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No One Saw It Coming—*Again*

Systemic Risk and State Foreclosure Proceedings: Why a National Uniform Foreclosure Law Is Necessary

HELEN MASON*

I. INTRODUCTION

In the months preceding the financial collapse in 2008, most individuals in this country were oblivious to the looming problem about to envelop the country. How did the default of a few sub-prime loans mushroom into one of the most severe financial crises to ever face the nation? Answers may be found in dozens of post-collapse books, and, while opinions may differ as to the primary cause, most will maintain

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that several developments played a role with inadequate risk management being a major factor. In the Treasury Department's proposal to Congress for regulatory reform, the problem was summed up simply as: "*No regulator saw its job as protecting the economy and financial system as a whole.*"[1] Subsequently, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or "the Act") was enacted with the intent to fill the gaps and create coordinated regulatory oversight to avert risks before the broader economy became endangered.[2] Nevertheless, there is a growing risk, for which there is no coordinated regulatory oversight that could damage the nation's economic well-being. That risk is a mature foreclosure crisis that continues to escalate. New problems are appearing, and there is no risk management for the nation's highly fragmented foreclosure system. The foreclosure system of each state can be affected by individual actions taken by the countless state, county, municipal, and judicial officers. No two states in the country have the same foreclosure laws, which, in some instances, date back to the seventeenth century.

There are a growing number of situations where the isolated action of an individual officer, such as a local judge, causes significant delays in the completion of foreclosures. But, delays are just one problem. There are instances where such action affects substantive rights in collateral, which, in turn, trigger bandwagon responses. It is estimated that, at the current rate, it will take over sixty years to complete the now-pending foreclosure actions in the state of New York (the delays likely triggered by a single judge from Long Island).[3] In addition to the current foreclosures, economists estimate that in the next several years there may be another seven million homes that will face foreclosure.[4] The slowdown in the foreclosure process due to legal and political wrangling is causing an increase in the actual number of homeowners who decide to strategically default and walk away from their homes.[5]

As of June 2011, the total residential mortgage debt in the U.S. was

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1. U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 2 (2009) [hereinafter U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM] (emphasis added), *available at* http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.

2. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code).

3. David Streitfeld, *Backlog of Cases Gives a Reprieve on Foreclosures*, N.Y. TIMES, June 19, 2011, http://www.nytimes.com/2011/06/19/business/19foreclosure.html?pagewanted=1 [hereinafter Streifeld, *Backlog*].

4. Laurie S. Goodman, *Dimensioning the Housing Crisis*, FIN. ANALYSTS J., May/June 2010, at 26, 26 *available at* http://www.cfapubs.org/doi/pdfplus/10.2469/faj.v66.n3.6.

5. *See* Satyajit Chatterjee & Burcu Eyigungor, *A Quantitative Analysis of the U.S. Housing and Mortgage Markets and the Foreclosure Crisis* 2–3 (Fed. Reserve Bank of Phila., Working Paper No. 11-26, 2011), *available at* http://www.philadelphiafed.org/research-and-data/publications/working-papers/2011/wp11-26.pdf; Shuang Zhu & R. Kelley Pace, *The Influence of*

$10.3 trillion.[6] Of that amount, $5.1 trillion is insured or guaranteed by a government-sponsored enterprise or federal agency.[7] The United States Federal Reserve currently holds approximately $1.1 trillion of the agency's mortgage-backed securities ("MBSs"),[8] which were purchased as part of the financial crisis rescue. The Federal Reserve Bank of New York also owns $26 billion in private-label MBSs in its Maiden Lane special purpose entities as part of the American International Group ("AIG") bailout.[9] The dominant role assumed by the federal government in the mortgage financing market has exposed the American taxpayer to the real potential of massive monetary losses.[10] Thus, the protection of the overwhelming federal interest in the collateral associated with these obligations is of vital importance.

The federal government has many intertwined roles in the current crisis: the regulator of virtually every participant in U.S. financial markets, receiver of failed financial institutions,[11] guarantor of most home mortgages,[12] creditor of financial institutions,[13] and owner of securities backed by home mortgages.[14] These responsibilities arose as a consequence of the sovereign functions of the federal government.[15] The

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Foreclosure Delays on Borrower's Default Behavior 3 (Apr. 19, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1717127.

6. *Mortgage Debt Outstanding*, BOARD OF GOVERNORS OF THE FED. RES. SYS. (June 22, 2012), http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm.

7. *Id.*

8. *Id.*

9. CONG. OVERSIGHT PANEL, MARCH OVERSIGHT REPORT: THE FINAL REPORT OF THE CONGRESSIONAL OVERSIGHT PANEL 17 n.51 (2011) [hereinafter CONG. OVERSIGHT PANEL, FINAL REPORT], *available at* http://www.gpo.gov/fdsys/pkg/CHRG-112shrg64832/pdf/CHRG-112shrg64832.pdf; *see also American International Group (AIG), Maiden Lane II and III*, BOARD OF GOVERNORS OF THE FED. RES. SYS. (Apr. 16, 2012), http://www.federalreserve.gov/newsevents/reform_aig.htm.

10. *See, e.g.*, MARK JICKLING, CONG. RESEARCH SERV., RS22950, FANNIE MAE AND FREDDIE MAC IN CONSERVATORSHIP 1 (2008) (no words were minced in explaining the consequence of conservatorship: "the U.S. taxpayer now stands behind about $5 trillion of GSE debt"), *available at* http://fpc.state.gov/ documents/organization/110097.pdf.

11. *See, e.g.*, *Problems in Mortgage Servicing From Modification to Foreclosure: Hearing on Examining Problems in Mortgage Servicing from Modification to Foreclosure and the Impact These Problems Have Had on U.S. Homeowners and the Housing Market During the Economic Downturn Before the S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. 284 (2010) (statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation), *available at* http://www.fdic.gov/news/news/speeches/chairman/spdec0110.html; CONG. OVERSIGHT PANEL, FINAL REPORT, *supra* note 9, at 12–18.

12. *See* LENDER PROCESSING SERVS., LPS MORTGAGE MONITOR: OCTOBER 2011MORTGAGE PEROFROMANCE OPERATIONS 5 (2011), *available at* http://www.lpsvcs.com/LPSCorporateInformation/CommunicationCenter/DataReports/MortgageMonitor/201109MortgageMonitor/LPSMortgageMonitorSeptember2011.pdf (over 75% of all active loans are backed by the government).

13. *See, e.g.*, CONG. OVERSIGHT PANEL, FINAL REPORT, *supra* note 9, at 15–25.

14. *Id.*

15. *See* Lebron v. Nat'l R.R. Passenger Corp., 513 U.S. 374, 400 (1995) ("We hold that

inability to help homeowners or curtail the foreclosure crisis, despite the expenditure of hundreds of billions in federal dollars, is due, in part, to the disparate regulation of the foreclosure process by each state. Furthermore, coordinated regulation of mortgage financing, servicing, default, and foreclosure is required to effectively protect consumers and enhance the competitiveness and stability of U.S. financial markets. Collectively, the increasing intervention by state actors in the foreclosure process may pose a serious risk to the nation's economy as a whole. The country does not want to look back and say again: "*No regulator saw its job as protecting the economy and financial system as a whole.*"[16]

Because of the need to protect these vital federal interests, this article urges Congress to enact legislation adopting a national, uniform, and non-judicial foreclosure process for all federally related mortgages.[17] The Act should explicitly preempt state foreclosure law and be applied retroactively to any federally related mortgage. I will address several reasons why a federal uniform foreclosure law is needed as well as the constitutional basis for the preemption of state law and retroactive application of the new federal law. This article proposes the general structure of the new federal law and offers suggestions for the disposition of foreclosed housing inventory.

II. THE FINANCIAL CRISIS OF 2008 HAD ITS ORIGINS IN THE HOUSING MARKET

"[D]ecades ago, Congressional charters set up Fannie Mae [Federal National Mortgage Association] and Freddie Mac [Federal Home Loan Mortgage Corporation] as government-sponsored enterprises (GSEs)—privately owned financial institutions established by the government to fulfill a public mission."[18] The two GSEs were created to provide stability to the secondary residential mortgage market and to promote access to mortgage credit and home ownership.[19] To accomplish these goals,

where, as here, the Government creates a corporation by special law, for the furtherance of governmental objectives, and retains for itself permanent authority to appoint a majority of the directors of that corporation, the corporation is part of the Government for purposes of the First Amendment.").

16. U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM, *supra* note 1, at 4 (emphasis added).

17. *See* 12 U.S.C. § 2602(1) (2006) (defining "federally related mortgage loan"); 12 C.F.R. § 590.2 (2012) (defining "Federally-related loans"); 24 C.F.R. § 3500.2 (2012) (defining "Federally related mortgage loan").

18. CONG. BUDGET OFFICE, PUB. NO. 4021, FANNIE MAE, FREDDIE MAC, AND THE FEDERAL ROLE IN THE SECONDARY MORTGAGE MARKET viii (2010) [hereinafter CONG. BUDGET OFFICE, FEDERAL ROLE], *available at* http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/120xx/doc12032/12-23-fanniefreddie.pdf.

19. *Id.*

GSEs engage in two lines of business. The first is a credit guarantee business, whereby Freddie and Fannie guarantee the timely payment of principal and interest on MBSs.[20] In the second line, Fannie and Freddie manage retained portfolios containing mortgages and MBSs (each other's and those issued by private companies).[21] Funding for portfolio holdings is provided by issuance of debt obligations which are, in turn, sold to investors.[22]

U.S. house prices began to rise above historical values in the late 1990s.[23] Analysts attribute the rapid growth in the demand for homes and the associated rise in housing prices to unusually low interest rates, large capital inflows, rapid income growth, and innovations in the mortgage market.[24] In 1999, Congress repealed the Glass-Steagall Act, which resulted in significant deregulation of the Wall Street financial services industry.[25] Around that time, the GSE's credit guarantees provided mortgages borrowers with more credit availability and lower interest rates.[26] There was a rapid rise in nonprime loans that originating lenders sold into the secondary market.[27] As a result, the home-lending industry changed from an originate-to-own to an originate-to-sell business model.[28] Mortgage originators obtained mortgage guarantees from GSEs or other private insurers and started selling them to third parties. Lenders were incentivized to sell the mortgages because they could make a quick profit, refinance existing or purchase new mortgages, and distribute the risk of default to others.[29]

Until 2008, the GSEs' debt securities and MBSs were not officially backed by the federal government.[30] Nevertheless, most investors believed that the government would not allow Fannie and Freddie to

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20. *Id.* at 2.

21. *Id.*

22. *Id.*

23. *See* CARL LEVIN & TOM COBURN, S. PERMANENT SUBCOMM. ON INVESTIGATIONS, WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 7, 41, 65–66 (2011), *available at* http://hsgac. senate.gov/ public/_files/Financial_Crisis/FinancialCrisisReport.pdf.

24. *Id.* at 41.

25. *See id.* at 15–16. The Gramm–Leach–Bliley Act of 1999 repealed provisions of the Glass–Steagall Act of 1933, which had generally required banks, investment banks, securities firms, and insurance companies to operate separately, and instead allowed them to openly merge operations. *Id.* It also eliminated the Glass-Steagall prohibition on banks engaging in proprietary trading and exempted investment bank holding companies from direct federal regulation. *Id.* Some have said the repeal created conflict of interest within the financial industry and fostered "too big to fail" by allowing banks to become too large, complex, and intertwined which led to the financial crisis. *Id.* at 16.

26. *See* CONG. BUDGET OFFICE, FEDERAL ROLE, *supra* note 18, at viii.

27. *See* LEVIN & COBURN, *supra* note 23, at 18–19.

28. *See id.* at 17–21 (explaining lenders' advantages in selling loans).

29. *See id.* at 20–21.

30. *See* CONG. BUDGET OFFICE, FEDERAL ROLE, *supra* note 18, at viii.

default on their obligations.[31] That perception of an implicit federal guarantee stemmed from the specific benefits, such as being exempt from corporate income taxes and having a line of credit with the Treasury, which the two entities received because of their status as GSEs.[32] When homeowners began to default en masse, securitized debt instruments were negatively impacted.[33] The ratings agencies downgraded MBSs, and the market for these debt instruments collapsed.[34]

In September 2008, a growing threat to the solvency of the GSEs was creating uncertainty in the broader financial markets.[35] In response, the federal government created the Federal Housing Finance Agency ("FHFA"), which assumed control of the two GSEs by placing them in conservatorship.[36] "[T]he Treasury bought just over $220 billion of the two entities' MBSs" and provided an unlimited guarantee of their obligations through 2012.[37] In addition, the Federal Reserve supported Fannie and Freddie by purchasing $1.25 trillion of their portfolio MBSs and more than $175 billion of their debt.[38]] The aid and the explicit federal guarantee allowed Fannie and Freddie to continue operating even though many financial institutions in the private sector were failing or withdrawing from the market.[39] "Consequently, in 2009, the two GSEs owned or guaranteed roughly half of all outstanding mortgages in the United States (including a significant share of subprime mortgages), and they financed three-quarters of new mortgages originated that year."[40] Unfortunately, rather than winding down the GSEs operations, "more than 90 percent of new mortgages made in 2009 carried a federal guarantee."[41]

The 2010 Dodd-Frank Act was enacted in response to the crisis. Section 1491(a)(9) of the Act details the consequence of the takeover of the GSEs: "The conservatorship for Fannie Mae and Freddie Mac has potentially exposed taxpayers to upwards of $5,300,000,000,000 worth of risk."[42] With trillions of dollars at stake and with federal tax dollars

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31. *Id.* at 3.

32. *Id.*

33. Victoria V. Corder, *Homeowners and Bondholders as Unlikely Allies: Allocating the Costs of Securitization in Foreclosure*, BANKING & FIN. SERVS. POL'Y REP., May 2011, at 19, 21.

34. *Id.*

35. *See* CONG. BUDGET OFFICE, FEDERAL ROLE, *supra* note 18, at 1.

36. *Id.* at 3; JICKLING, *supra* note 10, at 1.

37. CONG. BUDGET OFFICE, FEDERAL ROLE, *supra* note 18, at 9–10.

38. *See* CONG. OVERSIGHT PANEL, FINAL REPORT, *supra* note 9, at 17–18.

39. CONG. BUDGET OFFICE, FEDERAL ROLE, *supra* note 18, at viii.

40. *Id.* at viii–ix.

41. *Id.* at ix.

42. Dodd-Frank Act, Pub. L. No. 111-203, § 1491(a)(9), 124 Stat. 1376, 2206 (2010). What is also troubling is that the taxpayer liability resulting from GSEs' guarantees is not included as part of the federal budget nor considered under federal debt ceiling limitations. *See* CONG. BUDGET

guaranteeing over 90% of all new mortgages being made, there is an overwhelming federal interest in a foreclosure process that protects that interest and minimizes systemic risk.

III. REDUCING UNCERTAINTY IN THE HOUSING MARKET

Several factors are hindering the housing recovery.[43] First, in June 2011, 10.9 million U.S. homes had a mortgage that was "underwater"—what the borrower owed exceeded the market value of the property—and some homeowners were deeply "underwater."[44] By some estimates, there were 2.4 million borrowers at "near-negative equity"—defined as borrowers having less than five percent equity in the homes; "[t]ogether, negative equity and near-negative equity mortgages accounted for 27.5 percent of all residential properties with a mortgage nationwide."[45] Second, millions of houses are in foreclosure, and a number of obstacles have delayed their resolution.[46] Third, many financial institutions have tightened lending standards that precludes the refinancing of existing mortgages.[47] The loan losses and increased uncertainty that accompanied the housing collapse also slowed the economy.[48] Unemployment rates rose to 10.2% and still remain at over 8%.[49] The numerous programs implemented to avoid foreclosures have produced neither stabilized home prices nor relief for troubled homeowners; the pressure exerted by oversupply cannot be overcome. The buildup of distressed supply has only grown over time. Lenders who are willing to underwrite

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OFFICE, PUB. NO. 4023, CBO'S BUDGETARY TREATMENT OF FANNIE MAE AND FREDDIE MAC 3 (2010) [hereinafter CONG. BUDGET OFFICE, BUDGETARY TREATMENT], *available at* http://www.cbo.gov/sites/default/files /cbofiles/ftpdocs/108xx/doc10878/01-13-fanniefreddie.pdf.

43. For a comprehensive analysis of the housing market, see generally JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., THE STATE OF THE NATION'S HOUSING 2011 (2011), *available at* http://www.jchs. harvard.edu/sites/jchs.harvard.edu/files/son2011.pdf. *See also generally* A. Gary Shilling, *Still Home Sick*, INSIGHT, May 2011 (discussing housing and identifying excess inventories as the primary culprit contributing to housing weakness).

44. Press Release, CoreLogic, New CoreLogic Data Reveals Q2 Negative Equity Declines in Hardest Hit Markets and 8 Million Negative Equity Borrowers Have Above Market Rates (Sept. 13, 2011), *available at* http://www.corelogic.com/about-us/news/asset_upload_file75_12141.pdf.

45. *Id.*

46. *See* JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *supra* note 43, at 4.

47. *See* Danielle DiMartino Booth & David Luttrell, *The Fallacy of a Pain-Free Path to a Healthy Housing Market*, ECON. LETTER: INSIGHTS FROM THE FED. RES. BANK DALL., Dec. 2010, at 1, 2 *available at* http://www.dallasfed.org/assets/documents/research/eclett/2010/el1014.pdf.

48. *See generally* John V. Duca, John Muellbauer & Anthony Murphy, *Housing Markets and the Financial Crisis of 2007-2009: Lessons for the Future*, 6 J. FIN. STABILITY 203 (2010), *available at* http://www. sciencedirect.com/science/article/pii/ S1572308910000343 (follow "PDF (771 K)" hyperlink).

