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Legal and Policy Choices in the Aftermath of the Subprime and Mortgage Financing Crisis

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LEGAL AND POLICY CHOICES IN THE AFTERMATH OF THE SUBPRIME AND MORTGAGE FINANCING CRISIS

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"Turned wrong way round, the relentless unforeseen was what we schoolchildren studied as 'History,' harmless history, where everything unexpected in its own time is chronicled on the page as inevitable. The terror of the unforeseen is what the science of history hides, turning a disaster into an epic."[1]

I. INTRODUCTION

As I write this Essay in mid-October 2008, the world is struggling through a mortgage financing crisis that has grown into overall financial turmoil. Unlike the historian analyzing the past, we do not have the benefit of a retrospective lens, nor do we have the comfort of knowing how this story will end (hopefully well). Rather, the markets and the legal and policy reactions change by the day if not by the hour; the situation and the best thinking on how to navigate it will surely shift from the time that I write this, to the time that it is published, to the time it is read.

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1. PHILIP ROTH, THE PLOT AGAINST AMERICA 113–14 (2004) (emphasis added).

In this Essay, I will suggest some issues and questions that are emerging in the crisis from my perspective as a real estate transactions professor and scholar for almost thirty years. In these early days, this Essay cannot provide a complete description of the overall problem and its ramifications. Moreover, a few things that we have come to learn the hard way are the almost unimaginable scope of the crisis, the interconnectedness of sectors of the economy that were not previously considered to be interdependent, and the ongoing outbreaks of new firestorms in particular industries and firms. When talking about the financial crisis, commentators often resemble the proverbial blind man describing the elephant—able to venture a hypothesis only about the small area within his grasp. Perhaps with time, we might be able to stitch these varied and competing descriptions into more comprehensive narratives (which will then be challenged and rewritten).

I will address two broad issues in this Essay. The first—the regulation of mortgage lending and markets as we go forward—is already well under debate. Second, I will focus in greater detail on the law of mortgages in the aftermath of the financial crisis. The questions I will discuss here may not be well known but are important to our real estate markets and system. While mindful of the enormity of the issues inherent in the financial crisis, the constantly shifting terrain, and Roth's admonition on living through history,[2] I will offer some thoughts for legislators, judges, regulators, and market players on how they might consider and resolve some aspects of the crisis.

II. REGULATION OF MORTGAGE LENDING AND MARKETS

What was first called the subprime crisis became a meltdown in mortgage financing and in the secondary markets for mortgages, and ultimately became a worldwide, general financial problem.[3] The story began with the making of subprime mortgages—residential mortgage loans to borrowers who did not qualify for a loan on usual terms under traditional underwriting and credit standards.[4] Subprime loans carried a higher interest rate than conventional loans, presenting a profitable revenue opportunity for the mortgage lending community.[5] Federal legislation—primarily the Community Reinvestment Act

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2. *Id.*

3. There may be differing versions of the narrative; like so much in the crisis, there are conflicting stories based on incomplete information and differing world views.

4. *See* Richard D. Marsico, *Subprime Lending, Predatory Lending, and the Community Reinvestment Act Obligations of Banks*, 46 N.Y.L. SCH. L. REV. 735, 735 (2002–2003). To compensate for the risk of these loans, lenders typically charge higher rates of interest. *See* Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 533 (2000).

5. *See* Mansfield, *supra* note 4; Marsico, *supra* note 4.

(CRA)—encouraged lending to lower-income borrowers to promote home ownership and the establishment of credit.[6] The data indicate, however, that CRA cannot be blamed for the current subprime crisis: most subprime loans were not made by CRA lenders (perhaps 20% were),[7] and legislation passed in 1977 could not logically have suddenly caused a crisis thirty years later—if the CRA were the problem, why wasn't there a subprime crisis years ago?[8]

In a typical scenario, subprime loans (like "prime" mortgage loans to borrowers who qualified under traditional underwriting standards) were originated by mortgage brokers and mortgage companies, purchased by local banks, and sold by local banks to investment banks. Thus, the mortgage brokers, mortgage companies, and local banks received a full return on their capital to lend again locally and also earned income on fees paid by each purchaser of the loan up the chain.

The investment banks then issued securities, typically bonds, representing the right to receive certain payments under the mortgages, usually slicing the right to receive portions of the income and principal payments into various tranches. Investment banks had rating agencies attest to the quality of the bonds—with the investment banks paying the rating agencies' fees—and the investment banks then sold the bonds to investors. The investors held or traded these mortgage-backed securities in an active market. Some investors sought to secure the payment of the mortgage bonds and hedge their risk; as a result, some insurance companies entered into credit-default swaps with the bondholder that guaranteed, in return for a premium payment, that the insurance company would pay the bond if the issuer defaulted.[9]

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6. *See* Sally Pittman, *ARMS, but No Legs to Stand on: "Subprime" Solutions Plague the Subprime Mortgage Crisis*, 40 TEX. TECH L. REV. 1089, 1092–93 (2008) (citing Souphala Chomsisengphet & Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, 88 FED. RES. BANK ST. LOUIS REV. 31, 31–32 (2006), *available at* http://research.stlouisfed.org/publications/review/06/01/ChomPennCross.pdf).

