How States Can Protect Homeowners Facing Zombie Second Mortgages: Suggested Language for a Second Mortgage Foreclosure Bill

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The Problem of Zombie Second Mortgages and the Need for Action

During the early 2000s predatory lenders often combined first and second mortgages in a single loan transaction. Referred to as "80-20 mortgages," the transactions typically financed 80% of the principal balance through a first mortgage and the other 20% through a second mortgage. This kept the first mortgage within a loan-to-value ratio for easy securitization. Many borrowers did not know they had two loans. Careless underwriting and abusive terms led to early defaults on many of these mortgages.

During the Great Recession, many borrowers who had entered into predatory second mortgages found themselves unable to make the payments. However, because housing values had dropped drastically, these lenders typically did not foreclose. Many lenders eventually sold the loans to debt buyers who paid pennies on the dollar in the hopes that property values would increase. Most of these debt buyers ignored the homeowners for years. They did not provide any ongoing information about who owned or serviced the loan and how the homeowner could contact them They did not send monthly statements providing an itemization of amounts owed.

Now that housing values have skyrocketed, these debt buyers are emerging, shocking homeowners with astronomical amounts of interest and fees allegedly due and attempting to foreclose in the hopes of making money on their investments.

Many of the debt buyers who are foreclosing on these mortgages do not have full loan histories. They cannot document prior assignments or the amounts they claim to be owed. Because of the long histories of inaction on the part of the loan owners, many homeowners lost opportunities to explore options for modifications and other loss mitigation options that could have substantially reduced the amounts claimed to be due. Instead, homeowners continued to pay regularly on their first mortgages. They now face the loss of all of their accrued home equity through foreclosure of a second mortgage they were not aware existed.

There has been limited action at the federal level to address unfair and deceptive zombie second mortgages. It is up to the states to act to protect homeowners trapped by a debt they believed was long behind them. This issue brief provides suggestions for statutory language that states can use to amend existing consumer protection statutes or create a new protective statute. It also reprints a Virginia law, enacted in 2024, that incorporates the same approach as the NCLC suggested language, although in a more limited way and a recent Ohio law that requires specific notice before foreclosing on a second mortgage.

Suggested Statutory Language to Address Zombie Second Mortgage Problems

The language proposed below provides safeguards to ensure that holders of second mortgages are providing proper notice and documentation before being allowed to foreclose. These protections will prevent unfair foreclosure of long-dormant second mortgages as well as older second mortgages taken as home equity lines of credit. These provisions can be enacted either as a series of amendments to a state's existing foreclosure statutes or as a new standalone chapter or section.

The suggested language is divided into three parts. Part (A) creates a statutory definition for the term "abandonment," a principle that is derived from common law and traditionally applied in the mortgage context. The definition is linked to specific conduct of holders of dormant second mortgage debt. Part (B) applies the definition of abandoned mortgage debt to create limitations on foreclosures. These limitations apply in both non-judicial and judicial foreclosure contexts. Finally, Part (C) establishes forms of affirmative relief that borrowers may seek outside of the foreclosure context to remedy harms created by abandoned second mortgage debt.

An Act to amend foreclosure procedures for subordinate mortgages

(A) Definitions

1) Subordinate mortgage. For purposes of the following provisions the term "subordinate mortgage" means a security instrument in residential real property voluntarily granted in connection with an extension of closed or open-ended credit that (i) was, at the time it was recorded, subordinate to another security interest encumbering the same real property and (ii) has not subsequently been elevated to a first priority lien by a recorded voluntary subordination agreement. The term includes security instruments that function in the form of a deed of trust.

2) Abandonment.

   a. **Abandonment of an entire mortgage debt.** The entire debt securing a subordinate mortgage is deemed abandoned if the loan owner, its agents, or their predecessors provided the borrower with no written communications regarding the loan for a cumulative period of three or more years. The failure to provide communications may include, but is not limited to the failure to provide: (1) periodic statements for each billing cycle when required by the Truth in Lending Act or state law, (2) transfer of loan servicing notices and early intervention or pre-foreclosure notices required by the Real Estate Settlement Procedures Act or state law; or (3) a notice of transfer of loan ownership required by the Truth-in Lending Act or

   b. **Abandonment of a portion of a mortgage debt.** If the loan owner, its agents, or their predecessors failed to provide the borrower with periodic statements for each billing cycle when required by the Truth in Lending Act or state law, the interest and fees assessed on the portion of the debt for which each periodic statement was not provided is deemed abandoned.

(B) Limitations on foreclosure

Alternative #1 (for states that allow non-judicial foreclosure):

(1) As a condition to exercising a power of sale or otherwise conducting a non-judicial foreclosure, the foreclosing entity must record a certification in the public land records that no portion of the mortgage loan is abandoned under the definitions described in part A above.

(2) A proposed sale may be enjoined on the basis that the foreclosure involves abandoned mortgage debt.

(3) If a borrower is successful in enjoining the sale on the basis that all or a portion of the mortgage debt is found to be abandoned, the borrower shall be entitled to recover attorney fees and costs against the foreclosing entity.

