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**TO:** Interested Parties

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**RE:** Fixing "Foreclosure-gate"

Late last week, Massachusetts' highest state court upheld a lower court ruling invalidating two foreclosures due to improper paperwork by banks. In its decision, the Massachusetts Supreme Judicial Court ruled that U.S. Bancorp and Wells Fargo had failed to prove they owned the mortgages when they foreclosed on two homes.

While consumer advocates are hailing the decision as a victory for borrowers, homeowners are more likely to suffer the downsides—not the benefits—from the Massachusetts ruling. This case is certain to set off a massive wave of litigation by borrowers and lawyers eager to challenge a pending foreclosure. This in turn will create tremendous uncertainty in the still-wobbly housing market: Will homebuyers who bought a home out of foreclosure worry that their purchase will be invalidated? Will prospective homebuyers get too nervous to come off the sidelines, thereby driving up inventory and driving down home values? Will some homeowners be encouraged to "strategically default" in the hopes of winning a "free house" from technically faulty paperwork?

Before "foreclosure-gate" opens the floodgates for both litigation and greater market uncertainty, policymakers need to step in with a common sense solution. As egregious as the paperwork failures were in the Massachusetts case, it would be far more damaging to the American economy if every foreclosure and every securitization were suddenly open to question.

This memo outlines a set of solutions aimed at ending the potential crisis touched off by the Massachusetts ruling. In particular, this memo proposes a series of policy ideas to achieve the following three goals:

#### 1. Protecting injured homeowners.

Homeowners who were genuinely damaged by paperwork failures deserve a fair remedy. For example, with regard to earlier controversies over "robo-signing" and other faulty practices, borrowers who were robo-signed for foreclosure despite a pending request for a modification or short sale should have their foreclosure proceedings suspended. These homeowners should instead receive an expedited review of their modification or short sale application, to be completed within 30 days. Banks should also refund any fees or other penalties levied as part of a genuinely erroneous foreclosure and be barred from seeking deficiency judgments.

#### 2. Keeping the housing market moving.

As devastating as the foreclosure crisis has been, the vast majority of Americans are facing a different kind of dilemma: how to restore the nearly \$7 trillion in housing wealth they've lost since the crisis began.<sup>2</sup> To help homeowners regain their wealth, policymakers must keep the housing market moving—including preventing unnecessary litigation that adds to borrower and investor uncertainty.

The Massachusetts decision shouldn't justify the creation of a cottage legal industry aimed at stalling inevitable foreclosures. Creating a limited safe harbor from paperwork-related litigation for pending foreclosures on abandoned or severely delinquent properties would provide more certainty to the housing market and help triage potentially successful modifications from inevitable foreclosures. In addition, a one-year statute of limitations on paperwork-related lawsuits would ensure litigation doesn't drag on for years.

#### 3. Preventing future failures.

As a result of ongoing criminal and other investigations by state attorneys' general, banks and the lawyers they worked with are likely to pay the price for their transgressions. Equally important, however, is creating safeguard to prevent future abuses. The newly-created Consumer Financial Protection Bureau (CFPB) should take the lead in creating compliance procedures and an audit system to regulate the processing of foreclosure paperwork in order to prevent widespread documentary failures.

# When the paper trail matters

The Massachusetts ruling is only the latest chapter in an ongoing saga involving paperwork failures and mortgages. Late last year, the controversy began with reports of so-called "robo-signing" by banks.

In a legal deposition that has become the smoking gun for the robo-signing phenomenon, an employee of a "foreclosure mill" in Florida admitted under oath that he signed hundreds of affidavits a day to process pending foreclosures without actually having read or checked the documents. It later came to light that this employee was not alone, and in the 23 states that require a court to approve a foreclosure, thousands of foreclosures are now potentially under question.

Without doubt, robo-signing and similar practices are sloppy, negligent and egregious. But what robo-signing and other documentary failures do *not* do—despite what some advocates claim—is nullify the right *by someone* to foreclose on a defaulted mortgage. Lenders don't forfeit their right to collect on a loan just because of faulty paperwork. If a robo-signing lender "cures" these defects, an otherwise legitimate foreclosure will proceed.

There are, in fact, two important limitations to the Massachusetts ruling that potential litigants should heed:

# The Massachusetts court did not nullify the underlying mortgage debt owed by the homeowners.

The court simply ruled that the particular foreclosing banks did not adequately show they had the contractual right to enforce the loan. The court did not foreclose the possibility of another party being able to collect on the debt if it can show it has the right to do so.