7. Issue Brief, Ctr. for Responsible Lending, CRA Is Not to Blame for the Mortgage Meltdown (Oct. 3, 2008), http://www.responsiblelending.org/pdfs/cra-not-to-blame-for-crisis.pdf; Daniel Gross, *Are Minorities to Blame for the Subprime Mess?*, NEWSWEEK, Oct. 7, 2008, http://www.newsweek.com/id/162789; Posting of Aaron Pressman to Investing Insights, http://www.businessweek.com/investing/insights/blog/archives/2008/09/community_reinv.html (Sept. 29, 2008). Loans not made by depository institutions (e.g., mortgage brokers and mortgage banks) are not within the CRA. *See, e.g.*, Marsico, *supra* note 4, at 738 (discussing the assessment areas in which a given bank is evaluated for CRA compliance); John Taylor & Josh Silver, *The Community Reinvestment Act at 30: Looking Back and Looking to the Future*, 53 N.Y.L. SCH. L. REV. 203, 210–11 (2008–2009) (same).

8. *See* Marsico, *supra* note 4; Taylor & Silver, *supra* note 7.

9. *See generally* John P. Doherty & Richard F. Hans, *The Pebble and the Pool: The (Global) Expansion of Subprime Litigation*, *in* Thomson–West, FIRST FOCUS: THE SUBPRIME CRISIS (2008) (providing an overview of the different kinds of lawsuits, including contractual disputes over credit default swaps, brought by various entities against investment banks); Gretchen Morgenson, *First*

During the first years of securitization, packagers could issue bonds based on local banks' inventories of prime mortgages. These borrowers rarely defaulted, and the bonds had low risk. As demand for mortgage-backed securities grew, and the bundles required more mortgages, investment banks and local banks lowered their underwriting standards for borrowers.[10] Income, credit, and employment standards were lowered significantly, and verification requirements were reduced.[11] Mortgage brokers committed fraud independently and often encouraged and abetted fraud by borrowers.[12] More and more subprime mortgages were being sold on the secondary market through securities.[13]

Still, the arrangement worked fine. Then came the mid-2000s when borrowers began defaulting on mortgage loans.[14] This occurred for a variety of reasons: many of the latest borrowers were financially unsound and were soon unable to make the payments;[15] low initial teaser rates of interest (offered by the banks on variable rate mortgages to attract borrowers) expired and were reset at higher rates;[16] and the real estate market plateaued or even declined, so

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Comes the Swap. Then It's the Knives., N.Y. TIMES, June 1, 2008, at B1 (discussing litigation between UBS and Paramax Capital over a credit default swap that signifies the riskiness of such transactions).

10. Brooke Masters & Saskia Scholtes, *Payback Time*, FIN. TIMES, Aug. 9, 2007 (quoting Chairman of the Federal Reserve Ben Bernanke that "[t]he recent rapid expansion of the subprime market was clearly accompanied by deterioration in underwriting standards"). There is evidence that the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) played a limited role in the weakened underwriting standards, with the impetus largely coming from private lending sources. David Goldstein & Kevin G. Hall, *Private Sector Loans, Not Fannie or Freddie, Triggered Crisis*, MCCLATCHY NEWSPAPERS, Oct. 12, 2008, http://www.mcclatchydc.com/251/story/53802.html. The U.S. Department of Housing and Urban Development (HUD) has been criticized for its role in the subprime problem. *See, e.g.*, Carol D. Leonnig, *How HUD Mortgage Policy Fed the Crisis: Subprime Loans Labeled 'Affordable'*, WASH. POST, June 10, 2008, at A1 ("In 2004, as regulators warned that subprime lenders were saddling borrowers with mortgages they could not afford, the U.S. Department of Housing and Urban Development helped fuel more of that risky lending.").

11. *See, e.g.*, Masters & Scholtes, *supra* note 10 ("The recent rapid expansion of the subprime market was clearly accompanied by deterioration in underwriting standards.").

12. *Id.*

13. *See* Goldstein & Hall, *supra* note 10.

14. *See, e.g.*, Gretchen Morgenson, *Can These Mortgages Be Saved?*, N.Y. TIMES, Sept. 30, 2007, at B1 (reporting that in August 2007, foreclosure filings "soared to almost 244,000, up 36 percent from the previous month and more than double the number in August 2006").

15. *See, e.g.*, Ctr. for Responsible Lending, *supra* note 7 ("Because lenders used artificially low initial payments and passed the loans onto investors while hiding the disastrous consequences coming down the line, many borrowers found themselves in loans that were ultimately unaffordable.").