Alternative #2 (for states that require judicial foreclosure):

(1) In a judicial foreclosure proceeding it shall be a complete affirmative defense to the foreclosure action if the court finds that the plaintiff's claim is based on an abandoned mortgage debt as defined in part A above.

(2) In a judicial foreclosure proceeding it shall be an affirmative defense to any portion of the plaintiff's claim for relief to the extent that the court finds that the portion has been abandoned as defined in part A above.

(3) If the court determines that any portion of the plaintiff's claim has been abandoned, the defendant shall be entitled to recover attorney fees and costs against the foreclosing entity for pursuing the affirmative defense.

(C) Right to affirmative relief

(1) A court may declare all or a portion of a mortgage debt securing a subordinate mortgage abandoned if it meets the definition of abandonment in (A)(2) or if the court determines it to be abandoned by weighing the factors listed in (C)(2).

(2) The court may consider the following factors when determining abandonment of a subordinate mortgage loan pursuant pursuant to subsection (C)(1):

a. The failure to provide periodic statements for each billing cycle when required by the Truth in Lending Act or state law for two or more cumulative years;
b. The failure to provide a transfer of loan servicing notice to the borrower when required to do so by the Real Estate Settlement Procedures Act;
c. The failure to provide an early intervention notice or other pre-foreclosure notice as required by the Real Estate Settlement Procedures Act or state law;
d. The failure to provide a transfer of loan ownership notice to the borrower when required to do so by the Truth in Lending Act;
e. Providing the borrower with an IRS Form 1099 indicating that the debt had been written off, if the loan owner benefited from treatment of the loan as written off for federal taxation purposes;
f. The statute of limitations applicable to the debt; and
g. Any other circumstances that would indicate an intent to abandon the debt.

(3) Upon the Court’s declaration that all of the mortgage debt securing a subordinate mortgage is abandoned, the Court may order the loan owner, its agents, or their predecessors to:

a. cease all collection activity on the abandoned debt;
b. terminate all transfers or sales of the abandoned debt;
c. record a release of all liens securing the abandoned debt;
d. request that the tradelines for the abandoned loan be deleted from the borrower’s credit reporting file with any credit reporting agency to which the loan owner, its agents, or their predecessors previously reported the debt.

(4) Upon the Court’s declaration that a portion of the mortgage debt securing a subordinate mortgage is abandoned, the Court may order the loan owner, its agents, or their predecessors to:

a. remove all amounts declared abandoned from the amounts due on the loan;
b. provide the borrower an updated periodic statement and payoff statement with the abandoned portion of the debt removed;
c. cease all collection activity on the abandoned portion of the debt;
d. request that the tradelines for the abandoned loan be deleted from the borrower’s credit reporting file with any credit reporting agency to which the loan owner, its agents, or their predecessors previously reported the debt.

(5) Any loan owner, its agents, or their predecessors who attempts to collect or collects an abandoned subordinate mortgage debt from a person, including attempting to foreclose or foreclosing on any portion of such a debt, is liable to such person in an amount equal to the sum of:

a. any actual damage sustained by such person as a result of such conduct;
b. punitive damages as the court may allow in the case of a willful failure to comply with any requirement imposed under this chapter; and
c. in the case of any successful action to enforce the foregoing liability, the costs of the action, together with a reasonable attorney's fee as determined by the court.
d. (6) Per Se Unfair Trade Practice: It is an unfair and deceptive practice to conduct or threaten to conduct a foreclosure on a subordinate mortgage where all or part of the debt being enforced has been abandoned

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State Legislation Addressing Zombie Second Mortgages

Virginia’s 2024 subordinate mortgage legislation: an example of a new zombie second mortgage statute

In April 2024, the Governor of Virginia signed into law Va. H.B. 184, *An Act to amend and reenact § 55.1-321 of the Code of Virginia, relating to foreclosure procedures; subordinate mortgage; affidavit required.*

Virginia is a non-judicial foreclosure state. The new law requires, as a precondition to a foreclosure sale of a subordinate mortgage, that the lienholder must provide to the trustee an affidavit affirming whether monthly statements were sent to the borrower and, absent an exemption, for each billing cycle that they were not sent, the lienholder cannot collect interest, fees, or other charges. A borrower who believes certain amounts have been added that should not have been can petition the court for a waiver of such amounts. If successful, the borrower will be awarded attorneys' fees and costs.

The new law does not apply to subordinate lienholders who are either (a) the original creditor, (b) a mortgage servicer acting on behalf of the original creditor, (c) a national or state-chartered bank, or (d) a federal or state-chartered credit union.

The law provides protections similar to those suggested by NCLC for borrowers who fail to receive periodic statements for an extended period of time on the subordinate loan. The NCLC suggested language provides greater consequences with certain limitations on the ability to foreclose instead of just limiting the amount the lienholder can collect. The NCLC suggestions also are applicable to the loan owner, its agents, or their predecessors, so would include the entities exempted in the Virginia law.

Bill Text: Va. H.B. 184, An Act to amend and reenact § 55.1-321 of the Code of Virginia, relating to foreclosure procedures; subordinate mortgage; affidavit required.