49. *See* Press Release, Nat'l Conference of State Legislatures, Nat'l Unemployment Update: Unemployment Drops to 8.1 Percent in August 2012 (Sept. 7, 2012), *aivailable at* http://www.ncsl.org/ issues-research/labor/national-employment-monthly-update.aspx.

new mortgages are unable to determine the underlying value of the collateral.

Former Federal Reserve Chairman, Alan Greenspan, provided an analysis as to why the U.S. recovery after the 2008 crisis has been so weak.[50] He discussed the role of "uncertainty" and how it has created an aversion to fixed or long-term investing, such as housing, which has hampered economic recovery.[51] He described how government intervention to support housing prices has delayed the liquidation required to restore balance to the market.[52] Further, he explained that for speculators to be effective in stabilizing markets, they have to believe that they are able to judge oversold markets.[53] Greenspan also note that "unpredictable . . . government intervention[s]" thwart speculative activity that would "add support to a market when it is weakest" and buying is riskiest.[54] He explained that the "mere uncertainty" of possible intervention causes speculators to remain on the "sidelines."[55]

Many foreclosures are warranted and need to occur to clear the market of economic inefficiencies. Most programs initiated to prevent foreclosures seem to ignore the difference between home affordability and loss of homeownership equity. The government strategies are designed, in part, to support home prices.[56] However, without price-supports provided through federal programs, there would be market correction and lower home prices, thereby creating a large inventory of affordable homes available to rent or purchase.[57] Market corrections are painful; but loss of equity, in and of itself, should not be the single subject debated by policymakers.[58] All costs and benefits need to be consid-

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50. *See* Alan Greenspan, Commentary, *Activism*, 14 INT'L FIN. 165 (2011), *available at* http:// onlinelibrary. wiley.com/doi/10.1111/j.1468-2362.2011.01277.x/pdf (analyzing the housing market's slow recovery).

51. *See generally id.*

52. *See id.* at178.

53. *See id.* at 179.

54. *Id.*

55. *Id.*

56. *See* EDWARD VINCENT MURPHY, CONG. RESEARCH SERV., RL 34653, ECONOMIC ANALYSIS OF A MORTGAGE FORECLOSURE MORATORIUM 13 (2008), [hereinafter MURPHY, ECONOMIC ANALYSIS], *available at* http://fpc.state.gov/documents/organization/110095.pdf.

57. *See, e.g.*, David Streitfeld, *Ruins of an American Dream*, N.Y. TIMES, Aug. 24, 2008, at BU1 (describing a family that abandoned a house and $3,400 monthly mortgage payment to foreclosure and began renting a brand new house two miles away for $1,200 per month).

58. *See, e.g.*, Rachel D. Godsil & David V. Simunovich, *Protecting Status: The Mortgage Crisis, Eminent Domain, and the Ethic of Homeownership*, 77 FORDHAM L. REV. 949, 985 (2008) ("The mortgage crisis has not generally been viewed as likely to lead to a rash of homelessness—rather, it has raised the specter of people losing homes they purchased. In other words, most who are concerned about the mortgage foreclosure debacle recognizes that homeowner status is at issue.").

ered in the mix of strategy.[59]

For example, a recent economic study found "fairly surprising" results as to what happens to households after they experience a foreclosure.[60] Contrary to concerns urged by policy makers, the results indicated that housing consumption does not decrease. The study found that most post-foreclosure households will maintain their sizes and compositions, live in single-family structures of similar size and quality, and relocate in neighborhoods with characteristics very similar to their old neighborhoods.[61] "No perfect solution to the housing crisis exists."[62] The continuing price declines will undoubtedly cause more economic disruption. Despite years of intervention through numerous programs, uncertainty in the housing market is still prevalent and continues to hamper economic recovery. Given that time has not proven beneficial in any material way in stabilizing housing prices, allowing the market to clear may now be the better policy choice.

IV. Impact of State Foreclosure Law on the Return of Private Capital to the Market

Dodd-Frank was enacted in the wake of the crisis to enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets.[63] The Act was the "largest single legislative overhaul of the financial services industry since the 1930s."[64] One key objective of the Act was to provide the tools needed to adapt to changes in the financial market and to effectively manage financial crises.[65] The Act has provisions that regulate how loans are obtained, maintained, securitized, and

59. *See, e.g.*, Kristen David Adams, *Homeownership: American Dream or Illusion of Empowerment?*, 60 S.C. L. Rev. 573, 596 (2009) ("[H]omeownership sometimes brings dependence and loss of wealth rather than the expected independence and increased wealth.").

60. Raven Molloy & Hui Shan, *The Post-Foreclosure Experience of U.S. Households* 24–25 (Fin. & Econ. Discussion Series, Working Paper No. 2011-32, 2011), *available at* http://www.federalreserve.gov/Pubs/ FEDS/2011/201132/201132pap.pdf.

61. *Id.* at 25. *But see* Katie Jones, Cong. Research Serv., R40210, Preserving Homeownership: Foreclosure Prevention Initiatives 3 (2009), *available at* http://www.policyarchive.org/handle/ 10207/bitstreams/19135.pdf (speculating that families would end up in substantially less desirable neighborhoods or more crowded living conditions or be forced to move in with others).

62. Booth & Luttrell, *supra* note 47, at 3.

63. *See* Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code); U.S. Dep't of the Treasury, Financial Regulatory Reform, *supra* note 1, at 2.

64. Eric M. Hurwitz, *Litigation Risk for the Residential Mortgage Industry in the Wake of the Dodd-Frank Act*, 27 The Review of Banking & Financial Services 1 (2011), http://www.stradley.com/library/files/hurwitz_authored_1_2011.pdf.

65. *See* Dodd-Frank Act, 124 Stat. at 1376; U.S. Dep't of the Treasury, Financial Regulatory Reform, *supra* note 1, at 2–4.

leveraged.[66] Yet, despite its 2,300 pages, it fails to regulate and standardize how home ownership is foreclosed. The hodgepodge approach to states' lender remedies is currently impeding the Obama Administration's ability to "effectively manage" its programs to mitigate the ongoing foreclosure crisis. The antiquated patchwork of state-specific foreclosure state laws can, and does, directly impact the motivation of borrowers and lenders to either cooperate or not cooperate with efforts to avoid foreclosure.

In February 2011, the Obama Administration released a report, *Reforming America's Housing Finance Market*, that outlines options for the future of housing finance.[67] The goal is to "help restore trust in the underlying foundation of the mortgage market so borrowers, lenders, and investors have the confidence to purchase a home, issue a loan, or make an investment."[68] The report recognizes the key role of the securitization market in housing finance, but it concedes that private capital has largely exited the market and has not yet returned, leaving federally-related entities "to insure or guarantee more than nine out of every ten new mortgages."[69] While the Obama Administration's focus is on financing, its plan also proposes that the flaws in the "nation's broken system of mortgage servicing and foreclosure processing" should be addressed.[70] This note suggests that one such flaw is the nation's fragmented foreclosure system operating under a set of non-uniform laws.

While the Uniform Commercial Code modernized the laws for security interests in personal property, mortgage law affecting interests in real property has never been so thoroughly overhauled. Mortgage laws differ greatly among the states because each has attempted "to remedy deficiencies in"... the "English law inherited by the American colonies."[71] The current foreclosure crisis proves that the uncertainty created by the lack of standardized servicing and foreclosure laws has caused a

66. *See, e.g.*, Dodd-Frank Act tit. VII §§ 711–754 (containing provisions to regulate portfolio margining and derivatives); *id.* tit. IX, subtit. D, (titled "Improvements to the Asset-Backed Securitization Process" and containing provisions for risk retention, disclosure, and due diligence); *id.* tit. XIV (titled "Mortgage Reform and Anti-Predatory Lending Act" and containing prohibitions on loan steering, limitations on originator compensation, and standards as to a borrower's ability to repay a loan); *id.* tit. XIV, subtit. E (titled "Mortgage Servicing" and containing provisions to regulate interest changes, notice, billing, and escrow for taxes and insurance).

67. U.S. Dep't of the Treasury & U.S. Dep't of Hous. & Urban Dev., Reforming America's Housing Finance Market: A Report to Congress 1–2 (2011), *available at* http://portal.hud.gov/hudportal/documents/huddoc?id=housingfinmarketreform.pdf.

68. *Id.* at 2.

69. *Id.* at 12.

70. *Id.* at 2.

71. U.S. Department of Housing and Urban Development, Providing Alternatives to Mortgage Foreclosure: A Report to Congress 108 (March 1996).

significant problem for the market. As the crisis continues to unfold, state and local lawmakers and community activists increasingly demanded some type of action. The various responses across the nation created a shifting environment with countless regulators at the state, county, and judicial level imposing their individual "fixes." Such a system does not promote stability; it precludes effective management of the current (or a future) financial crisis and will thwart the return of private capital to the mortgage market.

There have been numerous attempts during the past century to achieve greater uniformity in foreclosure law.[72] "The basic argument for a uniform approach . . . has existed for a long time . . . . Money for real estate projects comes from national and international sources unrelated to the location of the project. Lenders who supply this money are more likely to lend it if they can readily predict the performance of their investment."[73] For mortgage insurers, guarantee agencies, and servicers to participate in the secondary market, there must be "predictability of title," economic efficiency, "fairness," and "avoidance of misunderstandings."[74] The current state foreclosure system does not meet these needs. This is because, over the years, each state has developed its own unique procedures, right of redemption, and right to a deficiency judgment.[75] In fact, the "[c]haracterization of a mortgage as either a conveyance of a lien or conveyance of legal title . . ." or "Deed of Trust" has long "been a source of confusion."[76] Any deviation from a state's articulated procedures, especially with respect to due process, may threaten or even invalidate the foreclosure sale.

At lease seventeen states require that mortgages be foreclosed only by a judicial action.[77] A judicial foreclosure involves a lengthy series of steps: "filing of a foreclosure complaint and lis pendens notice; service of process on all" interested parties; "a hearing"; "the decree or judgment; the notice of sale; a public foreclosure sale, usually conducted by a sheriff" or other public official; "post-sale adjudication as to the disposition of the foreclosure proceeds; and, if appropriate, the entry of a

72. *See, e.g.*, Grant S. Nelson & Dale A. Whitman, *Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act*, 53 DUKE L.J. 1399, 1407–15 (2004).

73. Patrick A. Randolph, Jr., Symposium Article: *The Future Of American Real Estate Law: Uniform Foreclosure Laws And Uniform Land Security Interest Act*, 20 NOVA L. REV. 1109, 1110–1111 (1996).

74. *Id.* at 1111.

75. Nelson & Whitman, *supra* note 72, at 1403–06.

76. Frank S. Alexander, *Federal Intervention In Real Estate Finance: Preemption And Federal Common Law* 71 N.C.L. REV. 293, 301-303 (1993).

77. Dan Immergluck et al., Legislative Responses to the Foreclosure Crisis in Nonjudicial States 4 & n.6 (Jan. 27, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1749609.

deficiency judgment. In some cases, an appeal may follow."[78] Judicial foreclosure is often a long and costly process. The remaining thirty-three states and the District of Columbia utilize a non-judicial process that tends to be shorter in duration, substantially less complicated, and less costly than its judicial counterpart.[79] "After varying degrees of notice, the mortgaged property is sold at a public sale by a disinterested third party, such as a sheriff or a trustee or by the mortgagee."[80]

After completion of the foreclosure sale, twenty-two states provide a "statutory redemption" period during which the mortgagor-debtor and, in many instances, junior lien holders can "regain title after the foreclosure sale by paying the foreclosure purchaser the sale price plus accrued interest and other expenses."[81] This period can be as long as a year and may be available in both judicial and non-judicial foreclosure.[82] For a homeowner, probably the most important disparity in foreclosure laws among states is the personal liability of the borrower and post-foreclosure deficiency judgments. In many states, a lender may foreclose on the home first and then pursue a deficiency judgment, which is usually the difference between the foreclosure sale price and the mortgage debt.[83] Foreclosed homes seldom fetch enough to cover the outstanding loan amount. This is because buyers may have financed up to 100% of the value of the property during the housing boom and because today's foreclosures take place following a four-year decline in home values. In some states, this decline exceeds 50%.[84]

A few states prohibit any personal liability on purchase-money mortgage obligations.[85] In that setting, the mortgage obligation is simply non-recourse as a matter of law.[86] Twenty-one states use "fair market value" legislation to limit the deficiency to the difference between the mortgage debt and the fair value of the foreclosed real estate, rather than

78. Grant S. Nelson, *Confronting the Mortgage Meltdown: A Brief for the Federalization of State Mortgage Law*, 37 PEPP. L. REV. 583, 588 (2010) (footnote omitted).

79. *Id.* at 3–4.

80. See Nelson, *supra* note 78, at 588–89.

81. *See* Nelson & Whitman, *supra* note 72, at 1404 & n.21.

82. *See id.* at 1403–04. *See also, e.g.*, CAL. CIV. PROC. § 729.030 (West 2012) (nonjudicial foreclosure; three-month to one-year period of post-foreclosure redemption); IOWA CODE § 628.3 (2012) (judicial foreclosure; one-year period).

83. *See* JOHN RAO & GEOFF WALSH, FORECLOSING A DREAM: STATE LAWS DEPRIVE HOMEOWNERS OF BASIC PROTECTIONS 3–4, 38–40 (2009), *available at* http://www.nclc.org/images/pdf/pr-reports/report-foreclosing-dream.pdf.

84. *See* Press Release, CoreLogic, July Home Price Index Rises 3.8 Percent Year-Over-Year—Biggest Increase Since 2006 (September 4, 2012), http://www.corelogic.com/about-us/researchtrends/asset_upload_file841_16445.pdf.

85. *See id.* at 5, 38–40.

86. *See id.*

the difference between the debt and the foreclosure sale price.[87] The findings of a recent study substantiate that the disparity in laws among the states creates non-competitive and unfair markets for consumers. Researchers found that consumers in non-recourse states were approximately 30% more likely to default.[88] Furthermore, for homes appraised at $500,000 to $750,000, borrowers are more than *twice* as likely to default in non-recourse states.[89] Borrowers faced with a deficiency judgment may find themselves at the mercy of a lender who may or may not consider negotiation or mitigation. Or worse, banks may sell their deficiency judgments to collection agencies that may relentlessly pursue a borrower to collect the amounts still owed after foreclosure until the statute of limitations runs (twenty years in Florida).[90] Collection agencies are seizing money from checking/savings accounts, garnishing wages, and seizing other assets owned by the borrower in order to satisfy the deficiency judgment, thereby prolonging the financial nightmare for these families.[91]

Over the years, Fannie and Freddie have required the use of dozens of note and mortgage forms designed to create some semblance of mortgage law uniformity.[92] Congress has also enacted legislation on a wide variety of substantive and procedural mortgage law issues. The state mortgage foreclosure system places substantial roadblocks and inefficiencies in the path of a satisfactory federal resolution of the mortgage crisis. Millions of home mortgages will have to be foreclosed in spite of mitigation attempts. Federal interests will be served by a uniform foreclosure process that is both efficient for the government and fair to borrowers.

Before there can ever be a significant return of private investment in the mortgage market, it will be crucial that the market's need for certainty in the foreclosure process be met. Historically, capital generated by sales of MBSs to investors has resulted in the increased availability and lower cost for the residential and commercial markets. Prior to the housing collapse, private label securitization accounted for about 50

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87. *Id.*

88. Andra C. Ghent & Marianna Kudlyak, *Recourse and Residential Mortgage Default: Evidence from U.S. States* 28 (Fed. Reserve Bank of Richmond, Working Paper No. 09-10R, 2011), *available at* http:// aux.zicklin.baruch.cuny.edu/ghent/research/RecourseandForeclosure.pdf.

89. *Id.* at 2.

90. *See* Doreen Hemlock, *Bank Can Go After Other Assets in Florida if You Default on Mortgage*, SUN SENTINEL (Jan. 10, 2011), http://articles.sun-sentinel.com/2011-01-10/business/fl-bank-mortgage-garnish -20110107_1_florida-banks-shari-olefson-collection-agency.

91. *See id.*

92. Julia Patterson Forrester, *Fannie Mae/Freddie Mac Uniform Mortgage Instruments: The Forgotten Benefit to Homeowners*, 72 MO. L. REV. 1077, 1083–87 (2007).

to 60% of mortgage securitizations.[93] Today, over 80% of mortgage securitization is done by the GSEs.[94] Foreign entities have often chosen the United States to conduct their securitizations because of the relative stability of the American economy and its legal and political system. In contrast, the laws of other countries suppress their MBSs market because of "the length of adjudication, the lack of trust law, [and] problems with possession and security interests."[95] For instance, in Brazil, applicable laws may prevent a lender from selling foreclosed land for up to seven years.[96] Many of these difficulties, traditionally thought to be problems of emerging economies, have now surfaced across the United States.[97]

The enormous capacity of land to generate capital and foster homeownership should not be lost. Risk, uncertainty, and costs can be minimized through the use of standardized procedures governed by uniform laws and regulations. The housing finance system is a "vital link to sustainable homeownership and rental options for millions of Americans, and it is central to our nation's economy."[98] The problems and complications that have emerged in the crisis have heightened the urgency for the changes that must occur in the regulation of finance and mortgage law. Failure to adopt federal, uniform foreclosure laws will undercut the integrity, efficiency, competitiveness, and stability of the U.S. financial markets—the very purpose of Dodd-Frank.

V. Federal Programs Based on Assumption that Delaying Foreclosure Helps Economy

As millions of borrowers fell into foreclosure in 2008, "policymakers were concerned about both the social and economic effects of mass foreclosures and the systemic risk to the banking system caused by nonperforming mortgages."[99] At that time, an extensive body of research indicated that a sharp rise in foreclosures would cause large drops in

93. Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 Wis. L. Rev. 565, 584 (2009)

94. *See* Sec. Indus. & Fin. Mkts. Ass'n, U.S. Mortgage-Related Securities Outstanding (Aug. 1, 2012), www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/SF-US-Mortgage-Related-SIFMA.xls.