16. *See id.*

borrowers could not refinance their way out of trouble.[17] Lenders began foreclosing, and properties did not sell well—or eventually at all—in the depressed and saturated market. Payments to bondholders were interrupted, values of the bonds in markets plunged out of fear of problems with the underlying mortgages, investors experienced sharp declines in the value of their mortgage bond holdings, bond issuers were under pressure, and credit-default swap guarantors lacked adequate cash to pay off the claims for the many defaulted bonds.[18] Also, mortgage lending and secondary market transactions effectively stopped.[19] The crisis then rippled from the secondary mortgage markets to the broader financial sector, and from the United States to the world.[20]

Commentators, polemicists, and politicians are already arguing over whom or what should be held responsible for the mortgage and secondary market crisis. We have heard various—and sometimes competing—theories: "deregulation"[21] and "too much regulation;"[22] "greed,"[23] "irresponsibility"—if not fraud—by many who were involved[24] (perhaps mortgage brokers, borrowers, lenders, "Wall Street," investors, and rating agencies); too much

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17. Anthony Lendez & David Hille, *Is There a Legal Defense to the Mortgage Mess?: Litigation Arising from the Subprime Market Collapse Will Hinge on Lenders' Good Faith*, NAT'L L.J., Apr. 21, 2008, at S1, S7.

18. *See* Gretchen Morgenson, *Behind Biggest Insurer's Crisis, a Blind Eye to a Web of Risk*, N.Y. TIMES, Sept. 28, 2008, at A1; Mary Williams Walsh, *Insurance on Lehman Debt is the Industry's Next Test*, N.Y. TIMES, Oct. 11, 2008, at B1.

19. *See, e.g.*, Bob Tedeschi, *Ripples from the Subprime Storm*, N.Y. TIMES, Mar. 25, 2007, § 11, at 13 ("The subprime mortgage industry . . . ha[s] either stopped lending or has limited the conditions under which they will lend to subprime borrowers.").

20. *See, e.g.*, Mark Landler, *Deutsche Bank Posts Quarterly Loss, Evidence of the Reach of the Financial Crisis*, N.Y. TIMES, Apr. 30, 2008, at C10 ("Deutsche Bank's loss, analysts say, is . . . a sign of how far the financial crisis has spread beyond its roots in the American mortgage market.").

21. *See, e.g.*, Adam Nagourney, *Economic Woes Set Tone for Rivals in 2nd Debate*, N.Y. TIMES, Oct. 7, 2008, at A1 (quoting President Barack Obama, "'Let's, first of all, understand that the biggest problem in this whole process was the deregulation of the financial system.'").

22. *See, e.g.*, Floyd Norris, *Proceed With Care, Mr. Obama*, N.Y. TIMES, Nov. 6, 2008, at B1 ("[T]here may well have been too much regulation of some markets and some activities of financial institutions—regulation that encouraged and accelerated the growth of a parallel unregulated financial system.").

23. *See, e.g.*, David Stout, *"Headed Out of Town," Bush Turns Reflective*, N.Y. TIMES, Dec. 19, 2008, at A32 (discussing President Obama's "assertions that 'Bush deregulation' had led to a culture of recklessness and greed on Wall Street.").

24. *See, e.g.*, Andrew E. Kramer, *Moscow Says U.S. Leadership Era is Ending*, N.Y. TIMES, Oct. 3, 2008, at A6 ("Prime Minister Vladimir V. Putin made a speech about what he called American financial 'irresponsibility' on Wednesday, blaming non-Russian causes for Russia's stock plunge of more than 50 percent.").

money chasing too few good deals[25] (with the result that poor mortgage investments were sold and bought); "predatory" business practices by lenders;[26] and on and on. Historians and economists will eventually weigh in with more sober and long-term views. However, government officials, legislators, judges, and market participants are making decisions daily based on their best conceptions of reality.

There have been bipartisan calls for increased regulation of the markets.[27] The great unknowns, of course, are the terms and the nature of the regulation. Care must be taken to correct the abuses but not to choke the functioning of the markets. Furthermore, some solutions must be left to the markets themselves. Let me suggest some factors that must be on the table in the search for a solution:

Secondary Market. The secondary market for mortgages has generated capital for residential as well as commercial mortgages in areas of the United States lacking adequate local funding and has provided a market mechanism for efficient capital transactions.[28] Funding through the secondary market has enabled first time buyers to acquire homes. This beneficial mechanism needs to be preserved.

Globalization. Mortgage capital markets have become global and interconnected. We cannot and should not want to turn back the clock on this reality. Globalization can bring great benefits, though it also brings risk. This dynamic must be understood.

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25. *See, e.g.*, Carol D. Leonnig, *AIG to Pay Millions to Top Workers*, WASH. POST, Nov. 14, 2008, at D1 ("AIG's troubles stem from bad bets it made guaranteeing and buying risky mortgage investments.").

26. *See, e.g.*, Eric Lipton & Stephen Labaton, *A Deregulator Looks Back, Unswayed*, N.Y. TIMES, Nov. 17, 2008, at A1 ("[Former senator Phil Gramm] led the effort to block measures curtailing deceptive or predatory lending, which was just beginning to result in a jump in home foreclosures that would undermine the financial markets.").