Here's a common sense version of what this means: Say that John lends Jane \$100 and writes an IOU to that effect. If John loses the IOU, Jane still owes \$100—she doesn't get to keep the cash for free. Now say that John moves to Australia and hires Bob to collect the \$100 for him. While Jane may protest that Bob lacks the legal authority to collect the loan on John's behalf, the underlying obligation still stands—she owes someone \$100. Moreover, Bob does not need to produce the original IOU to prove that he's entitled to collect on John's behalf. All he needs is a signed agreement with John "assigning" John's right to collect to Bob.

This hypothetical is actually not that different from what happened in the Massachusetts case. The banks were the equivalent of "Bob" in the preceding example, except that they did not fulfill the legal requirements necessary to act as if they had stepped into the shoes of the original lender. But nothing changes the fact that a borrower still owes the original loan, and by defaulting on a mortgage, borrowers are in breach of their original contracts. The Massachusetts case does not mean that homeowners are now entitled to a free ride on their loans.

### The Massachusetts court did not question the validity of the securitization process.

While the court questioned whether the mortgages involved in the case had been validly assigned to a securitization trust (apparently the mortgages were not included on the list of securitized loans), the court did not challenge the process of securitization itself.

Thus, the Massachusetts ruling does not validate the so-called "produce the note" phenomenon now gaining favor among some advocates, in which homeowners challenge foreclosures on the grounds that "those initiating foreclosure proceedings on behalf of securitized pools of mortgage loans had no right to do so, because they couldn't prove they actually owned the debt."

According to *The Huffington Post*, lawyers pursuing this tactic have helped some homeowners stay in their homes for as long as five years after foreclosure proceedings have begun.<sup>4</sup> As a result, there are even analyses circulating inside the financial services industry that "in order for the mortgage note to be sold or transferred to someone else (and therefore turned into a mortgage-backed security), this document has to be physically endorsed to the next person."<sup>5</sup>

Securitization is a practice that began in 1970<sup>6</sup> when the first mortgage-backed securities were issued.\* It is also specifically sanctioned under the Uniform Commercial Code (UCC), which has been adopted by all 50 states and which governs all commercial transactions including real estate. In fact, states adopted a series of revisions to the Uniform Commercial Code in 2001 precisely to clarify the legal issues surrounding the securitization of mortgage loans.<sup>7</sup> Under the UCC, physical possession of the note and the mortgage<sup>8</sup> are *not required* to enforce the loan.<sup>†</sup>

# Three steps to fixing "Foreclosure-gate"

Despite the limitations of the Massachusetts ruling, it's nevertheless likely that this decision will be construed far more broadly than it should be and could potentially encourage needless litigation on foreclosures that should not be challenged.

To date, there's been no evidence that lenders have been initiating en masse foreclosure proceedings against borrowers who are not delinquent or in default. According to Bank of America's CEO Brian Moynihan, as many as 80% of foreclosure sales in the second quarter of 2010 involved borrowers who had not made a payment in a year."

As the law makes clear, if a foreclosure proceeding is otherwise justified (i.e. the borrower isn't paying the loan), documentary failures don't nullify a lender's underlying right to a remedy. (This is why a blanket foreclosure moratorium is needless as well as harmful.)

Nevertheless, there have been reports of legitimate cases where a borrower in the process of a modification or short sale found that process short-circuited by a rubberstamped, robo-signed foreclosure—resulting in genuine harm to the borrower. Moreover, banks have undeniably engaged in irresponsible, if not reprehensible behavior, and should be held to account.

The three-step solution described below is one possible way to address genuine grievances by homeowners and bring lenders into compliance, while at the same time promoting more certainty in the markets.

<sup>\*</sup> A related set of misunderstandings underlies the problem with MERS, the electronic mortgage registry that has also come under question complicating the question of legal title. This is a separate issue that will be addressed in a later memo.

<sup>&</sup>lt;sup>†</sup> In legalese, Section 309(4) of Article 9 of the UCC provides that in the case of sales of promissory notes, the security interest in those notes is automatically "perfected" upon "attachment." This means that the execution of a valid sales agreement to sell the note is all that's needed to transfer the obligation—the buyer of the notes doesn't also need to gain possession of the notes to "perfect" a security interest (i.e. make it enforceable). Nor does the buyer of a note need to gain possession of the underlying mortgage to have an enforceable obligation. Under Section 203(b) of the UCC, whomever holds an interest in the note also essentially holds the mortgage (a doctrine called "the mortgage follows the note").

