed an entity called "Sub Trust Co." that served as the substitute trustee while the attorney represented Sub Trust Co. and the lender. The

attorney prepared and filed all the documents, oversaw service on the parties, and often was the sole attendee at the hearing. This was efficient and cost-effective since many foreclosures are not contested by borrowers. If the foreclosure was uncontested, or if the borrower attended hearings solely to seek a continuance (i.e., to provide time to refinance the debt), a lawyer could serve a dual role without violating his fiduciary duty.

The amendment to Section 45-10 calls into doubt this practice even in uncontested foreclosures. Going forward, if a lender instructs its counsel to foreclose a deed of trust, counsel's first task will be to retain an independent substitute trustee. The lender will need to pay for the substitute trustee. (These costs usually can be added to the debt secured by the deed of trust.) Bank's counsel will need to coordinate with the substitute trustee to schedule the foreclosure hearing. Since a lender often is uncertain if a borrower will attend the foreclosure hearing, the substitute trustee and counsel both will need to attend.

Technically, the use of a separate entity such as Sub Trust Co. would not violate amended Section 45-10 because Sub Trust Co., not the attorney, is the substitute trustee, and the statute prohibits an "attorney" from serving in both capacities. We would caution lenders, however, from trying to save costs and expedite foreclosures with this approach because we would expect borrowers and their counsel to argue this arrangement violates the intent and spirit of the amendment.

Because the amendment to Section 45-10 took effect immediately, it could affect existing foreclosures. If lender's counsel presently is serving as both the trustee and counsel for a lender in a foreclosure pending as of August 30, 2017, the lender can expect the borrower to argue that the foreclosure is defective. Lenders should be proactive in addressing the potential for the borrowers to move to have the foreclosure dismissed as unlawful.

The amendment to Section 45-10 allows an attorney who, as trustee, has initiated a foreclosure proceeding to resign as substitute trustee and act as counsel for the noteholder. It is unclear, however, if resignation will cure the problem, since borrowers will still be able to argue that the foreclosure was "initiated" in violation of amended Section 45-10. To avoid dismissal, the safest course for lenders may be to have counsel remain as substitute trustee and retain new counsel to represent the lender's interests.

If you have questions about the amendment to Section 45-10 or other foreclosure questions, please contact our for Creditors' Rights Practice Group more information on how best to proceed given this change to the statute.

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