27. *See, e.g.*, Jackie Calmes, *Both Sides of the Aisle See More Regulation, and Not Just of Banks*, N.Y. TIMES, Oct. 13, 2008, at A15 ("Democrats, who typically have been on the defensive in recent decades as the more pro-regulatory party, now are playing offense. . . . Yet Republicans, led by Mr. McCain, are promising that they, too, will support toughened government regulations."); Stephen Labaton, *S.E.C. Concedes Oversight Flaws Fueled Collapse: Deregulation Faulted*, N.Y. TIMES, Sept. 27, 2008, at A1 (quoting Securities and Exchange Commission Chairman Christopher Cox, "'The last six months have made it abundantly clear that voluntary regulation does not work.'").

28. *See* Edward L. Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 NOTRE DAME L. REV. 497, 501 (1989) ("[M]ore efficient means have been developed to assist private issuers in placing their mortgage securities in the secondary market."); David Alan Richards, *"Gradable and Tradable": The Securitization of Commercial Real Estate Mortgages*, 16 REAL EST. L.J. 99, 103 (1987) ("The residential secondary mortgage market . . . has two main functions: (1) redirecting capital within the traditional housing finance system, and (2) shifting capital from the general capital market to the housing finance system.").

Fraud and Predatory Lending. Regulation, legislative and political doctrines imposing liability, and criminal sanctions to counteract fraud in the marketplace should be aggressively used. Fraud is antithetical to the contracting paradigm and destroys the premise and efficiency of the markets.[29] Conflicts of interest, such as when bond issuers pay fees to supposedly neutral rating agencies, must be addressed. Moreover, predatory lending laws need to be enforced and, where appropriate, expanded.[30]

Personal Responsibility v. Paternalism. The right balance must be struck between personal responsibility and benevolent paternalism in adjudicating particular disputes and also in setting the ground rules for the overall system. This is a tricky task as there are strong views, many variables, and numerous individual players that these concepts affect. Society also has a stake because, as a group, we may not wish to tolerate the cost and fallout of an unregulated market system, even if some individuals may be willing. And, there is the moral hazard of bailouts, present and future, that may encourage undesirable actions by market participants at all levels. Consider these examples: How would an outright ban on subprime mortgages affect those with poor credit histories who could only qualify for a nonconventional mortgage and who have been successful in paying off the mortgages and thus acquiring a first home?[31] Or, if the premise of hedge funds is that they are for high net worth individuals who can afford to make riskier investments for a higher reward, can we justify bailouts—and on what terms—of such entities because of the national interest in the banking system?

Government, Markets, and Federalism. Some longstanding philosophical questions will have real world consequences: What should be subject to government regulation as opposed to market discipline? Is market regulation a

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29. *See, e.g,* David Cho, *Housing Boom Tied to Sham Mortgages: Lax Lending Aided Real Estate Fraud*, WASH. POST, Apr. 10, 2007, at A1 ("Using inflated appraisals and other doctored papers . . . [s]ome home prices were inflated by 100 percent or more.").

30. For discussions on predatory lending issues, see generally *In re First Alliance Mortgage Co.*, 471 F.3d 977, 991–92 (9th Cir. 2006) (finding class-wide fraud by a bankrupt subprime lender); Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1317–66 (2002) (suggesting that the doctrine of "suitability" be imported into the law of predatory lending); David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 1023–53 (2006) (outlining existing remedies for predatory lending); Joshua Michael Stolly, Comment, *Subprime Lending: Ohioans Fall Prey to Predatory Lending at Record Levels—What Next?*, 34 OHIO N.U. L. REV. 289, 299–309 (2008) (listing several federal and state responses to predatory lending).

31. For example, a Massachusetts statute does not ban subprime loans but requires the borrower to receive counseling from a certified third party as to the advisability of the loan. MASS. GEN. LAWS ANN. ch. 184, § 17B 1/2 (West Supp. 2008).

federal matter, a state matter, or both? From where should reforms come—the legislature, the administrative agencies, or the courts?

Racial Discrimination. Racial minorities received a disproportionate number of subprime loans—compared to conventional loans—which has had a devastating effect on minority and inner-city communities.[32] Courts[33] and legislators will need to address discrimination in lending decisions. Moreover, the negative impact of subprime lending on particular neighborhoods and communities will require comprehensive legislative and regulatory responses.

The Federal Government. What is the role of the federal government in the housing market, especially after the conservatorship of Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac)? Is the government the home lender of last resort? What are the costs and benefits of that status? How will this work? Will this be better than the confused, ambiguous role of Fannie Mae and Freddie Mac pre-conservatorship, where the companies had the dual loyalty of serving their shareholders and the public and where the extent of the federal "guarantee" of their activity was opaque? And, of course, how will the government buyout of poorly performing mortgage securities work out?