95. *See* Erica W. Stump, *Securitizations in Latin America*, 8 U. Miami Bus. L. Rev. 195, 203–204 (2000) (describing Mexican law).

96. Georgette Chapman Poindexter & Wendy Vargas-Cartaya, En Ruta Hacia El Desarrollo: *The Emerging Secondary Mortgage Market in Latin American*, 34 Geo. Wash. Int'l L. Rev. 257, 262 (2002).

97. *See, e.g.*, discussion *infra* Part VIII.

98. U.S. Dep't of the Treasury & U.S. Dep't of Hous. and Urban Dev., *supra* note 67, at 31.

99. Cong. Oversight Panel, Final Report, *supra* note 9, at 68–69.

house prices, residential investment, and consumption of durable goods.[100] The underlying premise was that foreclosed homes have a spill-over effect, causing a decline in value of homes in the surrounding neighborhood.[101] It was thought that these effects would lead to a significant decline in overall economic activity.[102] Accordingly, if house prices were maintained through government support, it was thought that this outcome could be averted.[103] It was urged that foreclosure delays were necessary to maintain price stability and restore stability to the housing market.[104] The importance of the effect of foreclosures on real economic activity was a key factor in policy interventions that sought to reduce the number of foreclosures.[105]

However, the economic rationale for those policies has been undermined by the recent findings of two separate studies.[106] The Calomiris, Longhofer, and Miles study was designed to determine the *causal* relationships between prices and foreclosures on a macro-economic level (in other words: does the decrease in price cause the foreclosure or does the foreclosure cause the decrease in price?).[107] The research was significant because it was the first such macro-level study and its findings would be pertinent to the controversy between those who fear that accelerating foreclosures "will cause further distress for home prices," and those who fear "dragging out the liquidation process leads to prolonged large nega-

100. *See, e.g.*, Atif Mian & Amir Sufi, *Household Leverage and the Recession of 2007 to 2009* (Nat'l Bureau of Econ. Research, Working Paper No. 15896, 2010), *available at* http://www.nber.org/papers/ w15896.pdf (originally presented in 2009); *see also* Guido Lorenzoni, *Inefficient Credit Booms* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 13639, 2007), *available at* www.nber.org/papers/w13639. pdf.

101. *See* MURPHY, ECONOMIC ANALYSIS, *supra* note 56, at 7, 13.

102. Mian & Sufi, *supra* note 100, at 4, 20.

103. *See, e.g.*, MURPHY, ECONOMIC ANALYSIS, *supra* note 56, at 7, 13; *see also* Booth & Luttrell, *supra* note 47, at 1–3.

104. *See* EDWARD VINCENT. MURPHY, CONG. RESEARCH SERV., RS22943, H.R. 6076: HOME RETENTION AND ECONOMIC STABILIZATION ACT OF 2008 1–2 (2008), *available at* http://digital.library.unt.edu/ark:/ 67531/metacrs10787/m1/1/high_res_d/RS22943_2008Aug29.pdf.

105. *See generally* CONG. OVERSIGHT PANEL, FINAL REPORT, *supra* note 9, at 68–72 (citing interventions to reduce foreclosures such as the Emergency Economic Stabilization Act of 2008; the foreclosure moratoria in Maryland and Nevada; the Obama Administration's Home Affordability Modification Program of 2009; the Federal Reserve's purchases of Fannie Mae and Freddie Mac government-sponsored-entity bonds, which eased mortgage rates and supported home prices; and mortgage modification plans).

106. *See* Charles W. Calomiris, Stanley D. Longhofer & William Miles, The Foreclosure-House Price Nexus: A Panel VAR Model for U.S. States, 1981-2009, at 11 (March 1, 2012) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1160 062 (suggesting the correlation between foreclosures and prices is driven by strategic choices of homeowners and lenders); Chatterjee & Eyigungor, *supra* note 5, (explaining that delays in the foreclosure system cause a rise in the number of foreclosures).

107. Calomiris, Longhofer & Miles, *supra* note 106, at 2.

tive effects on [the economy]."[108] The key finding of the study was that the negative price effect of a foreclosure is small and transitory—which they note "stands in contrast to some of the popular wisdom about the connections between foreclosures and prices."[109] In fact, they found that the long-term impact of price declines on foreclosures "is 79 percent larger than the impact of foreclosures on prices."[110] The report concludes by suggesting that "[t]he decline in house prices between 2007 and 2009 was driven mainly by shocks originating elsewhere, and reflected in shocks to housing sales, which in turn likely reflect the steep recession's effect on housing demand."[111]

Similarly, the research of Chatterjee and Eyigungor sought to answer the question: "[I]f we prevented foreclosures, would house prices fall less?"[112] Like Calomiris, they found a small correlation between the rise in foreclosures and drop in house prices; but more importantly, they found that without any foreclosures, "the drop in house prices would still be 84% of the observed drop in house prices."[113] In addition, their findings go further to specify that "the factor most responsible for the drop in house prices is the disruption in the flow of credit to homebuyers."[114] They found that tight credit accounted for 71% of the drop in house prices between the second quarters of 2006 and 2009.[115]

The corroborating findings of the two economic studies clearly diminish the relevance of any spill-over effect of foreclosures on house prices and the economy. Consequently, the findings also refute any justification for government intervention intended to slow foreclosures with the hope of that stability in housing price would follow. The well-intended delays in the foreclosure process imposed by federal, state, and

108. *Id.* at 3 (citing Ali Anari et al., *Bank Asset Liquidation and the Propagation of the Great Depression*, 37 J. MONEY, CREDIT & BANKING 753 (2005)).

109. *Id.* at 26. The authors of this study examined the details of several studies that found negative effects of foreclosures on home prices. *See id.* at 4–8. "At the micro level, the general conclusion [wa]s that rising foreclosures do lower house prices, although different authors f[ou]nd varying magnitudes for that effect. *Id.* at 7. The authors identify the variables and limitations of each study, such as limited locations of sample set, multiple simultaneous influences, other differences in sample driving results, and the failure to distinguish a "distress" effect from a "supply" impact. *Id.* at 4–8. The authors noted one study that found "that the marginal impact of additional foreclosures *declines* as foreclosures increase." *Id.* at 5 (citing William H. Rogers & William Winter, *The Impact of Foreclosures on Neighboring Housing Sales*, 31 J. REAL EST. RES. 455 (2009)). The authors provide details of their research design model, explaining how it "captures the dynamic linkages" among multiple variables using comprehensive state level data for the United States from 1981 to 2009. *See id.* at 8–10.

110. *Id.* at 2.

111. *Id.* at 26.

112. Chatterjee & Eyigungor, *supra* note 5, at 32.

113. *Id.*

114. *Id.* at 2.

115. *Id.*

local activists will not stabilize housing prices and, unfortunately, will likely cause long-term negative effects on the broader economy.

VI. Federal Programs Adjust as Causes for Default Change Over Time

The crisis began as early as 2005 with "a surge in subprime foreclosures" in a few housing markets.[116] The subprime loans in many areas didn't initially cause problems due to the rapid appreciation in home prices.[117] By the second half of 2006, however, home prices in most places started to flatten or decline, which, in turn, caused foreclosures to increase in more places.[118] "By 2009, as unemployment continued to rise, the number of foreclosures of prime loans had begun to overtake the number of subprime foreclosures . . . ."[119] The spike in foreclosures at that time was worse in the areas where there had been a rapid increase in home prices.[120] Now, more than five years after the onset of the housing crisis, there is still severe weakness in most housing markets. During this period, the central premise of each federal program created was that more mortgage modifications are necessary and that these modifications will improve the housing and mortgage markets.

Initially, it was thought that the financial crisis and its repercussions for the housing market were mainly attributed to subprime lending and the mass origination of unaffordable or unsustainable mortgages.[121] The number of high risk loans increased from about $125 billion or 12% of all U.S. loan originations in 2000, to about $1 trillion or 34% of all loan originations in 2006.[122] Altogether from 2000 to 2007, U.S. lenders originated about 14.4 million high risk loans.[123] The majority of those loans (59%) were used to refinance an existing loan, rather than to buy a

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116. Immergluck et al., *supra* note 77, at 1.

117. Id.

118. Delinquencies on home mortgages began to rise, resulting in an increase in foreclosures. Mortgage Bankers Association, National Delinquency Survey Results Q4 2011, at 5–7 (Feb. 16, 2012), http://www.imba.org/files/public/NDSQ411.pdf

119. Immergluck et al., *supra* note 77, at 1.

120. Immergluck et al., supra note 77, at 1.

121. *See* Christopher L. Foote et al., Fed. Reserve Bank of Bos., Public Policy Discussion Papers No. 09-2, Reducing Foreclosures 4 & n.7 (2009), *available at* http://www.bostonfed.org/ economic/ppdp/2009/ppdp0902.pdf; *see also id.* at 1 ("One of the most influential strands of thought contends that the crisis can be attenuated by changing the terms of 'unaffordable' mortgages. . . . Proponents of this view, however, worry that without government intervention, this win-win outcome will not occur.").

122. U.S. Gov't Accountability Office, GAO-09-848R, Characteristics and Performance of Nonprime Mortgages 1 (2009), *available at* http://www.gao.gov/new.items/ d09848r.pdf.

123. *Id.* at 4.

new home.[124]

In 2008, the concern was "affordability," so foreclosure-prevention policies focused on resolving issues of high debt-to-income ("DTI") ratios and interest-rate resets.[125] Many of the proposals used either modification or forbearance (or some combination of the two).[126] Modification changes the terms of the loan (a reduction in the interest rate or principal balance).[127] "Forbearance, on the other hand, involves a lender temporarily agreeing to accept lower payments, without changing any of the original terms of the loan."[128] Economists were predicting in 2008 that about 8% of the underwater mortgages would actually result in a default and that fear of massive "walk away" defaults was unlikely (as discussed below, the 8% prediction was far too low).[129] They concluded that forbearance is a more effective tool for reducing foreclosures because it "allow[s] borrowers to delay, but not to avoid eventually repaying the mortgage in full."[130] Similarly, economists suggested that lowering current mortgage payments "can help at-risk borrowers" and make default less likely "without generating serious moral hazard problems, involving assistance, funded at the public's expense, to those who do not need it."[131]

In 2009, the economic recession and unemployment—which reached a twenty-six-year high of 10.2% in October 2009—created new issues to deal with in addition to the existing challenges related to foreclosure.[132] For example, foreclosures were being seen in a whole new demographic: borrowers with good credit and good loans who were walking away from homes. In May 2009, the Mortgage Bankers Associ-

124. *See id.* at 24. Many of these borrowers "refinanced their mortgages at a higher amount than the loan balance to convert their home equity into money for personal use (known as 'cash-out refinancing')." *Id.* at 7. "Of the subprime mortgages originated from 2000 through 2007, 55 percent were for cash-out refinancing, 9 percent were for no-cash-out refinancing, and 36 percent were for a home purchase." *Id.*

125. *See* JONES, *supra* note 61, at 10–11, 16–18.

126. *See* CHRISTOPHER L. FOOTE, KRISTOPHER GERARDI & PAUL S. WILLEN, FED. RESERVE BANK OF BOS., PUBLIC POLICY DISCUSSION PAPERS NO. 08-3, NEGATIVE EQUITY AND FORECLOSURE: THEORY AND EVIDENCE at 19 (2008), *available at* http://www.bos.frb.org/economic/ppdp/2008/ppdp0803.pdf.

127. *Id.*

128. *Id.*

129. *See, e.g., id.* at 2, 11. *Cf. id.* at 2–4 (using data from a recession in the early 1990s where homeowners faced negative equity and finding that not all borrowers with negative equity will default on their mortgages, which made it difficult to determine which borrowers actually require help in order to prevent foreclosure and which ones do not).

130. *Id.* at 26.

131. *Id.*

132. *See* Peter Goodman, *U.S. Unemployment Rate Hits 10.2%, Highest in 26 Years*, N.Y. TIMES (Nov. 6, 2009), http://www.nytimes.com/2009/11/07/business/economy/07jobs.html?_r=2&hp.

ation reported that prime borrowers accounted for the largest share of new foreclosures.[133] The economic research in 2009 indicated that the source of mortgage defaults "appear[ed] to be the *interaction* of falling prices [creating negative equity] *and* adverse life events [such as job loss]."[134] "Temporary assistance," they suggested, "may not help borrowers facing permanent income shocks, but it would help borrowers undergoing transitory setbacks."[135]

In 2008, Congress enacted the Housing and Economic Recovery Act ("HERA") which included a $300 billion foreclosure prevention component, Hope for Homeowners ("H4H"), to be administered by the Federal Housing Administration. The purpose of H4H was to refinance the loans of distressed borrowers by requiring lenders to write-down borrowers' mortgages and then refinance the home for not more than 90% of the current value. But, the program was ill equipped to handle the large amount of borrowers with second and sometimes even third mortgages. Junior lien holders opposed agreeing to refinancing terms that essentially wiped out their interests.[136] Because of this and other issues, the first two and a half months that H4H began operating only 312 applications were received throughout the whole country. In order to increase participation, the Department of Housing and Urban Development ("HUD") attempted to modify the program to increase the loan amount to a maximum of 96.5% of appraised value of the home, but this change was ineffective.

In 2009, the Obama Administration revealed its Making Home Affordable ("MHA") plan which was another attempt at reducing foreclosures.[137] MHA pledged additional capital to the GSEs and also entailed two primary programs, the Home Affordable Refinance Program ("HARP") and the Home Affordable Modification Program ("HAMP"). HARP permitted the refinancing of present GSE loans of up to 105% of the market value. HAMP, the more ambitious component of MHA, "called on lenders to reduce mortgage payments to 38 percent of borrower income, after which the federal government would pay 50 percent of the cost of reducing them to 31 percent of income."[138] Additionally, HAMP offered a method to evaluate a borrower's claim for

133. Peter Coy, *Foreclosure: Now an Upscale Blight*, BUSINESSWEEK (June 4, 2009), http://www.businessweek.com/magazine/content/09_24/b4135026913979.htm?chan=top+news_top+news+index+-+temp_top+story.

134. FOOTE ET AL., *supra* note 121, at 3 (emphasis added).

135. *Id.* at 7.

136. *See, e.g.*, JONES, *supra* note 61, at 13 ("Any second lien-holders are required to release their liens . . . and second lien-holders were compensated for releasing their liens with a share of any future profit from the home's eventual sale.").

137. *See id.* at 9.

138. Immergluck et al., *supra* note 77, at 8.

loan modifications and modification process. However, after the first year, the number of loan modifications that re-defaulted and were dropped from the program surpassed the number of new modifications.[139] By late 2010, even the pace of temporary modifications had begun to slow. Questions were raised in 2009 by the Congressional Oversight Panel ("COP") regarding whether HAMP would merely forestall foreclosure for many homeowners because so many re-defaulted.[140]

In 2010, unemployment emerged as a key "driver of delinquencies and foreclosures," undermining efforts for any loan modification under HAMP.[141] Once again, the COP suggested that "the best foreclosure mitigation initiative would be a sound economy with low unemployment."[142] In response to challenges posed by "second lien mortgages, unemployed borrowers, and borrowers with negative equity," new programs were implemented.[143] The Second Lien Modification Program offers incentive payments to servicers, borrowers, and second-lien holders for their voluntary participation.[144] However, the program to date has seen relatively little use. The Hardest Hit Fund is a "program designed in part to deal with the problem of unemployed homeowners."[145] It "provides TARP money to state-run foreclosure mitigation programs in specific states hit hardest by home value decreases and unemployment."[146]

The HAMP Principal Reduction Alternative attempts to deal with negative equity by incentivizing lenders to grant a principal reduction and also includes an equity sharing option.[147] The "Home Affordable Foreclosure Alternative and the FHA Short Refinance Program are also intended to address problems caused by negative equity" through "the use of short sales and deeds-in-lieu of foreclosure for HAMP-eligible borrowers who are underwater and unable to qualify for modifications."[148]

In October 2011, in an effort to adjust to the evolving foreclosure problem, the Administration announced that the Home Affordable Refinance Program ("HARP"), introduced in 2009, would be revamped and

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139. U.S. DEP'T OF THE TREASURY, MAKING HOME AFFORDABLE PROGRAM: SERVICER PERFORMANCE REPORT THROUGH OCTOBER 2010, at 2 (2010), *available at* http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/Oct%202010%20MHA%20Public%20Final.pdf.

140. *See generally* CONG. OVERSIGHT PANEL, FINAL REPORT, *supra* note 9, 68–95 (describing the HAMP program).

141. Id. at 73.

142. *Id.*

143. *Id.* at 80.

144. *Id.* at 81.

145. *Id.*

146. *Id.*

147. *Id.* at 82.