## **Step 1: Protecting injured homeowners**

Rather than a blanket moratorium, we propose a "surgical intervention" aimed specifically at five categories of borrowers who suffered real harm from a robo-signed or slipshod foreclosure:

- Mistaken foreclosures. These are borrowers who have been current on their mortgage payments and against whom a foreclosure proceeding should never have been filed.
- **Pending modifications.** These are borrowers who had previously requested a modification but essentially lost their chance at a modification because of a robo-signed foreclosure.
- Pending short sales. These are borrowers who were in the process of having a short sale of their home approved but lost their chance at an approval because of a robo-signed foreclosure. In most cases, when presented with the option of approving a short sale or going through with foreclosure proceedings, time and costs would dictate the former be the most logical outcome.
- **Borrowers catching up.** These are borrowers who may have been delinquent on their mortgage but who made a payment and were foreclosed on anyway because of a faulty process that failed to take that payment into account.

These aggrieved borrowers should be entitled to four things: (1) the immediate suspension of foreclosure proceedings; (2) the right to sue for actual damages caused by a wrongful signed foreclosure; (3) access to a 30-day expedited application process for loan modification if they have an application pending (but without a guarantee the modification will be granted); and (4) a refund of any fees and charges assessed by the bank, as well as protection from any deficiency judgments (if a borrowers was seeking a modification or short sale).

Ideally, banks should step up to deliver the remedies described above in (1), (3) and (4). But in the absence of proactive action by the banks, the newly created Consumer Financial Protection Bureau (CFPB), together with the Federal Housing Administration and HUD, might be well-suited to take on the task of regulating and enforcing this expedited review process.<sup>‡</sup>

# Step 2: Keeping the housing market moving

The potential existence of thousands of foreclosures with faulty paperwork could prove to be a litigation bonanza—but one that in many cases only forestalls the inevitable while creating continued uncertainty for buyers and investors. In fact, the threat of continued litigation could hamper the housing market significantly:

<sup>&</sup>lt;sup>†</sup> As a future paper will address, this process could provide a new model for standardizing and "triaging" candidates for modification so that borrowers with the best chance of a successful modification move quickly through the process

- Buyers may be reluctant to buy a foreclosed property if they are concerned the foreclosure could be challenged and their purchase nullified;
- Title insurers may refuse to issue policies or raise their premiums if they are concerned that a challenged foreclosure could cloud the title on a future sale; and
- Investors in mortgage-backed securities may demand higher premiums (which will eventually result in higher interest rates for borrowers) to compensate for the risk of litigation.

To bring clarity and certainty to the market, Congress should enact the following: (1) a "safe harbor" barring paperwork-related litigation on certain foreclosures; and (2) a statute of limitations to limit the time period in which suits can be brought.

#### Safe Harbor

This proposal would be similar to that offered up by Federal Deposit Insurance Corporation (FDIC) Chair Sheila Bair, who recently proposed the notion of a safe harbor. Specifically, Bair proposed that foreclosures be allowed to proceed "if the property is vacant or if the lender/servicer offered a meaningful payment reduction — say a minimum of 25%—and the borrower could still not perform on the loan." Following similar reasoning, Congress could enact a safe harbor barring lawsuits to challenge foreclosures in two circumstances where a delay would be especially fruitless—in the case of vacant or abandoned homes, and in the case of loans that have been in default for 18 months or more.

No foreclosure challenges on vacant or abandoned homes. According to news reports, one in three homes in the process of foreclosure is vacant.<sup>11</sup> Processing foreclosures on vacant homes is essential to restoring the housing market. In the second quarter of 2010, as many as 18.9 million homes stood vacant.<sup>12</sup>

Vacant homes are not only drains on local municipalities such as police and fire resources while offering no tax revenue to the burdened communities; they attract crime and depreciate home values via urban blight. As housing expert Allan Mallach notes, "...it is critical to understand that even one vacant, boarded-up property can undermine the vitality of an entire city block." One study found, for example, that "the presence of an abandoned house on a block reduces the value of all the other property by an average of \$6,720." (This study, however, was in 2001, and it's likely that the damage done today by a vacant home in the neighborhood far exceeds that amount.)

Borrowers on vacant homes (many of whom have likely "strategically defaulted" and walked away) should not be allowed to challenge a foreclosure so that a vacant home stays vacant still longer and can't be returned to the available housing stock.