Intermediation. There were many intermediaries involved in the secondary market process—mortgage brokers, local lenders, regional lenders, investment bankers, rating agencies, servicers, mortgage purchasers, mortgage repurchasers, and so on. Moreover, loans were sliced and repackaged into different tranches, splitting apart various rights of the mortgage. To the extent that intermediation has served to insulate players from responsibility or to obscure liability for their actions, legislation and regulation is needed. The complexity of the instruments, with buyers not knowing what they were getting, also led to bad business decisions. The market is now punishing the "smartest guys in the room" who failed to declare that the emperor had no clothes.[34] Borrowers and investors need to better understand the costs and benefits of the

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32. *See, e.g.*, GREGORY D. SQUIRES, ECON. POLICY INST., DO SUBPRIME LOANS CREATE SUBPRIME CITIES?: SURGING INEQUALITY AND THE RISE OF PREDATORY LENDING 4 (2008), http://www.sharedprosperity.org/bp197/bp197.pdf (stating that people of color have been disproportionally represented in the subprime market as opposed to the conventional mortgage market).

33. *See, e.g.*, M & T Mortgage Corp. v. Foy, 858 N.Y.S.2d 567, 568 (Sup. Ct. 2008) (holding that a mortgage creates a rebuttable presumption of discrimination when it carries an interest rate exceeding 9% and is granted to a minority buyer for the purchase of property in a minority area).

34. *See, e.g.*, Peter S. Goodman, *The Free Market: A False Idol After All?*, N.Y. TIMES, Dec. 30, 2007, § 4, at 4 (describing banks "who, only a year ago, were being lauded for creativity," but who are now "writ[ing] off vast sums of money"); Nelson D. Schwartz, *Uncharted Territory Led to a New Kind of Crisis*, N.Y. TIMES, Sept. 20, 2008, at C6 (stating that traders "may not have fully understood what they owned and traded").

intermediated system—the possible upshot may be the market alternative of disintermediated and less opaque loans.

Home Ownership. Home ownership has long been a part of the American dream. Is this ideal still valid today?[35] How can this be achieved most fairly and efficiently? What is the role of the individual and government in making this ideal a reality?

Risk Shifting. The market systems for spreading the risk of default on mortgage instruments did not work. The role, independence, and judgment of rating agencies blessing mortgage securities need close study and action. Credit-default swaps have been cited as a major cause of the financial crisis.[36] Through credit-default swaps, Congress permitted AIG and others, in essence, to guarantee mortgage bonds without reserves, disclosure, or regulation (and also to guarantee them to non-holders who were simply betting on default of a bond that they did not actually hold). Credit-default swaps[37] did not shift the risk within the market; instead, the taxpayers are paying the bill.

These issues present a large and complicated agenda for legislatures, regulators, courts, and markets as they shape the future of financial markets. Moreover, the policy factors discussed above should also influence the legislatures and the courts that make decisions on the law of mortgages in the aftermath of the mortgage financing crisis of 2008—this is the subject of Part III.

III. THE LAW OF MORTGAGES

The aftermath of the financial crisis and the collapse of Fannie Mae and Freddie Mac could well affect the law of mortgages in various states. Structural changes in the mortgage industry and possible legislative, regulatory, and

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35. *See, e.g.*, Gerald Korngold, *Resolving the Intergenerational Conflicts of Real Property Law: Preserving Free Markets and Personal Autonomy for Future Generations*, 56 AM. U. L. REV. 1525, 1536–37 (2007) ("[T]here is a serious threat that home ownership, even rental housing, has become unaffordable for significant segments of our society, placing this facet of the American dream beyond the reach of too many . . . ."). *But see* Kristen David Adams, *Homeownership: American Dream or Illusion of Empowerment*, 60 S.C. L. REV. 573 (2009) (questioning whether American's overvalue the "illusion" of homeownership).

36. *See, e.g.*, Edmund L. Andrews, *Obama Names Insider to Commodities Post*, N.Y. TIMES, Dec. 19, 2008, at B3 ("[C]redit-default swaps . . . greatly aggravated the damage caused by the subprime mortgage meltdown.").

37. The Commodity Futures Modernization Act of 2000 barred federal and state regulation of credit default swaps. Pub. L. No. 106-554, 114 Stat. 2763 (codified as amended at scattered sections of 7, 15, and 26 U.S.C.). For criticisms of this vehicle, see Hannah Fairfield, *A Snarl of Regulation*, N.Y. TIMES, Oct. 4, 2008, at B9 ("This is the first crisis since the 1987 market crash . . . exposing regulatory redundancies and enormous gaps, like a lack of oversight for some derivatives and credit default swaps.").

judicial responses may alter two key trends that have developed over the past decade or two—the nationalization of mortgage law and the modernization of the law of mortgages.

A. Nationalization and Standardization

Fannie Mae and Freddie Mac, as they existed prior to the federal conservatorship on September 7, 2008,[38] helped to bring about a degree of nationalization and standardization of mortgage law.[39] Fannie Mae and Freddie Mac were successful through market power, while attempts at state-based uniform legislation failed.