148. *Id.* at 83.

extended through December 31, 2013.[149] In order to be eligible for refinancing, the original loan must be owned or guaranteed by Fannie or Freddie and the loan must have a securitization date prior to June 1, 2009.[150] The biggest change is the removal of the 125% loan-to-value ceiling, which will allow many more homeowners to qualify for the program.[151] HARP allows homeowners facing difficulties refinancing through conventional methods because of little or negative equity to apply for the refinancing of their mortgage at the current lower interest rates. Removing previous loan-to-value ceilings will allow homeowners who are severely underwater due to plummeting property values to take out new loans at today's lower interest rates.[152] The amendments also reduce borrowing fees and eliminate some appraisals. The key incentive for lenders is the waiver of representations and warranties by Fannie or Freddie.[153] "The lender will not be responsible for any of the representations and warranties associated with the original loan."[154] "The lender is also relieved of the standard underwriting representations and warranties with respect to the *new* mortgage loan as long as the data in the case file is complete and program instructions are followed for collecting information on income, employment, assets, and fieldwork."[155] "Administration officials . . . hop[e] that eliminating the risk associated with rep[resentation]s and warranties—whether transferred from the original loan or on the new loan—will spark . . . competition among lenders to help homeowners get into the program."[156]

VII. WHY HAVE FEDERAL PROGRAMS FAILED TO STABILIZE THE HOUSING MARKET?

U.S. household real estate values have plummeted from $20.85 trillion in 2007 down to $15.96 trillion in December 2011—for a loss of approximately 4.89 trillion dollars.[157]

149. FANNIE MAE, SELLING GUIDE ANNOUNCEMENT SEL-2011-12, at 1 (2011), *available at* https://www. efanniemae.com/sf/guides/ssg/annltrs/pdf/2011/sel1112.pdf.

150. *See* FANNIE MAE, HOME AFFORDABLE REFINANCE (DU REFI PLUS AND REFI PLUS) FAQS 6 (2012), *available at* https://www.efanniemae.com/sf/mha/mharefi/pdf/refinancefaqs.pdf.

151. *See* Carrie Bay, *Big Four Set to Participate in HARP 2.0*, DS NEWS (Oct. 27, 2011), http:/ /www. dsnews.com/articles/index/big-four-set-to-participate-in-harp-20-2011-10-27.

152. *See id.*

153. *See id.*

154. Carrie Bay, *Fannie and Freddie Detail New HARP Guidelines*, DS NEWS (Nov. 15, 2011), http:// www.dsnews.com/articles/print-view/fannie-and-freddie-detail-new-harp-guide lines-2011-11-15.

155. *Id.* (emphasis added).

156. *Id.*

157. Bd. of Governors of the Fed. Reserve Sys., *Flow of Funds Accounts of the United States: Flows and Outstandings Fourth Quarter 2011*, FED. RES. STAT. RELEASE, Mar. 8, 2012, at 106 tbl.B.100, *available at* http://www.federalreserve.gov/releases/z1/20120308/z1.pdf.

A. *Deleveraging: The Unwinding of Debt by Homeowners*

The dramatic growth of household debt and leverage between 2002 and 2006 was a key factor contributing to the onset of the recession that began in December 2007.[158] In the mid-1980s, the ratio of debt to personal disposable income for American households was 65%, but it had more than doubled to 133% by 2007.[159] A combination of several factors encouraged increased household borrowing.[160] Low interest rates and access to easy mortgage credit permitted homes to be purchased with little or no down payment.[161] "Many of these purchases [we]re structured with a first loan that cover[ed] 80 percent of the value of the house and a second loan . . . taken out at the same time" for the balance of the purchase price.[162]

Rising real estate prices were both a cause and a consequence of increased borrowing: as property prices rose, buyers borrowed more to purchase them, thereby pushing up prices even more.[163] "The rapid rise in household net worth encouraged lenders to ease credit even further based on the assumption that house price appreciation would continue indefinitely."[164] Homeowners used refinancing or lines of credit to extract the equity from rapidly appreciating home values, which "provided hundreds of billions of dollars per year in spendable cash . . . that was used to pay for a variety of goods and services."[165] The growth of alternative mortgage products and the expansion of the market for securitized loans also promoted increased household borrowing.[166] The

158. *See* Mian & Sufi, *supra* note 100, at 3, 20–23.

159. *See* Reuven Glick & Kevin J. Lansing, *U.S. Household Deleveraging and Future Consumption Growth*, FRBSF ECON. LETTER, May 15, 2009, at 1, 1 [hereinafter Glick & Lansing, *Household Deleveraging*] *available at* http://www.frbsf.org/publications/economics/letter/2009/el2009-16.pdf.

160. *See id.*

161. *See id.* at 1–2.

162. Eric S. Rosengren, President & Chief Exec. Officer, Fed. Reserve Bank of Bos., Address Before the New England Economic Partnership's Spring Economic Outlook Conference on Credit, Housing, and the Consequences for New England: Current Challenges in Housing and Home Loans: Complicating Factors and the Implications for Policymakers 11 (May 30, 2008), *available at* http://www/bos.frb.org/news/speeches/rosengren/2008/053008.pdf. In Massachusetts, these second loans increased from 26% in 2003 to 65% of subprime mortgages in the third quarter of 2005. *Id.* at 11.

163. *See* Mian & Sufi, *supra* note 100, at 7.

164. Reuven Glick & Kevin J. Lansing, *Consumers and the Economy, Part I: Household Credit and Personal Saving*, FRBSF ECON. LETTER, Jan. 10, 2011, at 1, 4, *available at* http://www.frbsf.org/ publications/economics/letter/2011/el2011-01.pdf.

165. *See, e.g.*, Glick & Lansing, *Household Deleveraging*, *supra* note 159, at 2.

166. *See generally* EDWARD V. MURPHY, CONG. RESEARCH SERV., RL33775, ALTERNATIVE MORTGAGES: CAUSES AND POLICY IMPLICATIONS OF TROUBLED MORTGAGE RESETS IN THE SUBPRIME AND ALT-A MARKETS 2–7 (2008), *available at* http://assets.opencrs.com/rpts/RL33775_20081008.pdf (explaining that alternative mortgages encompassed a variety of risky

rise in household debt coincided with a decline in the personal saving rate.[167]

Economist Hyman Minsky proposed a "financial instability hypothesis."[168] Minsky "argued that prosperous times can often induce borrowers to accumulate debt beyond their ability to repay out of current income, thus leading to financial crises and severe economic contractions."[169] The facts surrounding the current crisis clearly support Minksy's hypothesis. U.S. households are in the process of deleveraging their debt. That process may take years, and it can take different paths that will impact the economy in different ways. In households with little or no savings, deleveraging usually occurs through default, which shifts the loss to the lender or the taxpayer if the loan is government-insured.[170] For example, when a borrower is faced with a choice between paying a home loan and a credit card, liquidity concerns drive borrowers to pay the credit card first.[171] Consumer consumption can then be maintained, but the home will eventually be foreclosed.[172] For some households, repayment of the debt will strain the buyer's finances but may not end in default. Instead, deleveraging causes a reduction in other spending and increased saving, which in turn slows economic growth and increases unemployment.[173]

Recent economic studies have concluded that the accumulation of a high level of household debt prior to the financial crisis led to a severe and prolonged pull-back in consumption when housing prices collapsed.[174] Researchers concluded that high debt, loss of access to home

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mortgage products, including adjustable rate mortgages ("ARMs"), extremely low or zero down payment mortgages, interest-only mortgages, and negative amortization mortgages).

167. Reuven Glick & Kevin J. Lansing, *Consumers and the Economy, Part I: Household Credit and Personal Saving*, FRBSF ECON. Letter, Jan. 10, 2011, http://www.frbsf.org/publications/economics/letter/2011/el2011-01.html.

168. *See* Glick & Lansing, *Household Deleveraging*, *supra* note 159, at 3 (discussing Minksy's work).

169. *Id.* at 3.

170. *See* Reuven Glick & Kevin J. Lansing, *Global Household Leverage, House Prices, and Consumption*, FRBSF ECON. LETTER, Jan. 11, 2010, at 2, *available at* http://www.frbsf.org/publications/economics/letter/2010/el2010-01.pdf.

171. *See* Ethan Cohen-Cole & Jonathan Morse, *Your House or Your Credit Card, Which Would You Choose?: Personal Delinquency Tradeoffs and Precautionary Liquidity Motives* 2, 24 (Fed. Reserve of Bos., Working Paper No. QAU09-5, 2010), *available at* http://www.bos.frb.org/bankinfo/qau/wp/2009/ qau0905.pdf.

172. *See id.*

173. *See generally* Amir Sufi, Atif Mian & Kamalesh Rao, Household Balance Sheets and the Weak Recovery (November 2011) (unpublished presentation) [hereinafter Sufi et al., *Weak Recovery*], *available at* http://faculty.chicagobooth.edu/amir.sufi/MianSufi_summary_Nov2011_public.pdf.

174. *See, e.g.*, Veronica Guerrieri & Guido Lorenzoni, *Credit Crises, Precautionary Savings, and the Liquidity Trap* 2–3 (Nat'l Bureau of Econ. Research, Working Paper No. 17583, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1960130; Atif Mianet al.,

equity lines of credit, and the inability to refinance at lower rates caused a strong "pull-back" in consumption of goods (other than construction).[175] They contend that this deleveraging and consumption pull-back also explains 65% of job losses from 2007 to 2009.[176]

B. *Negative Equity*

The use of debt to acquire an asset, such as a house, magnifies the buyer's assumed risk. If a homeowner owns a house with positive equity but faces problems in making mortgage payments, the homeowner can either refinance or sell the home to recover the positive equity position. The homeowner is more likely to be able to avoid foreclosure if he has positive equity. However, if the value of the asset drops, the debt incurred to buy the asset must still be paid in full. If that debt exceeds the asset's market value, refinancing options are limited.[177] With the plummeting of home prices between 2006 and 2011, millions of homeowners found themselves facing this dilemma of limited refinancing options due to owing more on their mortgages than the current market value of the home.[178]

The extraordinary decline in home prices from their peak in 2006 provides a clear reason why so many homeowners are facing negative equity problems. S&P/Case-Shiller data of January 2012 shows that home prices are down from their peak in all twenty metro areas tracked, with Dallas in the best shape (-10.9%) and Las Vegas in the worst (-61.6%).[179] But what is more troubling is that in January 2012, eight of the twenty metro areas tracked were at their *lowest price points* since the crisis began.[180] Due to the decline in home prices, 11.1 million American homes had negative equity at the end of December 2011 according to CoreLogic, a data and analytics company.[181] Additionally, "2.5 mil-

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Household Balance Sheets, Consumption, and the Economic Slump 5 (Nov. 2011) (unpublished manuscript), *available at* http://www.aeaweb.org/?aea/2012conference/program/retrieve.php??pdf id=136.

175. *See generally* Sufi et al., *Weak Recovery*, *supra* note 173.

176. *Id.* at 10.

177. Yongheng Deng, John M. Quigley & Robert Van Order, *Mortgage Terminations, Heterogeneity and the Exercise of Mortgage Options*, 68 ECONOMETRICA 275, 277-78 (2000), *available at* http:// urbanpolicy.berkeley.edu/pdf/dqv_2000pb.pdf.

178. *See* Press Release, CoreLogic, *supra* note 44 (noting that negative equity significantly limits the ability of borrowers to capture the benefit of the current low interest rate environment).

179. *See* David Blitzer, *How the Cities Did in January*, HOUSINGVIEWS (Mar. 30, 2012), http:// www.housingviews.com/2012/03/30/how-the-cities-did-in-january.

180. *See id.*

181. *See* Press Release, CoreLogic, CoreLogic Reports Negative Equity Increase in Q4 2011 (Mar. 01, 2012), *available at* http://www.corelogic.com/about-us/news/asset_upload_file909_144 36.pdf.

lion borrowers had less than five percent equity."[182] "Together, negative equity and near-negative equity mortgages accounted for 27.8 percent [or more than one out of every four] residential . . . mortgage[s] nationwide . . . up from 27.1 in the [third quarter of 2011]."[183] "[T]he total mortgage debt outstanding on properties in negative equity increased from $2.7 trillion in the third quarter [of 2011] to $2.8 trillion in the fourth quarter."[184] Mark Fleming, chief economist with CoreLogic further reports that "[t]he negative equity share is back to the same level as Q3 2009, which is when we began reporting negative equity using this methodology."[185] This data tends to indicate that the bottom of the foreclosure crisis may not have been reached.

Price declines and loss of homeowner equity are central contributors to mortgage default.[186] In fact, negative equity is a more significant element than unemployment in causing foreclosures.[187] If there is little hope that the price of the house will recover to exceed the outstanding balance on the mortgage, the borrower may engage in "strategic default" and simply walk away from the home.[188] Many homeowners rationally conclude that they will be better off financially in the long run if they walk away from their mortgage.[189] According to Fleming, "[h]igh negative equity is holding back refinancing and sales activity and is a major impediment to the housing market recovery. The hardest hit markets have improved over the last year, primarily as a result of foreclosures. But nationally, the level of mortgage debt remains high relative to home prices."[190]

C. *Changing Credit Standards*

The mortgage credit standard used to determine whether potential homebuyers qualify for a loan was a major factor contributing to the creation of the financial crisis and is now a major factor that hampers the housing recovery.[191] The financial crisis resulted from an increase in the

182. *Id.*

183. *Id.*

184. *Id.*

185. *Id.* (internal quotation marks omitted).

186. *See* FOOTE, GERARDI & WILLEN, *supra* note 126, at 11; Calomiris, Longhofer & Miles, *supra* note 106, at 26–27; *see also generally* Neil Bhutta et al., *The Depth of Negative Equity and Mortgage Default Decisions* (Fed. Reserve Bd., Working Paper No. 2010-35, 2010), *available at* http://www.federalreserve.gov/pubs/feds/2010/201035/201035pap.pdf (discussing strategic defaults and the factors affecting the decision therein).

187. *See* FOOTE, GERARDI & WILLEN, *supra* note 126, at 12–14; Stan Leibowitz, *New Evidence on the Foreclosure Crisis*, WALL ST. J., July 3, 2009, at A13.

188. *See* Bhutta et al., *supra* note 186, at 3.

189. *See* Ghent & Kudlyak, *supra* note 88, at 28; Leibowitz, *supra* note 187.

190. Press Release, CoreLogic, *supra* note 44 (internal quotation marks omitted).

191. John V. Duca, John Muellbauer & Anthony Murphy, *House Prices and Credit*

underwriting of shaky mortgages such as loans with low or no down payments, increased debt ratios, impaired credit, no documentation, and negative loan amortization.[192] This was a drastic change when compared to loan standards that were common in the early 1990s.[193]

Lenders shifted from originating and holding mortgages to originating, selling, pooling, securitizing, and then packaging them for sale to investors. New financial products and alternative mortgages enabled millions of Americans who had not previously qualified to buy a home to become owners. Between 2002 and 2006, 9.1 million new homes were built.[194] Because of the relaxed credit standards prior to the crisis, the *average* loan-to-value ratio rose to 94%.[195] The lower down-payment requirements caused the demand for housing to increase which caused prices and construction to increase[196] This reinforced rising home-price "expectations among borrowers and lenders," which again increased lending and "further boost[ed] prices."[197]

During the aftermath, mortgage credit standards have tightened and most loans now require more income, collateral, and documentation. Dodd-Frank has created new prohibitions and standards for various consumer financial products, most notably, mortgage loans and, to a much more limited extent, credit and debit cards.[198] Title XIV of the Act is a maze of intertwined loan categories, requirements, and prohibitions. These rules cover mortgage origination and servicing practices and create remedies for borrowers if lenders break the rules. Some of the law's provisions apply to any loan secured by the consumer's principal dwelling, including for the first time, open end credit, and others only apply to residential mortgage loans. The law also creates a new class of "qualified mortgages" that are viewed as sufficiently safe to be sold into the secondary market to be securitized and as sufficiently fair to allow safe harbor from some of the prohibitions and restrictions imposed by the Act.[199] To qualify, a borrower must make a 20% down payment for

Constraints: Making Sense of the U.S. Experience 21–22 (Fed. Reserve Bank of Dall., Working Paper No. 1103, 2011), *available at* http://www.dallasfed.org/assets/documents/research/papers/2011/wp1103.pdf.

192. *See* Danielle DiMartino & John V. Duca, *The Rise and Fall of Subprime Mortgages*, ECON. LETTER: INSIGHTS FROM THE FED. RES. BANK DALL., Nov. 2007, at 1—3, *available at* http://www.dallasfed.org/ assets/documents/research/eclett/2007/el0711.pdf.

193. *See id.*

194. Booth & Lutrell, *supra* note 47, at 1.

195. John V. Duca, David Luttrell & Anthony Murphy, *When Will the U.S. Housing Market Stabilize?*, ECON. LETTER: INSIGHTS FROM THE FED. RES. BANK DALL., Aug. 2011, at 1, 2, *available at* http://www.dallasfed.org/assets/documents/research/eclett/2011/el1108.pdf.

196. *Id.*

197. *Id.*

198. Dodd-Frank Act, Pub. L. No. 111-203, § 1403, 124 Stat. 2139–41 (2010).

199. Dodd-Frank Act, Pub. L. No. 111-203, § 1412(b)(3)(B)(2), 124 Stat. 2148 (2010).

mortgage lenders to be exempt from holding 5% of the loan's risk. The Act also imposes an obligation on the lender to determine the borrower's "reasonable ability to repay" a loan.[200] As a result, fewer loans are being made, dampening housing demand along with prices and construction.[201]

D. *Securitization and Mortgage Servicer Issues*

Throughout the past decade, much home acquisition debt was securitized. Undoubtedly, the widespread emergence of borrower default and foreclosure currently being experienced was not contemplated in the legal structure of securitizations or in the terms of the Pooling and Servicing Agreements ("PSA"). The legal restrictions imposed by these agreements often act as a major impediment to servicers' willingness to modify loans in order to prevent a foreclosure. The beginning of the securitization process parallels that of a traditional real estate transaction. Mortgages are originated through banks and mortgage brokers. When they are sold in the secondary market, they can be left intact, but they are often securitized and then separated into groups (tranches) on the basis of certain common characteristics. The mortgages are securitized by investment banks (the sponsors) through the use of trusts that qualify for Real Estate Mortgage Investment Conduit ("REMIC") status.[202] These trusts are tax-exempt vehicles that pool the mortgages transferred to them and sell interests in the income stream from those mortgages to investors in the form of shares, or MBSs.[203] The governing document for securitizations, the PSA, includes various representations and warranties for the underlying mortgages.[204] It also describes the responsibilities of the trustee, holding the recorded mortgage documents, and of the servicer, playing an administrative role, collecting and disbursing mortgage payments on behalf of the investors in the MBSs.