If the proposed sale is initiated due to a default in payment under a security instrument that (i) was, at the time it was recorded, subordinate to another security interest encumbering the same real property and (ii) has not subsequently been elevated to a first priority lien by a recorded voluntary subordination agreement, such subordinate mortgage lienholder shall submit to the trustee an affidavit affirming whether monthly statements were sent to the property owner for each period that any interest, fees, or other charges were assessed. No such interest, fees, or other charges shall be assessed or charged for any period during which periodic statements were not sent unless the subordinate mortgage lienholder identifies a specific exemption pursuant to applicable law for which such subordinate mortgage lienholder was not required to send such specific statements for any period of time enumerated in the affidavit. Such affidavit shall also include an itemized list of the current amount owed, including any periods in which interest, fees, and other charges were waived because no monthly statements were sent during such period. The subordinate mortgage lienholder shall provide a copy of such affidavit to the person required to pay the instrument with written notice that a request for sale shall be made of the trustee upon the expiration of 60 days from the day of mailing such notice. Such notice shall be sent by certified mail, return receipt requested, to the last known mailing address of such person required to pay the instrument. Such notice shall advise the person required to pay the instrument that if such person believes that such interest, fees, or other charges have been assessed in error, such person may, prior to the sale, petition the circuit court of the city or county where such property or some part thereof lies for an accounting and order declaring the proper balance secured by the subordinate mortgage. If the court determines that charges were assessed in error, such person shall be entitled to recover attorney fees and costs against the subordinate mortgage lienholder. The provisions of this subsection shall not apply to subordinate lienholders who are either (a) the original creditor, (b) a mortgage servicer acting on behalf of the original creditor, (c) a national or state-chartered bank, or (d) a federal or state-chartered credit union.

A2. Any purchaser at a foreclosure sale shall provide certification that such purchaser shall pay off any priority security instruments no later than 90 days from the date that the trustee's deed conveying the property pursuant to such sale is recorded in the land records. The person originally required to pay the instrument shall have the right to petition the circuit court of the city

or county where the property or some part thereof lies to recover from the purchaser any payments toward such priority lien amounts made by such person required to pay the instrument after the date of the foreclosure sale, plus any attorney fees and costs.

Ohio's 2022 subordinate mortgage legislation: an example of a new zombie second mortgage statute

The Ohio second mortgage bill, H.B. 272, requires creditors to send a written notice to a debtor at least 30 days before filing a foreclosure action on a debt secured by residential real property, provided the debt is not a first mortgage and is in default or accelerated. The notice must include key information such as the debt amount, the creditor's contact details, the debtor's right to legal counsel, and potential bankruptcy relief options. If a creditor fails to send the notice due to an unintentional error, they may avoid civil liability if they promptly correct the mistake and make restitution to the debtor. Failure to meet these conditions gives the debtor the right to seek damages, but class actions are not permitted.

Bill Text: H.B. 272, Ohio Revised Code, Section 1349.78: Written notice to debtor.

Effective: July 6, 2022

(A) Not less than thirty days prior to a person filing a foreclosure action to collect on a debt secured by residential real property, the person shall first send a written notice as described in division (B) of this section via United States mail to the residential address of the debtor, if both of the following apply:

(1) The debt is secured by a mortgage lien on the debtor's residential real property that is not in the first mortgage position.

(2) The debt has either been accelerated or is in default in accordance with the terms set forth in the promissory note.

(B) The written notice may be included on, or accompany, any other communication, and shall be printed in at least twelve-point type and include the following:

(1) The name and contact information of the person collecting the debt;

(2) A statement of the amount of the debt;

(3) A statement that the debtor has a right to engage an attorney;

(4) A statement that the debtor may qualify for debt relief under Chapter 7 or 13 of the United States

Bankruptcy Code, 11 U.S.C. Chapter 7 or 13, as amended;

(5) A statement that a debtor that qualifies under Chapter 13 of the United States Bankruptcy Code may be able to protect their residential real property from foreclosure.

(C) Upon written request of the debtor, the owner of the debt shall provide a copy of the note and the loan history to the debtor.

(D)(1) As used in this division:

(a) "Bona fide error" means an unintentional clerical, calculation, computer malfunction or programming, or printing error.

(b) "Restitution" means either of the following:

(i) A waiver of all fees, costs, or expenses proximately associated with the failure to provide the notice to the debtor; or

(ii) Actual damages.

(2) Any owner of debt subject to divisions (A), (B), and (C) of this section shall not be held civilly liable in any action, if all of the following are met:

(a) The owner of the debt shows by a preponderance of evidence that the compliance failure was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid any such error.

(b) Within sixty days after discovering the error, and prior to the initiation of any action, the owner of the debt notifies the debtor of the error and the manner in which the owner of the debt intends to make full restitution to the debtor.

(c) The owner of the debt promptly makes reasonable restitution to the debtor.

(3) If, in the event of a compliance failure, the owner of the debt does not meet the conditions set forth in division (D)(2) of this section, a debtor injured by the error has a cause of action to recover damages. Such an action shall not, however, be maintained as a class action

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