1. Uniform Laws

Before Fannie Mae and Freddie Mac assumed a major role in standardization, lenders, counsel, and law reformers attempted to create an analog to the Uniform Commercial Code (UCC) for real estate mortgages.[40] This movement manifested itself in the adoption of the Uniform Land Transactions Act (ULTA) by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1975.[41] No state ever adopted ULTA.[42] In 1985 the NCCUSL adopted the mortgage portions of ULTA as the separate Uniform Land Security Interest Act (ULSIA).[43] No state subsequently adopted

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38. Henry M. Paulson, Jr., U.S. Sec'y of Treasury, Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), *available at* http://www.ustreas.gov/press/releases/hp1129.htm.

39. The Housing and Economic Recovery Act of 2008 (which became law on July 30, 2008) empowered the eventual takeover of Fannie Mae and Freddie Mac by the Department of the Treasury. Pub. L. No. 110-289, 122 Stat. 2654 (amending scattered sections of 5, 12, and 15 U.S.C.). For codification of the statute originally authorizing Fannie Mae, see 12 U.S.C. § 1717 (2006).

40. UNIF. LAND SEC. INTEREST ACT, prefatory note (withdrawn 1999), 7A (pt. 2) U.L.A. 244 (2006).

41. *Id.*; UNIF. LAND TRANSACTIONS ACT (1975) (amended 1977), 13 (pt. 2) U.L.A. 160 (2002).

42. R. Wilson Freyermuth, *Of Hotel Revenues, Rents, and Formalism in the Bankruptcy Courts: Implications for Reforming Commercial Real Estate Finance*, 40 UCLA L. REV. 1461, 1540 n.265 (1993).

43. UNIF. LAND SEC. INTEREST ACT, prefatory note (withdrawn 1999), 7A (pt. 2) U.L.A. 244 (2006); *see generally* Norman Geis, *Escape from the 15th Century: The Uniform Land Security Interest Act*, 30 REAL PROP. PROB. & TR. J. 289, 307–08 (1995) (providing background information on the ULSIA); Patrick A. Randolph, Jr., *The Future of American Real Estate Law: Uniform Foreclosure Laws and Uniform Land Security Interest Act*, 20 NOVA L. REV. 1109, 1110 n.1 (1996) (same).

the ULSIA.[44] These model statutes were intended to provide a uniform national law for mortgages, reduce the transaction costs for the flow of capital across state lines, encourage the primary and secondary mortgage markets, and modernize the law.[45] Less expensive loans would benefit borrowers, and efficient allocation of capital would be a social good.

Unlike the UCC, however, the uniform real estate acts were unsuccessful. The failure of these real estate statutes may have been due to the uniquely local and fixed nature of the asset, the power of local counsel unwilling to relinquish control over state real estate transactions to national players, a preference for the general reliability of existing mortgage law over an untried substitute, an unclear showing of the benefits of a standardized law, or other factors.[46] In any event, legislative attempts at creating a uniform law of mortgages among the states have been a failure.[47]

2. *Fannie Mae and Freddie Mac*

Through their dominant role in the secondary market, Fannie Mae and Freddie Mac helped to bring significant uniformity to the law of mortgages in various states, accomplishing some of what the uniform law mechanism was unable to do. Fannie Mae and Freddie Mac promulgated form notes, mortgages, and deeds of trust to simplify reviewing, buying, packaging, and selling mortgages.[48] The Fannie Mae and Freddie Mac forms became the gold standard for residential loans across the country because Fannie Mae and Freddie Mac required these in order for a mortgage to be bundled into a Fannie Mae or a Freddie Mac program.[49] Thus, through their power over the secondary market,

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44. Randolph, *supra* note 43, at 1110 n.2.

45. UNIF. LAND SEC. INTEREST ACT, prefatory note (withdrawn 1999), 7A (pt. 2) U.L.A. 244 (2006).

46. *See, e.g.*, Marion W. Benfield, Jr., *Wasted Days and Wasted Nights: Why the Land Acts Failed*, 20 NOVA L. REV. 1037, 1052–60 (1996) (discussing the reasons that states failed to adopt the uniform real estate acts); Ronald Benton Brown, *Whatever Happened to the Uniform Land Transactions Act?*, 20 NOVA L. REV. 1017, 1018–19 (1996) (listing the "Top Ten Reasons for the Demise of the ULTA").

47. *See* RESTATEMENT (THIRD) OF PROP.: MORTGAGES (1997) (providing a modern guide to courts on the law of mortgages and choosing between competing rules where there is a conflict).

48. *See, e.g.*, Andrew Lance, *Balancing Private and Public Initiatives in the Mortgage-Backed Security Market*, 18 REAL PROP. PROB. & TR. J. 426, 438 (1983) ("[Fannie Mae] prescribes operating standards for private mortgage insurers of pools at the same time that it and other agencies of the federal government are creating and insuring pools which compete with the private pools."). For sample Fannie Mae mortgages, see Legal Documents—Security Instruments, https://www.efanniemae.com/sf/formsdocs/documents/secinstruments/index.jsp#standard (last visited Mar. 25, 2009).