There are two crucial issues facing servicers when considering loan modifications. The first is protecting the tax-exempt status of pass-through REMIC. Pass-through REMICs are security structures which act as tax-free conduits for the funds for certificate holders of various classes of securities. In order to qualify for the tax-exempt status, the

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200. *See* Dodd-Frank Act § 1411, 15 U.S.C. § 1639c(a)(1) (Supp. IV 2011) ("[N]o creditor may make a residential mortgage loan unless the creditor makes a *reasonable and good faith determination* based on *verified and documented information* that, at the time the loan is consummated, the consumer has a *reasonable ability to repay the loan*, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments." (emphasis added)).

201. *See* Duca, Luttrell & Murphy, *supra* note 195, at 2–3.

202. *See* 1 STUART M. SAFT, COMMERCIAL REAL ESTATE WORKOUTS § 5:2 (3d ed. 2011).

203. *See id.*

204. *See generally id.* § 5:4 (discussing typical PSA contents and variations).

REMIC trust must hold a *fixed* pool of mortgages; that is, loans cannot be added or substituted. This creates a serious impediment to the modification of distressed loans because of the risk that the IRS may interpret a loan modification as the equivalent of a prohibited loan substitution, thereby revoking tax-exempt status.[205] The second issue for servicers is protecting investor interests. Most MBSs have a range of credit qualities. The highest-rated tranches pay out to investors first; the lowest-rated tranches are paid last. A modification that lowers a homeowner's payments will first affect the lowest-rated tranches in the pool, leaving those with higher ratings untouched.[206] It was thought that servicers were reluctant to modify securitized loans because of concerns that investors may sue them, alleging breach of a PSA obligation. To minimize this concern, Congress enacted "safe harbor" legislation limiting servicer liability as a result of loan modifications.[207]

Modifying a securitized loan was also complicated by the fact that many properties had a second mortgage. These loans were frequently securitized, with the first mortgage and the second loan being sold into separate portfolios.[208] Servicers of a first mortgage will not voluntarily reduce principal or interest payments that would simply flow to a formerly worthless second mortgage. The combination of second loans, securitization, and legal complexities makes it much more difficult to modify loans, particularly if the first and second mortgages have been packaged into separate securitizations. "Dealing with two different lenders or servicers, as well as different securitizations [and different loan servicing agreements], can significantly complicate efforts to restructure loans."[209]

Policymakers have presumed a lender would be better off modifying a delinquent loan and taking a small loss, rather than foreclosing and suffering a large loss. However, the costs and benefits of loan modifica-

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205. *See id.* § 5:2. *But cf.* MANUEL ADELINO ET AL., FED. RESERVE BANK OF BOS., PUBLIC POLICY DISCUSSION PAPERS NO. 09-4, WHY DON'T LENDERS RENEGOTIATE MORE HOME MORTGAGES? REDEFAULTS, SELF-CURES, AND SECURITIZATION 4 (2009), *available at* http://www.bos.frb.org/ economic/ppdp/2009/ppdp0904.pdf ("[T]he SEC ruled in 2008 that if default was 'reasonably foreseeable,' then contact with a borrower prior to 60-day delinquency would not affect the accounting status of the loan.").

206. *See id.* at 4, 7, 20. To compensate for risk, investors in lower-rated tranches receive a higher interest rate on their investment, just like investors in "junk" bonds. Similarly, there are mortgage-backed securities that have tranches separated out by interest and principal payments. In those cases, modifications that lower the interest rate would reduce returns (relative to the original loan) for investors in the interest only tranche while actually increasing returns for the principal-only tranche.

207. *See* Dodd-Frank Act § 1404, 15 U.S.C. § 1639b(d) (Supp. IV 2011) (amending the Truth in Lending Act).

208. *See, e.g.*, Rosengren, *supra* note 162, at 12.

209. *Id.*

tions are not clear. A 2009 study found that prior mortgage modification programs did little to prevent foreclosure.[210] The study found that average re-default rates for modified loans over the period between 2005 and 2008 were 50% for mortgages as a whole and 70% for subprime mortgages.[211] When the value of the house that collateralizes the loan is falling or when all parties know that the house has become unaffordable to the borrower, the servicer may simply decide to take a loss now by foreclosing rather than risk an even larger loss down the road. Therefore, servicers may be acting in the best interests of the investors when they foreclose because modifications do not always prevent foreclosures.[212]

VIII. FORECLOSURE DELAYS INFLUENCE BORROWERS' DEFAULT BEHAVIOR

Time required to complete the foreclosure process has increased significantly in recent years. This increased time to complete the foreclosure process has been attributed to new developments such as foreclosure documentation issues, foreclosure moratoria, state and federal mitigation efforts, and attempts to modify loans. As of September 2011, Lender Processing Services ("LPS") reported that about 2.2 million properties were in the foreclosure process, with 72% of owners having made no payments in more than a year, and almost 40% having made no payments in two years.[213] The time frames to move a property through a foreclosure to sale have increased from an average of 251 days in first quarter of 2008 to 410 days by the fourth quarter of 2010; and at the end of the third quarter of 2011, that average was 624 days.[214] In January 2010, the average time from foreclosure start to foreclosure sale in *judicial* states was over 900 days.[215] However, not all homeowners in

210. *See* ADELINO ET AL., *supra* note 205, at 25.

211. *See id.* at 19; *Cf.* Sanjiv R. Das, The Principal Principle 1, (Aug. 10, 2011) (unpublished manuscript), *available at* www.bnet.fordham.edu/Finance_Research_Center/loanmod_Fordham.pdf (citing Carrie Bay, *Fitch: Subpar Loan Mod Results Making U.S. Coreclosures a Reality*, DSNEWS (Feb. 7, 2011), http://www.dsnews.com/articles/fitch-subpar-loan-mod-results-making-us-foreclosures-reality-2011-02-07); Sumit Agarwal et al., *Market-Based Loss Mitigation Practices for Troubled Mortgages Following the Financial Crisis* 4, 19–21 (Fed. Reserve Bank of Chi., Working Paper No. 2011-03, 2010), *available at* http://www.chicagofed.org/digital_assets/publications/working_papers/2011/wp2011_03.pdf (finding that the rate of re-default is affected by many factors including the underlying loan characteristics (e.g. option ARM), loan modification terms (reduce payment, interest, or principal), and the borrower's characteristics and that modifications that include principal reduction with market rate interest reduction have a greater success rate).

212. *See* FOOTE ET AL., *supra* note 121, at 24–25.

213. *See* LENDER PROCESSING SERVS., *supra* note 12, at 3, 17.

214. *Id.* at 3.

215. *See* LENDER PROCESSING SERVS., LPS MORTGAGE MONITOR: FEBRUARY 2012 MORTGAGE PERFORMANCE OBSERVATIONS 9 (2012), *available at* http://www.lpsvcs.com/LPSCorporate

arrears suffer financial hardship due to unaffordable house payments. Those with significant negative equity in their homes may choose to strategically default even though they can afford to make the payments.[216]

One study found that the number of strategic defaulters as a percentage of total defaulters rose to 35.1% in September 2010 from 26.4% in March 2009.[217] The researchers suggested that the growing lag between delinquency and foreclosure provides an added inducement for this form of default.[218]

Notably, in two independent studies in 2011, researchers found that the increasing delay in foreclosures has a significant impact on borrower default behavior.[219] The research results show that borrowers who expect longer foreclosure time have a higher propensity to default, and that just a three-month increase in delay will increase the hazard of default by more than 30%.[220] The results were consistent across different types of loans and credit scores. The reports explain that during the delay period the "defaulting borrower could legally stay in the house without making payments and enjoy "free rent."[221] The research found that this benefit was an important factor in the increase in the foreclosure rate.[222] "The longer the delay, the [larger] the benefit the borrower could obtain from default."[223] In the current market, where many borrowers have negative equity, longer delays result in more strategic defaults, thereby extending the malaise.[224]

Similarly, Andrew Jennings of FICO has estimated that "25-30% of defaults are [already] premeditated."[225] He finds evidence of this effect in patterns exhibited by lower-risk borrowers, including behavior such

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Information/CommunicationCenter/DataReports/MortgageMonitor/LPS%20Mortgage%20 Monitor%20January%202012%20-%20Final.pdf.

216. *See* James R. Hagerty & Nick Timiraos, *Currents: Debtor's Dilemma: Pay the Mortgage or Walk Away — In Down Real-Estate Market, Homeowners Are Deciding to Abandon Their Loan Obligations Even If They Can Afford the Payments*, WALL ST. J., Dec. 17, 2009, at A22 (reporting evidence indicating that some borrowers have strategically purchased another home before walking away from their current home).

217. Luigi Guiso et al., *The Determinants of Attitudes Towards Strategic Default on Mortgages* (June 2011) (unpublished manuscript), *available at* http://www.kellogg.northwestern.edu/faculty/sapienza/htm/Guiso_Sapienza_Zingales_StrategicDefault.pdf.

218. *Id.* at 27.

219. *See generally* Chatterjee & Eyigungor, *supra* note 5, at 36 (explaining delays in the foreclosure system cause a rise in the number of foreclosures); Zhu & Pace, *supra* note 5 (same).

220. Zhu & Pace, *supra* note 5, at 3.

221. *Id.* at 1.

222. Chatterjee & Eyigungor, *supra* note 5, at 36.

223. Zhu & Pace, *supra* note 5, at 1.

224. *Id.* at 3.

225. *When the Roof Fell In*, ECONOMIST (Mar. 3, 2011), http://www.economist.com/node/18250439.

as taking out new loans on a different property prior to mortgage default on a preexisting mortgage loan.[226] Moreover, these practices are reported to be more widespread in non-recourse states, where lenders cannot make a claim on the borrower for any debt remaining after the property is sold.[227] Similar results have been found in other studies.[228]

IX. Robo-Signing Inquiry Creates Contagion Effect Increasing Foreclosure Delays

In the fall of 2010, multiple allegations about foreclosure documentation irregularities surfaced in several judicial foreclosure proceedings. Employees or contractors of Bank of America, GMAC Mortgage, Ally Financial and other major loan servicers "testified that they signed, and in some cases backdated, thousands of documents" claiming "personal knowledge of facts" related to mortgages when they did not have such knowledge.[229] Since that revelation, allegations of "robo-signing" have given rise to ongoing federal and state investigations and have called into question the basic validity of lenders' security interests in collateral in courts across the country.

In twenty-two states, judicial oversight is required in foreclosure proceedings.[230] In these judicial foreclosure states, the mortgagee must establish and prove its claim before a judge. In non-judicial states, a foreclosure can proceed upon adequate and timely notice to the borrower, as defined by statute.[231] A mortgage does not need to be recorded to be enforceable between the mortgagor and the mortgagee or subsequent transferee, but unless a mortgage is recorded, it does not provide the mortgagee or its subsequent transferee with priority over subsequent mortgagees or lien holders.[232] However, due to the rapid growth of mortgage securitization, the secondary market may have exceeded the

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226. *See id.*

227. *See id.*

228. *See, e.g.*, Dean Karlan & Jonathan Zinman, *Observing Unobservables: Identifying Information Asymmetries with a Consumer Credit Field Experiment*, 77 ECONOMETRICA 1993, 1995 (2009) (finding that between 13 and 21% of default behavior can be attributed to moral hazard on the part of the borrower).

229. CONG. OVERSIGHT PANEL, NOVEMBER OVERSIGHT REPORT: EXAMINING THE CONSEQUENCES OF MORTGAGE IRREGULARITIES FOR FINANCIAL STABILITY AND FORECLOSURE MITIGATION 4 (2010) [hereinafter CONG. OVERSIGHT PANEL, NOVEMBER REPORT], *available at* http://www.gpo.gov/fdsys/pkg/ CPRT-111JPRT61835/pdf/CPRT-111JPRT61835.pdf.

230. Mortgage Bankers Association, *Judicial Versus Non-Judicial Foreclosure* 3 (Oct. 26, 2010), www.mbaa.org/files/ResourceCenter/ForeclosureProcess/JudicialVersusNon-JudicialForeclosure.pdf.

231. MORTG. BANKERS ASS'N, JUDICIAL VERSUS NON-JUDICIAL FORECLOSURE 2 (2012), *available at* www.mbaa.org/files/ResourceCenter/ForeclosureProcess/JudicialVersusNon-JudicialForeclosure.pdf.

232. *See* RESTATEMENT (THIRD) OF PROP.: MORTGS. § 5.4 cmt. b (1997).

ability of local county land record systems to track mortgage-loan ownership. A single mortgage loan that is securitized may be sold several dozen times between different banks. To increase efficiency, the financial industry developed an electronic transfer process and created a company, the Mortgage Electronic Registration Systems, Inc. ("MERS"), that serves as the mortgagee of record in the county land records and runs a database that tracks ownership and servicing rights of mortgage loans.

The securitization process requires several properly executed transfers, and the MERS electronic process often circumvents county property offices.[233] When the number of foreclosures began to increase, some documentation issues were discovered and started an avalanche of questions about a wide range of legal issues including the legality of foreclosure proceedings and the legitimacy of MERS.[234] The problem is compounded by the fact that resolution of each of these issues is controlled by state law and lies in the hands of fifty states' judges and legislatures. Consequently, inconsistent and conflicting decisions create uncertainty and hamper the ability of parties in the securitization process to enforce foreclosure. MERS was used for years by the most active participants in the securitization market, including the largest banks, and processed over 60% of all MBSs.[235]

The representations and warranties by the MBSs originator or seller typically warrant good title, compliance with applicable law, underwriting standards, documentation of the loan and delivery of the mortgage files.[236] If any of these are breached and the breach materially affects the value of a loan, the loan may be "put-back",[237] requiring the sponsor to repurchase the loan for the outstanding principal balance plus any accrued interest. Court rulings that the MERS process is unlawful under state and local laws may create litigation claims for MBSs investors of breach of representations and warranties by the MBSs originator. Argua-

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233. Cong. Oversight Panel, November Report, *supra* note 229, at 2; Fed. Reserve Sys. et al., Interagency Review of Foreclosure Policies and Practicesr 10–11 (2011), *available at* http://www.federalreserve.gov/BoardDocs/RptCongress/interagency_review_foreclosures_20110413.pdf.

234. *See generally*, Law Dep't, MERSCORP, Inc. & Mortg. Elec. Registration Sys., Inc., Case Law Outline: 2nd Quarter 2011, at 7–93 (2011) *available at* http://www.mersinc.org/files/filedownload. aspx?id=302&table=DownloadFile (summarizing cases where MERS and its status is at issue and providing guidance for members as to the "official" position of MERS on specific issues).

235. *See* Press Release, MERSCORP, Inc., SunTrust Becomes Third Major Mortgage Provider in Recent Months to Require MERS System (Mar. 18, 2010), *available at* http://mersinc.org/media-room/press-release/archives-2010/27-media-room/press-release-archives/2010-articles/265-suntrust-becomes-third-major-mortgage-provider-in-recent-months-to-require-mers-system.

236. *See, e.g.*, Saft, *supra* note 202, at § 5:3.

237. Cong. Oversight Panel, November Report, *supra* note 229, at 17.

bly, these rulings may also create defenses for the borrowers to delay the foreclosure and enjoy free rent or perhaps be awarded the house free and clear. The repercussions caused by the MERS problems could be catastrophic. As warned by the Congressional Oversight Panel:

> This electronic process has, however, faced legal challenges that could, in an extreme scenario, call into question the validity of 33 million mortgage loans.
>
> . . . .
>
> If such problems were to arise on a large scale, the housing market could experience even greater disruptions than have already occurred, resulting in significant harm to major financial institutions. For example, if a Wall Street bank were to discover that, due to shoddily executed paperwork, it still owns millions of defaulted mortgages that it thought it sold off years ago, it could face billions of dollars in unexpected losses.[238]

On April 13, 2011, the Federal Reserve Board issued a joint report on the investigation of foreclosure practices of servicers arising out of the robo-signing allegations.[239] The report noted certain deficiencies in servicer performance relating to foreclosures and issued enforcement orders against some servicers. However, it was also reported that in most cases servicers had proper documentation, and the foreclosed loans were seriously delinquent.[240] The report emphasized that delaying foreclosures will have a negative impact on the economy.[241] Significantly, the interagency panel stated that "a uniform set of national mortgage-servicing and foreclosure-processing standards would help promote accountability and appropriateness in dealing with consumers and strengthen the housing finance market."[242]

At the conclusion of a separate investigation into robo-signing practices, on July 7, 2011, an FDIC division director reported to Congress that "[t]he mortgage-servicing system . . . has impaired the health and recovery of the housing and mortgage markets."[243] The results of

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238. CONG. OVERSIGHT PANEL, NOVEMBER REPORT, *supra* note 229, at 2.

239. *See* FED. RESERVE SYS. ET AL., *supra* note 233.

240. *Oversight of Dodd-Frank Implementation: A Progress Report by the Regulators at the Half-Year Mark: Hearing on Continuing the Oversight of the Dodd-Frank Wall Street Reform Act Before the S. Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. 72 (2011) (prepared statement of John Walsh, Acting Comptroller of the Currency), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-112shrg65718/ pdf/ CHRG-112shrg65718.pdf.

241. FED. RESERVE SYS. ET AL., *supra* note 233, at 5–6 (discussing the impact on the borrowers, industry, investors, judicial process, mortgage market, and communities).

242. *Id.* at 15.