No foreclosure challenges on severely defaulted loans. Borrowers who defaulted 18 months ago and have not cured are people who will likely never catch up on their mortgage. These borrowers might be facing a payment that they simply cannot afford under any circumstances, or they may be suffering from a prolonged bout of unemployment. They may also have opted for a strategic default. These borrowers also belong in the category of an "inevitable" foreclosure that a lawsuit will not ultimately prevent.

#### Statute of Limitations

In addition to the safe harbor, Congress should enact a 12-month statute of limitations<sup>§</sup> for when a paperwork-related lawsuit can be filed. (In the 23 states where a court must approve a foreclosure, the "clock" on the statute of limitations would begin to run from the date that a homeowner received notice of an approved foreclosure proceeding.)

This time period is long enough both to provide ample opportunity for injured parties to file legitimate lawsuits against the banks while also giving investors and buyers a deadline for certainty. It is also long enough to give banks enough time to accommodate modifications and approve short sales but not so short that banks can simply wait out the problem and fail to act on improving their procedures.

### **Step 3: Preventing future failures**

A limited safe harbor provision, subject to the conditions mentioned, is both necessary and justified to prevent unnecessary litigation from bringing the housing market to a halt.

What it emphatically does *not* do is shield bad actors from the consequences of their behavior. A safe harbor and statute of limitations will do nothing to protect banks and their lawyers from the investigations currently underway by state attorneys' general across the country. Nor will it prevent disbarment and other consequences that are likely to be suffered by lawyers at the "foreclosure mills" at the heart of the robo-signing scandal. The now infamous firm headed by David J. Stern in Florida, for example, "has seen its fortunes plummet, with major clients, like Fannie Mae, Freddie Mac, and Citigroup, cutting ties to Stern. Stern's operation has also laid off hundreds of employees in recent weeks." 16

While regulators ensure that bad actors get their just desserts, they should also focus on improving future paperwork compliance. The CFPB, for example, should consider creating standardized guidelines for ensuring "due diligence" in the foreclosure process that comports with state-specific requirements. Such standardization may actually benefit the banks by making foreclosures proceed more smoothly. By ensuring that the paperwork was right the first time, foreclosures will be less likely to be challenged or challenged successfully.

#### Conclusion

Banks, investors, homebuyers and regulators all bear some share of the blame for the circumstances that created the housing bubble to begin with and that led to the

<sup>§</sup> Precedents for a one-year statute of limitations include Section 13 of the Securities Act of 1933, which limits civil claims brought under Sections 11 and 12(a)(2) to one year after the discovery of a false or misleading statement in a prospectus. Given the acute amount of scrutiny that robo-signing is receiving, it's unlikely that a currently delinquent homeowner in the process of foreclosure would wait a year to challenge the paperwork.

eventual crisis. The current controversy over paperwork is likely only the beginning of the eventual problems the housing industry will face as it "deleverages" the excesses of the bubble years.

The three-step solution above attempts to fairly allocate responsibility among all parties while advocating pragmatic steps that will move the housing market back to health as quickly as possible.

#### **Endnotes**

<sup>1</sup> See, for example, Thom Weidlich, "Banks Lose Pivotal Foreclosure Case in Massachusetts High Court," *Bloomberg*, January 7, 2011, Accessed January 10, 2011. Available at: <a href="http://www.bloomberg.com/news/2011-01-07/us-bancorp-wells-fargo-lose-pivotal-massachusetts-foreclosure-case.html">http://www.bloomberg.com/news/2011-01-07/us-bancorp-wells-fargo-lose-pivotal-massachusetts-foreclosure-case.html</a>.