49. *See generally* D. BARLOW BURKE, JR., LAW OF FEDERAL MORTGAGE DOCUMENTS (1989) (discussing the residential note and mortgage forms used by Fannie Mae and Freddie Mac).

residential borrowers were essentially forced to "agree" to the Fannie Mae and Freddie Mac terms. Through "consent," the Fannie Mae and Freddie Mac documents set the terms of the mortgage. These terms sometimes trump the ability of lenders to insert contrary terms into the instrument that would otherwise be enforceable under state law; on other matters, the forms provide a "consensual" right that the courts of a particular state would not have found. For example, the Fannie Mae form note allows prepayment of the mortgage without penalty;[50] without that Fannie Mae (and Freddie Mac) provision, many states would not permit prepayment as a matter of law.[51]

However, the requirements of the Fannie Mae and Freddie Mac forms significantly reduced bargaining by the lender and the borrower, taking terms off the table. Therefore, at least theoretically, uniformity reduced the choice of market terms for the players. As a corollary, the work of attorneys representing residential borrowers and lenders became largely commoditized, with little left to negotiate. Costs of a deal were lowered, but the ability to represent clients fully was also compromised. Moreover, from a system perspective, it has been argued that uniformity can lead to the loss of the benefits of a federalist system where different states are permitted to make rules that best reflect regional preferences;[52] the experimentation among different states can lead to innovation adopted by others.[53] Finally, if there is to be federal preemption of mortgage law, it might be better accomplished more transparently through congressional study and action.[54]

The uniformity of residential mortgages in Fannie Mae and Freddie Mac pools served to lower transaction costs and bring other benefits of standardization, as well as to resolve or reverse by agreement certain issues in state law. So, what will happen to these mortgage documents and accompanying

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50. Fannie Mae/Freddie Mac, Uniform Instrument Form 3200, Multistate Fixed Rate Note (Single Family), *available at* https://www.efanniemae.com/sf/formsdocs/documents/notes/pdf/3200.pdf.

51. *Compare* Clover Square Assocs. v. Nw. Mut. Life Ins. Co., 674 F. Supp. 1137, 1138–39 (D.N.J. 1987) (finding no right to prepay as a matter of law), *aff'd*, 869 F.2d 588 (3d Cir. 1989) *with* Hatcher v. Rose, 407 S.E.2d 172, 177 (N.C. 1991) (presuming a right to prepay), *and* Mahoney v. Furches, 468 A.2d 458, 461 (Pa. 1983) (same).

52. Michael H. Schill, *Uniformity or Diversity: Residential Real Estate Finance Law in the 1990s and the Implications of Changing Financial Markets*, 64 S. CAL. L. REV. 1261, 1299–1300 (1991).

53. *Id.* at 1287.

54. For examples of federal preemption through congressional action, see Garn-St. Germain Depository Institutions Act of 1982, 12 U.S.C. § 1701j-3 (2006) (preempting state law that barred "due-on-sale clause[s]" in mortgages); the Multifamily Mortgage Foreclosure Act of 1981, 12 U.S.C. §§ 3701–3717 (creating a "uniform Federal foreclosure remedy for multifamily mortgages"); and the Single Family Mortgage Foreclosure Act of 1994, 12 U.S.C. §§ 3751–3768 (permitting power of sale foreclosure with HUD mortgages).

Fannie Mae and Freddie Mac regulations post-conservatorship? Will there continue to be uniformity, with its advantages? Or, will more terms now be subject to negotiation, with the arguable benefits and clear costs? Will Fannie Mae and Freddie Mac continue to trump state mortgage law via the terms of their documents, or will they take a more laissez-faire attitude? Will consumer protection be a concern (prepayment provisions favored consumers, at least in the short run)? All of these questions will be answered in the period going forward.

B. Modernization

In recent years there have been important steps taken to modernize mortgage creation, transfer, and recording. The growth in the secondary markets spurred a number of these changes. Legislatures and courts need to address the problems that the subprime crisis and mortgage market collapse engendered. At the same time, they should be careful to preserve the positive changes in the law of mortgages that the secondary market has brought. Decisionmakers, moreover, have an opportunity to advance further modernization by altering rules of state mortgage law to ensure the fair and efficient transfer of notes and mortgages on the secondary market.

1. From Twigs to Bytes

It has taken centuries for our current law of mortgages and recorded documents to evolve.[55] We all remember from our 1L Property course that, until the sixteenth century, land could only be transferred by the process of livery of seisin.[56] This process required the grantor and the grantee to go to the property being conveyed, where the grantor had to declare the prescribed words of transfer and hand the grantee a twig or other physical manifestation of the land.[57] Only with the Statute of Uses of 1536 could grantors transfer land by document without going to the property.[58] This was an important milestone in the process of converting land from feudal property to a commercial asset that could be bought and sold easily in the marketplace. Another milestone was the passage of the recording acts at the dawn of the American republic, which allowed buyers of interests in real property to trade in confidence and

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55. *See generally* Ann M. Burkhart, *Real Estate Practice in the Twenty-First Century*, 72 MO. L. REV. 1031, 1031–35 (2007) (discussing the evolution of real estate law).