243. *Mortgage Servicing: An Examination of the Role of Federal Regulators in Settlement Negotiations and the Future of Mortgage Servicing Standards Before the Subcomms. on Fin. Insts. & Consumer Credit & on Oversight & Investigations of the H. Comm. on Fin. Servs.*, 112th Cong. 105 (2011) (prepared statement of Mark Pearce, Director, Division of Depositor &

their investigation caused the FDIC to request that the Financial Stability Oversight Council "examin[e] the potential financial systemic risks surrounding mortgage servicing and foreclosures."[244] The FDIC's investigation discovered that there were 67 borrower class-action suits pending in 23 states "challenging foreclosures based upon [alleged] robo-signing[s], defective assignments, [and] reliance upon [MERS]."[245] There are also tens of thousands of individual state court foreclosure proceedings where borrowers are asserting a variety of allegations that are forestalling foreclosures.[246] It was noted that similar actions could proliferate, and until resolved, would create market uncertainty "discourag[ing] the return of private capital to the mortgage market."[247]

Despite the fact that agency investigations found that essentially all of the loans foreclosed were in serious default and that servicers had possession of all loan and mortgage documents, there has been an overwhelming outcry of moral indignation and allegations of fraud with a campaign slogan of "*show the note!*"[248] Consistent with the advice of a former Chief of Staff to never let a crisis go to waste, a cottage industry has erupted to help homeowners negotiate, defend, delay, and avoid foreclosure. However, the well-intended efforts of state actors to stop or delay foreclosures are really attempts to re-allocate losses that have already been allocated by contract. Such actions create incentives for others to engage in the same tactics, creating the risk of contagion and unintended consequences.

X. State Legislative Actions That Delay Foreclosure

A newly enacted Nevada law that imposes substantial obstacles in the foreclosure process became effective on October 1, 2011. This resulted from the enactment of a new law that became effective October 1, 2011, in Nevada that imposed substantial obstacles in the foreclosure process.[249] The law requires any notice of default to include a notarized affidavit attesting to the full name and address of the current and any prior beneficiary of the deed of trust (i.e., the mortgage), the amounts due, the actual or constructive possession of the note and deed of trust,

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Consumer Protection, Federal Deposit Insurance Corporation), *available at* http://financialservices.house.gov/uploadedfiles/112-44.pdf.

244. *Id.*

245. *Id.* at 101.

246. *See id.* at 100.

247. *Id.* at 97.

248. Julie Schmit, *Homeowners use 'show me the note' to fight foreclosure*, USA TODAY (Dec. 21, 2010, 8:06 AM), http://usatoday30.usatoday.com/money/economy/housing/2010-12-21-mortgagenote21_CV_N.htm.

249. Nev. Rev. Stat. § 107.080 (2011).

as well as the authority to foreclose.[250] The problem is that the affiant must testify based on "personal knowledge" as to all of the items contained in the affidavit.[251] Failure to comply is subject to a civil penalty, and the penalty to make false representations was made a felony.[252] The law also creates a private right of action for borrowers, which includes attorneys' fees and treble damages, when a trustee does not "comply with *any* requirement" of the foreclosure.[253] In practice, it is not likely that there is a representative for any servicer that will be able to provide testimony based on personal knowledge to all of the items required. It has been generally accepted that statements or testimony from a beneficiary, servicer, or trustee is based on the business records exception to the hearsay rule. A second important change under the Nevada law requires each assignment of a mortgage or the beneficial interest under a deed of trust to be filed with the county recorder's office in the county where the home is located.[254] This appears to be designed to stop the use of MERS and force the recordation of transfers of all beneficial interest in mortgage loans to be made in county recorders' offices. The third change under the law provides that a foreclosure sale that does not substantially comply "must" be declared vo*id.*[255] It also creates a second private cause of action against the trustee or beneficiary, allowing treble damages, attorney's fees and costs "unless the court finds good cause for a different award."[256] It is plain to see why this has had a chilling effect on the filing of new foreclosure proceedings.

A recent study reported legislative changes affecting mortgage foreclosure that were adopted after the financial crisis by states that use a non-judicial foreclosure process.[257] Between January 2005 and May 2010, there were "almost 200 substantive provisions" enacted "that concern [the regulation of] mortgage default, servicing and foreclosure processes."[258] This activity took place across 33 states and the District of Columbia.[259] Generally, "the adopted changes . . . were largely in favor of the borrower," involving "increases in notice periods or detailed directions to lenders/servicers to take particular steps."[260] In addition, legislative proposals were made "in [a few] non-judicial states to switch

250. *Id.*
251. *Id.*
252. *Id.*
253. *Id.* (emphasis added).
254. *Id.*
255. *Id.*
256. *Id.*
257. *See generally* Immergluck et al., *supra* note 77.
258. *Id.* at i–ii.
259. *See id.*
260. *Id.* at iii.

to a judicial process."[261]

"A number of states [took] action to halt the foreclosure process for a period [of time] to allow the opportunity for loan workouts and mediation. California, Colorado, Michigan, and Nevada are among [the] states that have issued temporary delays at some point."[262] Mediation programs have been implemented in twenty-one states, and "several more were considering similar legislation."[263] "Nevada's law provides that the borrower's election to participate in an optional mediation program can halt foreclosure proceedings until the mediation is complete."[264] New laws were enacted in some states that make it mandatory to give specific notice about foreclosure assistance resources within in their states.[265] Laws enacted in states like California and Nevada provide protections for renters in foreclosed properties.[266] "A number of states have sought to protect distressed homeowners from foreclosure rescue scams . . . ."[267]

The "more substantive efforts to reduce foreclosures, including mediation programs, have been found in judicial foreclosure states."[268] It was concluded that "the judicial process . . . offers more time and opportunity for incremental interventions" than non-judicial systems.[269] Also, the "judicial process affords a borrower opportunity to [assert various] challenge[s], and judges have "far greater latitude" to exercise their authority and discretion "to respond to . . . changes."[270] For example, in Florida, several circuit courts implemented foreclosure programs that may require mandatory mediation, voluntary mediation, informal negotiations, or even a paper-based modification request resembling HAMP.[271]

261. *Id.* at 2 n.2.
262. *Id.* at 16.
263. *See id.* at 17.
264. *Id.* at 16.
265. *See id.* at 28 fig.7, 38–39.
266. *See id.* at 34, 40.
267. *Id.* at 16.
268. *Id.* at 2.
269. *Id.* at 2.
270. *Id.* at 2.
271. *See, e.g.*, *In re* Mediation - Mandatory Mediation Circuit Court Seminole Cnty. Owner-Occupied Residential Mortg. Foreclosures, Fla. Admin. Order No. 12-25-S (July 26, 2012) (on file with Clerk, Fla. 18th Jud. Cir.) (superseding Fla. Admin. Order 09-09-S (2009)), *available at* http://www.flcourts18.org/ PDF/A.O.12-25-S.pdf; *In re* Admin. Order for Case Mgmt. of Residential Foreclosure Cases and Mandatory Referral of Mortg. Foreclosure Cases Involving Homestead Residences to Mediation, Fla. Admin. Order. No. 2011-06 (Aug. 12, 2011) (on file with Clerk. Fla. 19th Jud. Cir.) (amending Fla. Admin. Order No. AO 2010-03 (2011)), *available at* http://www.circuit19.org/documents/AO/2011/AO%202011-06%20Foreclosure.pdf; *In re* Case Mgmt. of Residential Foreclosure Cases and Mandatory Referral of Mortg. Foreclosure Such Cases to Mediation, Fla. Admin. Order No. 11-09 (July 1, 2011) (on file with Clerk, Fla. 11th Jud.

XI. Judicial Actions That Delay Foreclosure

Throughout the United States, courts have a heightened awareness of the interests of homeowners in foreclosure. Consequently, judges are meticulously examining complaint allegations being filed by lenders or servicers to ensure that they meet all state and local statutory and procedural requirements. When they have fallen short, foreclosure actions have been delayed or dismissed. For instance, the New York appellate court in *Aurora Loan Services, LLC v. Weisblum*, dismissed the suit, based on Aurora's failure to strictly comply with the statutory-content requirements in the Home Equity Theft Prevention Act (hereinafter HEPTA) notice, a condition precedent to the commencement of the action.[272] Aurora had provided a notice, but it "did not contain the statutorily-required list of counseling agencies. Nor did Aurora submit an affidavit of service to establish proper service on both borrowers 'by registered or certified mail and also by first-class mail' to their last known address."[273] The court determined that this "substantial failure" to comply with the local law could not be deemed "a minor irregularity" to be disregarded.[274]

The issue of who has standing to foreclose has become hotly contested in courts across the country. In judicial foreclosure, a party must establish that it has "standing" to sue the homeowner to foreclose. Standing is an interest in the property sufficient for a court to hear a plaintiff's claim. Generally, when a homeowner has defaulted, physical possession of the original note is required to enforce the terms of the loan. As a result, for both securitized and non-securitized loans, the foreclosing party must establish standing by showing it is the holder entitled to enforce the promissory note.[275] The issue of standing has been separately raised to challenge the chain of title on the mortgage securing the note and the ability of the foreclosing party to prove proper transfer under state and local laws. This raises serious problems for the securitization market because of the complex chain of title issues involved and the severe consequences if invalid. Therefore, improper transfers of the mortgage can affect subsequent transfers of the property. Several state court decisions involving judicial and non-judicial foreclosure proceed-

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Cir.) (superseding Fla. Admin. Order No. 10-03 A1 (2010)), *available at* http://www.jud11.flcourts.org/documents/Administrative_Orders/1-10-03-A1-Foreclosure%20Case%20Management%20Referral%20Homestead%20Residences%20to%20Mediation.pdf.

272. Aurora Loan Servs., LLC v. Weisblum, 923 N.Y.S.2d 609, 614 (N.Y. App. Div. 2011).

273. Victoria P. Spears, *Failure to Show "Strict Compliance" with State Requirements Dooms Mortgage Foreclosure Action*, 128 The Banking Law Journal 657, 64–65 (2011).

274. *Aurora Loan Servs.*, 923 N.Y.S.2d at 617.

275. *See* U.C.C. §§ 1-201(20); 3-302(e) (2011).

ings illustrate that the legal standard being applied to determine the "standing" issue is inconsistent across states and jurisdictions.

In a highly publicized case, *U.S. Bank National Ass'n v. Ibanez*, the Supreme Judicial Court of Massachusetts (a non-judicial foreclosure state) upheld a lower court's decision to void a foreclosure sale because the trustee for a mortgage-backed trust, U.S. Bank, could not prove that the mortgage had been assigned to it prior to the notice of foreclosure sale.[276] The first assignment of the mortgage was in blank, and the trustee argued that the PPM documented the assignment of the mortgage. Noting that Massachusetts is a *title theory* state, the court relied on Massachusetts *common* law dating back to 1880 and held: "In Massachusetts, where a note has been assigned but there is no written assignment of the mortgage underlying the note, the assignment of the note does not carry with it the assignment of the mortgage."[277] However, the court's rationale is at odds with the rule for assignments of mortgages codified by UCC Section 9-203(g), which explicitly provides that the mortgage automatically follows the note.[278] Massachusetts adopted UCC Article 9 after the common law decision, which the court held was controlling. Thus, under the ruling the implications could be that if a trustee does not have sufficient documentation of assignment of the note *and* underlying collateral (the mortgage), assignment of the mortgage will not be presumed, and the trustee will not be considered a holder in due course of the underlying collateral and will be unable to foreclose.[279] The court rejected the banks' request to apply the decision only to future foreclosures saying that the ruling did not change the law.[280] As a result, homeowners' titles have been successfully challenged by those who lost their property to foreclosure and by those who acquired their property after foreclosure.[281]

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276. *See* U.S. Bank Nat'l Ass'n v. Ibanez, 941 N.E.2d 40, 55 (Mass. 2011).

277. *Id.* at 51, 53–54.

278. *See* U.C.C. §§ 9-203(g) & cmt. 9; 9-308(e) (2011).

279. The Massachusetts court's decision was negatively received by the Permanent Editorial Board for the UCC. *See* PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, DRAFT REPORT: UCC RULES APPLICABLE TO THE ASSIGNMENT OF MORTGAGE NOTES AND TO THE OWNERSHIP AND ENFORCEMENT OF THOSE NOTES AND THE MORTGAGES SECURING THEM 8–9 & n.37 (2011), *available at* http://extranet.ali.org/directory/files/PEB_Report_on_Mortgage_Notes-Circulation_Draft.pdf (identifying *Ibanez* in a footnote and explaining the proper interpretation of the applicable UCC rules). The Board further stated that all fifty states have adopted the rules and that the rules preempt inconsistent principles of common law. *See id.* at 2 & nn.5, 8.

280. *See Ibanez*, 941 N.E.2d at 55. *Ibanez* was major decision that could affect thousands of foreclosures that have been completed across Massachusetts. The opinion could be interpreted to invalidate every foreclosure sale where the foreclosing party could only produce an assignment of the mortgage dated after the date of the publication of notice but with the stated effective date of the assignment prior to the publication date. The decision could spark challenges in other states as well.

281. *See, e.g.*, Bevilacqua v. Rodriguez, 955 N.E.2d 884, 892–93 (Mass. 2011). In *Bevilacqua*,

In a recent Florida (judicial-foreclosure state) case, the appellate court in *Glarum v. LaSalle Bank National Ass'n* held that a foreclosure affidavit of indebtedness submitted by a bank employee was inadmissible hearsay because the person relied on computerized information and did not have personal knowledge of "who, how, or when" the data was entered, notwithstanding Florida's rules for the admission of business records which, in part, allow a qualified witness to attest to the accuracy of computerized records.[282] A similar situation faces foreclosure lawyers in New York, who must now meet a requirement, imposed in October 2010 by a New York Chief Judge, which requires the attorney of record to personally "affirm the accuracy of their documentation" (as opposed to the submission of an affidavit of the client representative).[283] Applied Analytics reported that in the state of New York, it is estimated it will take sixty-two years at the current pace for lenders to repossess on the 213,000 home loans "now in severe default or foreclosure."[284]

However, it is not only the state legislative bodies and courts adopting new requirements. The Register of Deeds in Salem, Massachusetts now requires "the law firm and/or the lender presenting . . . documents for recording, [to] sign a notarized affidavit, under the pains and penalties of perjury, . . . certify[ing] the authenticity of . . . signatures, including the notary's," as a condition to recording.[285] In addition, "the affidavit . . . states that the signatory of the affidavit accepts full responsibility, should any of the statements be incorrect which could corrupt or cloud the homeowner's chain of title."[286] In a similar action, the Register of Deeds in Greensboro, North Carolina, will not accept for filing any documents containing a signature with the name of a known robo-signer.[287]

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the Massachusetts Supreme Judicial Court held that the sale of foreclosed property from a lender whose foreclosure is invalid under *Ibanez* is void. *See id.* Therefore, the plaintiff/purchaser did not own the property and thus lacked standing to pursue an action to quiet title. *See id.* at 886–87, 889, 892–93.

282. Glarum v. LaSalle Bank Nat'l Ass'n, 83 So. 3d 780, 782–83 (Fla. 4th Dist. Ct. App. 2011) (per curiam). This appears to be the first Florida case to specifically hold that an affidavit of a loan servicer relying on computer records is inadmissible hearsay because the affidavit was unable to identify (i) who made the data entries, (ii) how the data entries were made, or (iii) when the data entries were made. *See id.* If it is interpreted in its broadest terms, *Glarum*, however, could be viewed as requiring the affiant to be the actual person who entered the data into the loan servicer's computer system.

283. *See* Streitfeld, *Backlog*, *supra* note 3.

284. *See id.*

285. Press Release, S. Essex Dist. Registry of Deeds, Mass. Register of Deeds John O'Brien is First in the Nation to Say No to Recording Robo-Signed Documents; N.C. Register of Deeds, Jeff Thigpen Agrees (June 7, 2011), *available at* http://www.salemdeeds.com/pdf/ROBOPress.pdf.

286. *Id.*

287. *See id.*; Press Release, Guilford Cnty. Register of Deeds, Mortgage Fraud Information from Press Conference (2012), *available at* http://countyweb.co.guilford.nc.us/fraud-alerts.

This line of court rulings has led to inconsistent requirements and rules formulated by individual judges and have the potential to cause horrific unintended consequences. This isn't necessarily a win for homeowners. Questions can be raised whether completed negotiations that led to modification or forbearance are valid. Will an owner of a piece of real estate be able to confidently convey the property? Securitizations across the country could be called into question.

XII. CONSTITUTIONAL AUTHORITY FOR RETROACTIVE PREEMPTION OF STATE FORECLOSURE LAW

There is Constitutional authority for federal preemption of state foreclosure laws pursuant to the Commerce[288] and Bankruptcy Clauses.[289] Congress also has the power to make all laws that are "necessary and proper" for carrying out these enumerated powers.[290] In fact, Congress enacted legislation in 1981 and in 1994 that authorizes a non-judicial foreclosure process for specified loans and exempts HUD from state foreclosure laws.[291] This note proposes that Congress has authority pursuant to the Commerce Clause to adopt a new uniform foreclosure law, applicable to any federally-related mortgage, which specifically preempts state foreclosure laws and procedures. This law should be adopted as an amendment to Dodd-Frank and explicitly state that it is to be applied retroactively to existing mortgages. Using this authority, Congress could protect Federal financial interests and could construct a more targeted solution for homeowners facing default than is possible through current programs. This law would also provide an essential tool needed for regulatory coordination to protect consumers and minimize systemic risk to the financial system and the economy as a whole.

The U.S. Supreme Court will uphold commerce-based laws if it finds that the activity being regulated substantially affects interstate commerce. The Court has held that statutes regulating one of three categories of commercial activities are within congressional authority:

> First, Congress may regulate the use of the channels of interstate commerce. Second, Congress is empowered to regulate and protect the instrumentalities of interstate commerce, or persons or things in

288. U.S. CONST. art. I, § 8, cl. 3.

289. *Id.* cl. 4. Such laws must be "uniform." *Id.* The Supreme Court has approved Congress' use of this authority to impair contracts and even to avoid liens. *See* Ry. Labor Execs.' Ass'n v. Gibbons, 455 U.S. 457, 466 (1982) (citation omitted). This power provides a distinct advantage over state foreclosure laws to overcome hurdles for loan modification programs and caused by second liens.