- <sup>2</sup> Rex Nutting, "Housing is the forgotten crisis", *MarketWatch*, December 15, 2010, Accessed January 10, 2011. Available at: <a href="http://www.marketwatch.com/story/housing-is-the-forgotten-crisis-2010-12-15">http://www.marketwatch.com/story/housing-is-the-forgotten-crisis-2010-12-15</a>.
- <sup>3</sup> Shahien Nashiripour and Ryan Grim, "Who Owns Your Mortgage? 'Produce the Note' Movement Helps Stall Foreclosures," *The Huffington Post*, June 17, 2010, Accessed October 29, 2010. Available at: <a href="http://www.huffingtonpost.com/2009/09/22/whos-got-the-mortgage-pro">http://www.huffingtonpost.com/2009/09/22/whos-got-the-mortgage-pro</a> n 294169.html.
  - <sup>4</sup> Ibid.
- <sup>5</sup> This quote was taken from the text of an email forwarded to the authors that has received wide circulation inside the financial services industry. The original author is unknown.
- <sup>6</sup> United States, Congress, House of Representatives, Subcommittee on Housing and Community Opportunity, Subcommittee on Financial Institutions and Consumer Credit, "Hearing on Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit," Statement of Cameron Cowan on behalf of the American Securitization Forum, 108th Congress, 1<sup>st</sup> Session, November 5, 2003, Accessed January 10, 2011. Available at: <a href="http://www.riskcenter.com.tr/risknews/risknewsfiles/gls14.pdf">http://www.riskcenter.com.tr/risknews/risknewsfiles/gls14.pdf</a>.
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- <sup>8</sup> For a primer on title law, see for example, Karen Gelernt, "Viewpoint: Title Transfer Law 101," *American Banker*, October, 19, 2010, Accessed January 10, 2011. Available at: <a href="http://www.cadwalader.com/assets/article/101910GelerntAmericanBanker.pdf">http://www.cadwalader.com/assets/article/101910GelerntAmericanBanker.pdf</a>.
- <sup>9</sup> "On the Call: Bank of America CEO Bryan Moynihan," *Associated Press,* October 19, 2010, Accessed November 1, 2010. Available at: <a href="http://abcnews.go.com/Business/wireStory?id=10397888">http://abcnews.go.com/Business/wireStory?id=10397888</a>.
- <sup>10</sup> Ronal D. Orol, "Bair backs "safe harbor" plan on foreclosures," *The Wall Street Journal*, Market Watch, October 25, 2010, Accessed November 2, 2010. Available at: <a href="http://www.marketwatch.com/story/bair-backs-safe-harbor-plan-on-foreclosures-2010-10-25">http://www.marketwatch.com/story/bair-backs-safe-harbor-plan-on-foreclosures-2010-10-25</a>.
- <sup>11</sup> Stephen Meister, "Foreclosure-Gate is Quickly Spinning out of Control," *Real Clear Markets*, October 22, 2010, Accessed November 1, 2010. Available at: <a href="http://www.realclearmarkets.com/articles/2010/10/22/foreclosure-gate">http://www.realclearmarkets.com/articles/2010/10/22/foreclosure-gate is quickly spinning out of control.html</a>.
- <sup>12</sup>United States, Department of Commerce, Census Bureau, "Residential Vacancies and Homeownership in the Second Quarter 2010," *U.S. Census Bureau News*, July 27, 2010, Accessed October 14, 2010. Available at: <a href="http://www.census.gov/hhes/www/housing/hvs/qtr210/files/q210press.pdf">http://www.census.gov/hhes/www/housing/hvs/qtr210/files/q210press.pdf</a>.
- <sup>13</sup> Alan Mallach, "How to Spend \$3.92 Billion: Stabilizing Neighborhoos by Addressing Foreclosed and Abandoned Properties," *Discussion Papers*, Federal Reserve Bank of Philadelphia, October 2008, Accessed November 2, 2010. Available at: <a href="http://philadelphiafed.org/community-development/publications/discussion-papers/DiscussionPapers">http://philadelphiafed.org/community-development/publications/discussion-papers/DiscussionPapers</a> Mallach 10 08 final.pdf.

<sup>&</sup>lt;sup>14</sup> "Blight Free Philadelphia: A Public-Private Strategy to Create and Enhance Neighborhood Value," Executive Summary, Eastern Pennsylvania Organizing Project and The Temple University Center for Public Policy, October 2001, p. iv, Accessed November 2, 2010. Available at: <a href="http://astro.temple.edu/~ashlay/blight.pdf">http://astro.temple.edu/~ashlay/blight.pdf</a>.

<sup>&</sup>lt;sup>15</sup> Dawn Wotapka, "UPDATE:50 State Attys General Investigate Mortgage Servicers," *The Wall Street Journal*, Dow Jones Newswires, October 13, 2010, Accessed January 11, 2011. Available at: <a href="http://online.wsj.com/article/BT-CO-20101013-710815.html">http://online.wsj.com/article/BT-CO-20101013-710815.html</a>.

<sup>&</sup>lt;sup>16</sup> Andy Kroll, "Inside Foreclosure King David Stern's Downfall," Mother Jones, November 4, 2010, Accessed January 10, 2011. Available at: <a href="http://motherjones.com/mojo/2010/11/david-stern-foreclosure-djsp-enterprises">http://motherjones.com/mojo/2010/11/david-stern-foreclosure-djsp-enterprises</a>.