290. U.S. CONST. art. I, § 8, cl. 18.

291. Multifamily Mortgage Foreclosure Act of 1981, 12 U.S.C. §§ 3701–17 (2006); Single Family Mortgage Foreclosure Act of 1994, 12 U.S.C. §§ 3751–68 (2006).

> interstate commerce, even though the threat may come only from *intrastate* activities. Finally, Congress' commerce authority includes the power to regulate those activities having a substantial relation to interstate commerce, . . . *i.e.*, those activities that substantially affect interstate commerce.[292]

The last category allows courts to examine the cumulative effect of a commercial activity on the economy as a whole. Historically, foreclosure law has been left to the states, and it could be argued that an isolated foreclosure of a home in a single state does not substantially affect interstate commerce. However, a federal foreclosure law designed to regulate the cumulative effects of a collapsing national housing market, with billions of taxpayer dollars being paid on mortgage guarantees and trillions more at risk, would likely fall into the category of activities that substantially affect interstate commerce. Also, it could be argued that the new law would be part of a larger regulatory scheme under Dodd-Frank "that could be undercut unless the intrastate [foreclosure] activity were regulated."[293]

A federal foreclosure law may preempt state or local law in three ways: (1) express preemption, where Congress specifically defines the extent to which it intends to preempt state law; (2) implied or field preemption, where a federal scheme so thoroughly occupies a legislative field "as to make reasonable the inference that Congress left no room for the States to supplement it;" and (3) conflict preemption, where it is impossible to follow both the federal and the state laws or when "state law stands as an obstacle to the accomplishment of the full purposes and objectives of Congress."[294] When Congress expressly states its intention to preempt state laws, courts will uphold the preemption as long as it is otherwise within constitutional limits.[295] However, when Congress fails to state clearly whether it intends to preempt state law, courts must

292. United States v. Morrison, 529 U.S. 598, 609 (2000) (alteration in original) (emphasis added) (quoting United States v. Lopez, 514 U.S. 549, 558–59 (1995)) (internal quotation marks and citations omitted).

293. *Lopez*, 514 U.S. at 561

294. US Airways, Inc. v. O'Donnell, 627 F.3d 1318, 1324–25 (10th Cir. 2010) (internal quotation marks and citations omitted); *see* also U.S. CONST. art. VI, cl. 2.

295. *See, e.g.*, Arizona v. United States, 132 S. Ct. 2492, 2500–01 (2012); Chamber of Commerce of U.S. v. Whiting, 131 S. Ct. 1968, 1974–75 (2011). Statutes stating an intention to preempt state laws include, e.g., 12 U.S.C. § 1701j-3 (2006) (due-on-sale clauses); 12 U.S.C. § 1735f-7 (2006) (Congress expressly preempted state laws concerning usury); Real Estate Settlement Procedures Act, 12 U.S.C. §§ 2601–17 (2006) (Congress imposed national standards concerning loan disclosures); Home Mortgage Disclosure Act, 12 U.S.C. §§ 2801–10 (2006) (requiring even state-chartered lenders to disclose information concerning the locations of properties on which they hold a mortgage); 12 U.S.C. § 3803(c) (Congress expressly preempted state constitutions and statutes in alternative mortgage instruments); Consumer Credit Protection Act, 15 U.S.C. §§ 1601–93r (2006) (Congress authorized Board to exempt institutions from state laws deemed to be inconsistent); Fair Housing Act, 42 U.S.C. §§ 3601–19 (2006) (Congress

determine congressional intent or "implied preemption."[296]

The constitutionality of the retroactive application of federal foreclosure law would likely be challenged in judicial foreclosure states. In such states, it could be asserted that a federal non-judicial foreclosure process deprives a homeowner of a right to a judicial proceeding that was guaranteed by state law at the time the mortgage was executed. The protection of this right arises through the Due Process Clause of the Fifth Amendment of the U.S. Constitution. The issue to be decided for satisfaction of due process is whether "the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means.[297] Clearly, this standard is met when Congress enacts a uniform foreclosure process to fairly deal with a crisis of the magnitude now facing the country. Consequently, to make Congressional intent clear, the proposed legislation should expressly preempt state and local foreclosure-related laws and provide for retroactive application to all federally-related mortgages.[298] Additionally, the scope of the savings clauses found in Title X of Dodd-Frank should be clarified to reflect the preemptive intent of the federal foreclosure provisions.

XIII. Preemption in Light of Dodd-Frank Act's Savings Clauses

The over 2,300 pages of the Dodd-Frank Act generate substantial reform for many facets of the financial industry. Significantly, the Act alters some aspects of federal preemption for laws regulating national banks, federal thrifts, and their subsidiaries.[299] Prior to the enactment of Dodd-Frank, the Office of Thrift Supervision ("OTS"), which regulated federal savings and loan associations, and the Office of the Comptroller

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preempted state laws thought to be discriminatory); 12 C.F.R. § 34.4 (2011) (comptroller promulgated rule exempting national banks from state specific state laws and regulations).

296. *See, e.g.*, United States v. Kimbell Foods, Inc., 440 U.S. 715, 728–29 (1979) (holding that absent explicit legislation, the test for determining whether a federal agency must comply with state law: (1) whether the federal program requires uniform national rules; (2) whether application of varying state laws would frustrate the federal program's objectives; and (3) whether failure to follow state law would disrupt commercial relationships that are based on state law); *cf.* Clearfield Trust Co. v. United States, 318 U.S. 363, 367 (1943) (holding that federal common law governs the dispute in the context of federal expenditure programs).

297. United States v. Carlton, 512 U.S. 26, 30–31 (1994) (internal quotation marks and citation omitted).

298. *Id.* (holding that the standard of due process under the Fifth Amendment of the Constitution is whether "the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means" (internal quotation marks and citation omitted)). The constitutionality of retroactivity would likely be raised in judicial foreclosure states because it would deprive a mortgagor of a right to a judicial proceeding that was guaranteed by state law at the time the mortgage was executed.

299. *See* Dodd-Frank Act tit. X § 1044, 12 U.S.C. § 25b (Supp. IV 2011); Dodd-Frank Act Wall Street Reform and Consumer Protection tit. X § 1046, 12 U.S.C. § 1465 (Supp. IV 2011).

of the Currency ("OCC"), which regulates national banks, had comprehensively exempted federally chartered lenders from a wide range of state laws.[300] In 2004, the OCC promulgated regulations that extended the exemptions to state-chartered subsidiaries of federal banks. In 2007, the Supreme Court, in *Watters v. Wachovia Bank, N.A.*, upheld the OCC exemptions.[301] Wachovia argued that its state-chartered subsidiary, Wachovia Mortgage, was not subject to certain state laws that were designed to prevent mortgage lending abuses.[302] The Court agreed, and reasoned that, because national banks have authority to make mortgage loans, state law does not apply whether the national bank or its state-chartered subsidiary makes the loans.[303]

The Dodd-Frank Act rolls back the scope of federal preemption of state consumer protection laws for national banks that existed following *Watters*.[304] Specifically, Title X of the Act creates a new regulator, the Consumer Financial Protection Bureau, with broad rulemaking and enforcement authority and the mandate to prevent "abusive" financial practices.[305] Within Title X, Subtitle D "Preservation of State Law," section 1044 provides limited criteria under which "state consumer financial laws" may be preempted under the Act.[306] It provides that state law is not preempted unless the state law discriminates against national banks or federal thrifts, "prevents or significantly interferes" with the institution's ability to do business, or is expressly preempted by federal law.[307] In effect, the Act adopts the Supreme Court's standard in *Barnett Bank of Marion County, N.A. v. Nelson*.[308] Section 1044 provides that

300. *See* 12 C.F.R. § 34.4(a) (2011); *Id.* § 560.2(a), (b).

301. *See* Watters v. Wachovia Bank, N.A., 550 U.S. 1, 20–22 (2007).

302. *See id.* at 9–10. The laws at issue involved the state's "visitorial power," which was defined as: "'(i) [e]xamination of a bank; (ii) [i]nspection of a bank's books and records; (iii) [r]egulation and supervision of activities authorized or permitted pursuant to federal banking law; and (iv) [e]nforcing compliance with any applicable federal or state laws concerning those activities.'" *Id.* at 14 (quoting 12 C.F.R. § 7.4000(a)(2) (2006)).

303. *See Watters*, 550 U.S. at 21–22.

304. *See id.* (recognizing the constitutionality of the broad preemptive scope of the National Banking Act and stating that "[r]egulation of national bank operations is a prerogative of Congress under the Commerce and Necessary and Proper Clauses"). The Court's decision is unaffected by the subsequent enactment of the Dodd-Frank Act and its savings clause.

305. Dodd-Frank Act tit. X § 1011, 12 U.S.C. § 5491 (Supp. IV 2011) (establishing the Bureau of Consumer Financial Protection); *id.* § 1022, 12 U.S.C. § 5512 (Supp. IV 2011) (outlining the Bureau's rulemaking authority); *id.* § 1031, 12 U.S.C. § 5531 (Supp. IV 2011) (stating that the Bureau should take action to prevent "unfair, deceptive, or abusive" financial practices).

306. Dodd-Frank Act tit. X § 1044, 12 U.S.C. § 25b(b) (Supp. IV 2011) (providing three bases under which federal law may preempt a "state consumer financial law": (1) the state law discriminates against national banks, "in comparison with the effect of the state law on a bank chartered by that State"; (2) the state law "prevents or significantly interferes with the exercise by the national bank of its powers"; or (3) the state law is preempted by some other federal law).

307. *Id.*

308. *See* Barnett Bank of Marion Cnty., N.A. v. Nelson, 517 U.S. 25, 28 (1996) (invalidating a

Title X of the Act "does not occupy the field" of any area of State law for purposes of a court's determination of conflict preemption of state law.[309]

Thereafter, Title XIV of the Dodd-Frank Act—the Mortgage Reform and Anti-Predatory Lending Act—prohibits or restricts certain mortgage lending practices, limits a lender's ability to compensate loan officers and brokers, and imposes new mandatory underwriting and servicing standards.[310] Title XIV codifies the concept of the borrower's reasonable ability to repay a home loan as a key factor in loan origination.[311] Section 1413 gives borrowers the right to defend against a judicial or non-judicial foreclosure or any other action to collect the debt, by asserting that the creditor violated the anti-steering and the ability-to-repay provisions of the Dodd-Frank Act.[312] Lenders are afforded a rebuttable presumption if they can show that a loan is a "qualified mortgage"[313] as defined in the act.[314] Broader objectives of mortgage reform are also extensively addressed in Title XIV.

In particular, Subtitle G, "Mortgage Resolution and Modification" directs the HUD Secretary to develop a program to "facilitate[e] the transfer of [at-risk multifamily] properties . . . to responsible new owners."[315] Similarly, section 1406 mandates a HUD study "to determine prudent statutory and regulatory" rules "for the widespread use of shared appreciation mortgages" as a form of mortgage modification.[316] In section 1491, the Act lists extensive Congressional "Findings" related to GSEs and their dominant role in the U.S. mortgage market, in terms of total dollar and market share.[317] Subtitle G details how, over time, the "mandated affordable housing goals" set by HUD for the GSEs changed, resulting in an increasingly larger percentage of their portfolios being

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state insurance law that prohibited national banks from selling insurance in small towns in Florida as preempted by a federal law).

309. Dodd-Frank Act tit. X § 1044, 12 U.S.C. § 25b(b)(4) (Supp. IV 2011).

310. Dodd-Frank Act tit. XIV §§ 1403, 1411, 1414, 15 U.S.C. §§ 1639b–c (Supp. IV 2011).

311. Dodd-Frank Act tit. XIV § 1411, 15 U.S.C. § 1639c (Supp. IV 2011) (in determining a consumer's ability to repay the loan, the consumer's credit history, current and expected income, expenses, debt-to-income ratio, and employment will be considered).

312. *See* Dodd-Frank Act tit. XIV § 1413, 15 U.S.C. § 1640 (Supp. IV 2011).

313. *See* Dodd-Frank Act tit. XIV § 1412, 15 U.S.C. § 1639c (Supp. IV 2011) (providing a lengthy definition of a qualified mortgage with parameters for verification of borrower's financial resources, permissible points and fees, debt to income ratios, and other regulations to be established).

314. *Id.* ("Any creditor with respect to any residential mortgage loan, and any assignee of such loan subject to liability under this title, may presume that the loan has met the requirements . . . if the loan is a qualified mortgage.").

315. Dodd-Frank Act tit. XIV § 1481, 12 U.S.C. §§ 5220b (Supp. IV 2011).

316. Dodd-Frank Act, Pub. L. No. 111-203, § 1406, 124 Stat. 1376, 2142 (2010).

317. *See* § 1491, 124 Stat. at 2205–06.

composed of subprime mortgage securities.[318] Section 1491(b) provides the "sense of the Congress that efforts to enhance . . . practices related to [mortgage] credit would be incomplete without reforms" to the GSEs.[319] Thereafter, section 1492 mandates that studies and reports be made relating to loan modification, mortgage foreclosure fraud, and education.[320] In addition, the Title mandates reporting of mortgage data[321] and increases funding for emergency mortgage relief,[322] legal aid for foreclosure-related issues[323] and for the "Neighborhood Stabilization Program."[324] Significantly, unlike Title X, there are no provisions in Title XIV that broadly limit its preemptive effect on state laws.[325] By requesting recommendations upon completion of the foreclosure-related studies, Congress signals it may enact further measures, as warranted.

XIV. Clear Need for Federal Foreclosure Act

Collectively, the findings of the many studies discussed above provide valuable information for policymakers to now consider as this foreclosure crisis continues to evolve. Many borrowers are now employing a cost-benefit analysis to decide their course of action. Borrowers with knowledge about the length to foreclose may have an incentive to use defensive tactics to delay foreclosure for an extended period of time, extracting substantial rent-free benefits from the mortgage lender.[326] More importantly, policies that increase a borrower's incentive to default will, in fact, produce more mortgage defaults. With strategic defaults on the rise, there have emerged "strategic default" consulting firms, law firms, and websites offering advice and information.[327] While there may not be a causal connection, the November 15, 2011, S&P Indices show that first mortgage default rates for October *rose* for the second consecutive month from 1.99% in September to 2.08%.[328]

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318. *Id.*
319. *Id.*
320. *See id.* § 1492, 124 Stat. at 2206.
321. *Id.* § 1493, 12 U.S.C. § 1715z-25 (Supp. IV 2011).
322. *Id.* § 1496, 124 Stat. at 2207–08.
323. *Id.* § 1498, 12 U.S.C. § 1701x-2 (Supp. IV 2011).
324. *Id.* § 1497, 124 Stat. at 2209–10.
325. *Compare id.* tit. XIV § 1400(b), 124 Stat. at 2136 (designating subtitles A, B, C, D, and §§ 1471–72, 1475–76 as being subject to the "savings" provisions of Title X), *with id.* tit. X § 1063, 12 U.S.C. § 5583 (Supp. IV 2011) (savings provision of Title X).
326. *See* Zhu & Pace, *supra* note 5, at 1–3.
327. *See, e.g.*, *Learn How to Strategically Default at StrategicDefault.org*, The Strategic Default Monitor (last visited May 30, 2012), http://www.strategicdefault.org; *see also* Les Christie, *Walk Away From Your Mortgage? Time to Get 'Ruthless'*, CNN Money (June 7, 2011), http://money.cnn.com/2011/06/07/real_estate/walk_away_mortgage/index.htm (discussing various instances of strategic defaults).
328. Maureen Maitland, *Second Consecutive Increase in First Mortgage Default Rates,*

Clearly, the financial crisis could become much worse if all 10.9 million underwater homeowners decide to default on their mortgages.

Delays in the foreclosure process that are caused by the well-intended intercession of many state and local activists will delay economic recovery and the resolution of this crisis. These delays have created uncertainty regarding the value of the mortgage assets held by financial institutions. Until the bottom of the housing market is reached and a consistent and reliable upward trajectory in housing prices is established, new housing construction will not proceed.[329] By injecting uncertainty as to when the housing market will bottom-out, foreclosure delays undermine the incentives of construction and development companies to invest.[330] This postponed investment lowers economic activity and further weakens the economic recovery.[331]

In the 1990s, Japan experienced a sharp drop in real estate prices that caused their financial system to be plagued with bad loans.[332] Japanese banks and politicians failed to deal with the problem causing the Japanese economy to suffer over a decade of slow economic growth.[333] At the time, Japanese policymakers argued that a policy of forbearance was essential to prevent a damaging real estate price crash. Japanese banks were often more supportive of problem borrowers than borrowers who were more creditworthy.[334] This policy also allowed Japanese

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HOUSINGVIEWS (Nov. 18, 2011), http://www.housingviews.com/2011/11/18/second-consecutive-increase-in-first-mortgage-default-rates.

329. *See* Dixie M. Blackley, *The Long-Run Elasticity of New Housing Supply in the United States: Empirical Evidence for 1950 to 1994*, 18 J. REAL EST. FIN. & ECON. 25, 37–38 (1999) (discussing the price elasticity of new housing supply); Christopher J. Mayer & C. Tsuriel Somerville, *Residential Construction: Using the Urban Growth Model to Estimate Housing Supply*, 48 J. URB. ECON., 85, 86–87, 105 (2000).

330. *See* Ben S. Bernanke, *Irreversibility, Uncertainty, and Cyclical Investment*, 98 Q.J. ECON. 85, 92–93 (1983) (now-Board-of-Governors-of-the-Federal-Reserve-Chairman Bernanke proposing that a temporary increase in uncertainty can cause a sudden drop in investment spending and that even a single unusual event can make investors less certain about the nature of the market, and thus cause them to adjust their behavior toward a higher degree of caution).

331. *See* Ali Anari, James Kolari & Joseph Mason, *Bank Asset Liquidation and the Propagation of the U.S. Great Depression*, 37 J. MONEY, CREDIT & BANKING 753, 760–61 (2005); Ben S. Bernanke, *Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression*, 73 AM. ECON. REV. 257, 264 (1983).

332. *See* Steve Lohr, *From Japan's Slump in 1990s, Lessons for U.S.*, N.Y. TIMES (Feb. 9, 2008), http://www.nytimes.com/2008/02/09/business/worldbusiness/09japan.html?pagewanted=1&_r=1&ei=5088&en=a0d4dac3e35e299a&ex=1360299600&partner=rssnyt&emc=rss.

333. *See id.*; Eric S. Rosengren, President & Chief Exec. Officer, Fed. Reserve Bank of Bos., Speech at the Institute of International Bankers Annual Washington Conference: Addressing the Credit Crisis and Restructuring the Financial Regulatory System: Lessons from Japan 3 (Mar. 2, 2009), *available at* http://www.bos.frb.org/news/speeches/rosengren/2009/030209.pdf.

334. *See* JIM SAXTON, JOINT ECON. COMM., RESEARCH REPORT NO. 110-30, POLICY LESSONS FROM JAPAN'S LOST DECADE 2 (2008), *available at* http://www.jec.senate.gov/republicans/public/?a=Files.Serve&File_id=9cbc8e9b-8277-44c8-b962-4bc1da97f158.

banks to avoid recognizing their losses.[335] While forbearing avoided a sharp nose dive in prices, it also created a climate of restrictive lending and ingrained cynicism where investors knew that prices were being artificially propped up.[336] There was a lingering suspicion that prices might fall in the future if (or when) more bad news emerged. A similar mindset seems to have now taken hold in the U.S., where everyday individuals are just waiting for the other shoe to drop. "Ironically, during that period, American policymakers repeatedly urged the Japanese to remove this unease, by recognising [sic] the bad loans and introducing measures to establish "clearing prices[.]"[337] Perhaps it is now time for the U.S. to heed its own advice.

This note suggests that a federal streamlined foreclosure process is critically needed and should be enacted with explicit language of Congressional intent to preempt state foreclosure-related laws. It should also define controlling law and thus provide a level playing field to achieve federal goals and assure consistent, predictable and fair mitigation and foreclosure process.

XV. Proposed Federal Foreclosure Act

The proposed Act would provide for a final non-judicial foreclosure process for all single-family "federally related mortgage loans" as that term is defined under Title 12 of United States Code.[338] The Act would expressly preempt all state foreclosure laws and would be applied retroactively to all "federally related mortgage loans," including such mortgage loans that are the subject of any pending state foreclosure proceedings.

The act should be proposed as an amendment to the Mortgage Reform and Anti-predatory Lending Act, Title XIV of the Dodd-Frank Act. The Secretary of HUD, in consultation with the Federal Housing Finance Agency (FHFA) and the Consumer Financial Protection Bureau (CFPB), shall establish a single set of uniform regulations controlling foreclosure procedures, including provisions for notice and fair hearing. The Secretary of HUD will appoint a foreclosure commissioner for the purpose of administering the foreclosure proceedings.

The Act would provide detailed prerequisites to foreclosure that would include:

335. *See id.*
336. *Id.*
337. Gillian Tett, *Housing market gridlock must be swiftly resolved*, FT.com (Nov. 4, 2010, 5:09 AM), http://www.ft.com/cms/s/0/8b371020-e834-11df-8995-00144feab49a.html#axzz2A5hjpC8F.
338. *See* Real Estate Settlement Procedures Act, 12 U.S.C. § 2602(1) (2006) (defining "federally related mortgage loan").

1.) *Default and Notice of Default*: A borrower's failure to pay the full amount of the payment due on the date it is due or a borrower's breach of any agreement set forth in the security agreement shall constitute a default. If payment is not received or the breach cured within 30 days of the default, a creditor may send a Notice of Default. Such notice would be given by personal delivery or by first class mail (sent to the last known address of record) to parties having an interest in the property subject to the mortgage being foreclosed, including:[339] owner, mortgagor, junior lien holders, parties who are in possession of the property (such as residential tenants), parties holding easement or servitude rights (such as home associations), parties with non-possessory interests in the property, persons claiming an interest in the property under a statutory lien or encumbrance created subsequent to the recording or filing of the mortgage being foreclosed. The notice would contain relevant information including: contact information of foreclosure the commissioner; the original mortgagee; the original mortgagor; street address or a description of the property sufficient to identify the property to be sold; details of default and action that must be taken to cure the default, including amount unpaid; information regarding hearing rights and rights to cure; and the date, time, and location of the foreclosure sale. A copy of the notice would also be published four consecutive weeks in a newspaper accepted as a newspaper of legal record in the county where the property being sold is located.

2.) *Right to Cure*: There will be a right to cure the default prior to the foreclosure sale. The borrower will be entitled to a forty-five (45) day period from the mailing of the Notice of Default to cure the default by taking the action to cure the default as set forth in the Notice, including paying all delinquent amounts, accumulated interest, late payment charges, plus reasonable costs and attorney fees actually incurred by the creditor. If the borrower fails to cure in the time allowed, the creditor may accelerate the entire indebtedness. The foreclosure process will terminate at any time prior to the actual sale if the default has been cured.

3.) *Right to a Hearing*: There would be a provision for a pre-foreclosure hearing prior to the foreclosure sale sufficient to satisfy Due Process. Defenses available under § 1413 of Title X of Dodd-Frank may be raised in the hearing at such time as provided under the regulations to be written. Such hearing will be available to all parties entitled to notice, such as subordinate lien holders. The commissioner will make a determination of the fact of default and whether it is lawful, under the appli-

339. *See* Mennonite Bd. of Missions v. Adams, 462 U.S. 791, 799 (1983) (holding that mortgagees have "property interest" warranting Due Process Clause notice in tax foreclosure sales).

cable contract terms, to proceed with foreclosure. The commissioner will determine whether a default exists at the time of the hearing so that the commissioner is justified in proceeding to foreclose. If no default is found, then clearly there is no basis for foreclosure.

4.) *Date and Manner of Sale*: The foreclosure sale would be held at public auction at a date, time and location as specified in the notice of default. Such date must be at least ninety (90) days after mortgagor received the Notice of Default to be established by the date on the proof of delivery. Regulations should attempt to include advertising methods to promote wider participation to increase value through competitive bidding. The Act would provide that the foreclosure sale price is conclusively deemed "fair market value" and makes the foreclosure purchaser a bona fide purchaser.[340]

5.) *Proceeds of Sale*: The foreclosure commissioner would pay the costs of foreclosure, tax liens, preservation of property costs (such as insurance and assessments), the principal, interest and charges of the mortgage being foreclosed. Any surplus proceeds of the sale would be paid first to holders of liens recorded after the mortgage in the order of priority under Federal law or the law of the State in which the security property is located with interest any balance paid to the defaulting homeowner.

6.) *Right of Redemption*: There shall be no right of redemption, or right of possession based upon a right of redemption, after the foreclosure sale has been completed.

7.) *Deficiency Judgment*: The mortgagee shall have no right to pursue or execute a deficiency judgment for the satisfaction of the indebtedness of the mortgagor that has not been satisfied by the proceeds of the foreclosure sale.

8.) *Effect of the Sale*: To assure certainty of title following the foreclosure sale, the Act would provide that a sale, conducted as prescribed, would bar all claims to the property sold for each entity to whom the notice of default and foreclosure sale was mailed and their heirs, those with actual knowledge of sale, and those claiming any interest in the property whose basis for claimed interest (i.e. assignment, mortgage) was not recorded in the proper place for recording or filing before the date on which the notice of the foreclosure sale was published.

This proposal is intended to provide sufficient notice and hearing rights to prevent causing any doubt as to validity of title passed under the statute based upon failure to satisfy constitutional requirements.

340. *Cf.* Sensenich v. Molleur (*In re* Chase), 328 B.R. 675 (Bankr. D. Vt. 2005) (holding that a provision designating "fair market value" price avoids potential challenges that the sale was a fraudulent conveyance under bankruptcy laws).

HUD has over twenty-five years of experience executing the pre-foreclosure procedures currently in place under the "Single Family Mortgage Foreclosure Act of 1994." The regulations adopted to implement the 1994 Act are elaborate and lengthy. With such experience, there should be few difficulties encountered in crafting new regulations for the proposed Act that satisfy constitutional requirements.

XVI. Post Foreclosure Disposition of Property

"An estimated 1 million or more properties will likely pass through REO inventory in 2011, with another million or so per year expected in both 2012 and 2013."[341] Recognizing the growing problem, the FHFA, along with the Treasury Department and HUD, issued an open request to all interested parties for submission of ideas or other strategies to improve the REO asset disposition programs of Fannie, Freddie, and the FHA in August 2011.[342] The objectives to be achieved included:

> reduce the REO portfolios of the Enterprises and FHA in a cost-effective manner; reduce average loan loss severities to the Enterprises and FHA relative to individual distressed property sales; address property repair and rehabilitation needs; respond to economic and real estate conditions in specific geographies; assist in neighborhood and home price stabilization efforts; and suggest analytic approaches to determine the appropriate disposition strategy for individual properties, whether sale, rental or, in certain instances, demolition.[343]

However, the FHFA request indicated that the agencies "anticipate respondents may best address these objectives through REO to rental structures."[344]

In order to establish the market bottom, a large inventory of REO properties must be liquidated. The creation of REO to rental program would only install another version of the many government strategies designed to artificially maintain house prices. It would delay housing stock from entering the market thereby creating a "shadow market" which will prolong the uncertainty that is already plaguing the market. Instead, what the housing market needs is certainty, which will stimulate investment and consumption and spur economic growth. The stated

341. Remarks by Elizabeth A. Duke, Member, Board of Governors of the Federal Reserve System, at the Federal Reserve Board Policy Forum: "The Housing Market Going Forward: Lessons Learned from the Recent Crisis," (Sept. 1, 2011), http://www.federalreserve.gov/news events/speech/duke20110901a.pdf.

342. *See* Fed. Hous. Fin. Agency et al., Request for Information: Enterprise/FHA REO Asset Disposition 1–2 (2011), *available at* http://online.wsj.com/public/resources/documents/08 1011_reo_rfi.pdf.

343. *Id.* at 1–2.

344. *Id.* at 2.

objectives outlined by the agencies can be met by adapting and employing innovative liquidation strategies as was done by the RTC during the savings and loan crisis of the 1990s.

Prior to the enactment of Dodd-Frank in 2010, the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") constituted the most significant restructuring of federal banking regulatory agencies since the 1930s.[345] Congress passed FIRREA in an effort to handle the crisis in the savings and loan industry and to prevent another financial crisis.[346] The Act created a new agency, the Resolution Trust Corporation ("RTC"), whose function was to manage all failing banks where a conservator or receiver had been appointed, as well as to manage and liquidate assets in the Federal Asset Disposition Association.[347]

Although facing a new financial crisis, the objectives that the FHFA hopes to achieve are similar to those sought by the RTC.[348] Many observers heralded the RTC as a great success.[349] In its six years of existence, the RTC resolved 747 insolvent thrifts and recovered $395 billion of the $456 billion in its charge.[350] The taxpayers' burden for the clean-up was just under $150 billion, an amount far less than many experts had predicted.[351] After only three years, the agency sold over $450 billion of real estate assets at an outstanding 86% of book value.[352] Many of the assets were difficult to dispose of, yet the RTC was able to succeed by employing many innovative strategies including bulk sales, auctions, and mortgage securitizations and shared equity ventures.[353]

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345. *See* GARY SHORTER, CONG. RESEARCH SERV., RS22959, THE RESOLUTION TRUST CORPORATION: HISTORICAL ANALYSIS 1–3 (2008) (discussing the passage of the FIRREA).

346. *See* H.R. REP. NO. 101-54, pt. 1, at 302–03 (1989), *reprinted in* 1989 U.S.C.C.A.N. 86, 98–99.

347. *See* 12 U.S.C. §§ 1441a(b)(3)–(6), 1441a(f) (1994), *repealed by* Dodd-Frank Act, Pub. L. No. 111-203, § 364(b), 124 Stat. 1376, 1555 (2010); Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, FDIC BANKING REV., 2000, at 26, 28, *available at* http://www.fdic.gov/ bank/analytical/banking/2000dec/brv13n2_2.pdf.

348. *See* § 1441a(b)(3)(C)(i)–(v) (listing goals of the RTC as (i) to "maximize[ ] the net present value return from the sale or other disposition of institutions"; (ii) to "minimize[ ] the impact of . . . transactions on local real estate and financial markets"; (iii) to "make[ ] efficient use of fund[ing]"; (iv) to minimize losses; and (v) to maximize the availability and affordability "of residential real property for low- and moderate-income individuals").

349. *See, e.g.*, Dean Foust, *Commentary: The RTC's Epitaph: It Worked*, BUSINESSWEEK (Jan. 14, 1996), http://www.businessweek.com/stories/1996-01-14/commentary-the-rtcs-epitaph-it-worked; Jeffrey Marshall, *Learning from the RTC*, 103 U.S. BANKER, Sept. 1993, at 28, 28, 37 (1993).

350. *See Foust*, *supra* note 349.

351. *See id.*; Marshall, *supra* note 349, at 28 (noting that after the agency had sold the bulk of its assets, many economists still expected costs to climb to $200 billion, or $500 billion when interest payments were factored into the calculation).

352. *See* Foust, *supra* note 349.

353. *See id.*; Marshall, *supra* note 349, at 28–29. RTC successfully assembled distressed assets

The successful disposition of REO inventory arising out of the current crisis will require a range of innovative solutions. The sheer volume of homes to contend with may be daunting. RealtyTrac reported in January 2012 that almost 1.9 million homes received about 2.7 foreclosure filings in 2011 and that it expects foreclosure activity for 2012 to be "higher than it was in 2011."[354] There have been estimates that there may be another seven million homes that will face foreclosure in the next several years.[355] The large volume of REO homes will be dispersed throughout the nation in concentrations that will vary and as a result, there will be logistical problems to overcome. There are many firms in the U.S. that have the current capability to use sophisticated analytical software to develop multiple options for the disposition of properties over time as new REOs enter the pool.

Unfortunately, unless credit is made more readily available across the spectrum of potential purchasers, these homes may end up exclusively in the hands of investors with access to private equity. Credit availability for first-time homebuyers, owner-occupied buyers, and small local investors is limited. Proposed regulations under Dodd-Frank regarding the Qualified Residential Mortgage and the Qualified Mortgage may further tighten available credit. To alleviate the credit crunch, short-term modifications to current agency programs could provide necessary backing to facilitate market-rate financing to purchase and/or rehab homes. In addition, the Fannie and Freddie restrictions limiting the number of individual homes that can be purchased by a small investor should be raised or eliminated for investors who can demonstrate a successful track record in managing multiple properties. In order to achieve the intended purpose of removing REO property from available housing inventory, the sale of any property in bulk should contain

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in large, bulk-sale packages with a mix of nonperforming mortgages and REO properties to attract institutional investors; sold assets at auctions, where the RTC contracts with professionals to market and manage the disposal of particular portfolio which allowed presenting a large number of assets to the market, while minimizing overhead costs; disposed assets through securitization, structure of each securitization transaction depended on the nature of the underlying asset, and addressed investor pessimism as to value of real estate assets by developing its own securitization model for mortgage backed securities known as Ritzy Maes. Substantial information about the risks of the underlying mortgages was disclosed and significant credit enhancement techniques were used (usually in the form of reserve funds) such that the RTC was able to attract investors. To dispose of some assets the RTC had to provide seller financing. In structuring some of these deals, the RTC would retain an equity stake so that the RTC would get a share of the up-side potential of the assets being sold. The RTC showed a great deal of flexibility in working with investors and so, overall, the RTC's resolution of the insolvent thrifts was considered a successful process by many.

354. 2011 Year-End Foreclosure Report: Foreclosures on the Retreat, REALTYTRAC (January 9, 2012), http://www.realtytrac.com/content/foreclosure-market-report/2011-year-end-foreclosure-market-report-6984.

355. Goodman, *supra* note 4, at 26.

enforceable restrictions on the resale of any included properties for a minimum of three years. This would encourage making homes available for rent by those families that have been displaced by foreclosure and would help to stabilize neighborhoods.

The use of public auctions, conducted utilizing a well-developed computer platform, could provide valuable tools to meet changing portfolio needs. Properties could be sold individually or in bulk as needed to achieve the best price. These auctions can also be nationally and locally advertised to attract more bidders and auctioned by state or region. Information regarding possible financing could be made available in print and on the auction web site. Bidders could be pre-qualified to assure certainty of execution of the purchase. Finally, any process used to dispose of REO property must include safeguards against fraud, provide for transparency, and be open to all interested and qualified buyers.

XVII. CONCLUSION

This article demonstrates that there is a clear need for an efficient, national uniform foreclosure procedure. State actions related to foreclosures are causing uncertainty in the rule of law, contract enforcement, and basic property rights. Perhaps the ultimate issue facing policy-makers is how to ensure the stable and efficient functioning of financial and economic markets to promote the general well-being of the country while protecting the interests of the individual without creating moral hazard. By balancing the interests of creditors and borrowers, a federal uniform foreclosure law will ensure fairness and return certainty to the foreclosure process, which, in turn, will bring vitality to the U.S. housing market and propel economic recovery.