56. A. JAMES CASNER, W. BARTON LEACH, SUSAN FLETCHER FRENCH, GERALD KORNGOLD & LEA VANDERVELDE, CASES AND TEXT ON PROPERTY 316 (5th ed. 2004).

57. *Id.*

58. *Id.*

encouraged markets for sales and financing.[59] In the twentieth century, recording offices made a major shift from hand copying instruments into the records to storing them on microfilm.[60]

Yet this was still a paper-based system, one built for a vision of land as a local asset involving local players.[61] Two recent, revolutionary trends pushed for changes in this old system. First, there was the explosion of the Information Age and the opportunity to employ modern computer technology to make the recording system more efficient, more transparent, and less costly.[62] Second, globalization of capital permitted the funneling of funds to American localities through the work of the secondary market.[63]

For example, forty-six states and the District of Columbia have adopted the Uniform Electronic Transactions Act (UETA), making electronic signatures equivalent to signatures on paper documents.[64] Eighteen states and the District of Columbia have adopted the Uniform Real Property Electronic Recording Act

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59. *See, e.g.*, Korngold, *supra* note 35, at 1535 ("[T]he creation of the recording system [allowed] buyers [to] pay in confidence [because] they would receive good title and streamlined forms of deeds . . . .") (citing LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 27, 173–75 (3d ed. 2005)).

60. Arthur A. Gaudio, *Electronic Real Estate Records: A Model for Action*, 24 W. NEW ENG. L. REV. 271, 273 (2002).

61. *See id.*

62. *See, e.g.*, Sam Stonefield, *Electronic Real Estate Documents: Context, Unresolved Cost-Benefit Issues and a Recommended Decisional Process*, 24 W. NEW ENG. L. REV. 205, 228 (2002) ("The use of electronic documents in real estate transactions will produce efficiencies and enhancements that will yield both direct and indirect economic benefits, as well as important public policy gains for public land records.").

63. *See, e.g.*, David Reiss, *The Federal Government's Implied Guarantee of Fannie Mae and Freddie Mac's Obligations: Uncle Sam Will Pick up the Tab*, 42 GA. L. REV. 1019, 1028 (2008) ("These two companies were unlike nearly all other financial institutions in the 1970s in that their businesses were not geographically restricted and they could develop a truly national market for mortgages.") (citing THOMAS H. STANTON, DEVISING AN EFFECTIVE LEGAL FRAMEWORK FOR SUPERVISING THE PUBLIC BENEFITS AND PUBLIC COSTS OF GOVERNMENT SPONSORED ENTERPRISES 2–3 (1999); Michael H. Schill, *The Impact of the Capital Markets on Real Estate Law and Practice*, 32 J. MARSHALL L. REV. 269, 270 (1999) ("Issuers of mortgage-backed securities pool hundreds of loans together, obtain credit enhancement, usually in the form of guarantees, from a secondary market agency and sell their interests in the pool of mortgages to investors.")).

64. National Conference of Commissioners on Uniform State Laws, A Few Facts About The Uniform Electronic Transactions Act, http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ueta.asp (last visited Mar. 25, 2009). In 2000, Congress passed the Electronic Signatures in Global and National Commerce Act (ESIGN). Pub. L. No. 106-229, 114 Stat. 464 (codified in scattered sections of 15 U.S.C.). ESIGN provides similar but more limited recognitions of electronic documents than the UETA. *See, e.g.*, David E. Ewan & Mark Ladd, *Race to the (Virtual) Courthouse: How Standards Drive Electronic Recording of Real Property Documents*, PROB. & PROP., Jan.–Feb. 2008, at 8, 11 ("The federal ESIGN Act adds some documents to its exclusion section that UETA does not.").

(URPERA), approved by the NCCUSL, in 2004.[65] URPERA provides that electronic documents satisfy recording requirements, that electronic signatures and notary acknowledgements are valid, and that recorders must accept electronic documents for recording and indexing.[66] Electronic recording and indexing might well lead to redefinition of century-old rules of search and constructive notice because the information is more easily accessible to searchers and there is less need to limit searches because of expense.[67]

2. *Mortgage Electronic Registration Systems, Inc. (MERS)*

Another recent development is the Mortgage Electronic Registration Systems, Inc. (MERS) for residential mortgages and related documents. In 1993, the Mortgage Bankers Association, Fannie Mae, Freddie Mac, the Government National Mortgage Association (Ginnie Mae), the Federal Housing Administration, and the Department of Veterans Affairs created MERS.[68] MERS provides "electronic processing and tracking of [mortgage] ownership and transfers."[69] Mortgage lenders, banks, insurance companies, and title companies become members of MERS and pay an annual fee.[70] They appoint MERS as their agent to act on all mortgages that they register on the system.[71]

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65. National Conference of Commissioners on Uniform State Laws, A Few Facts About The Uniform Real Property Electronic Recording Act, http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-urpera.asp (last visited Mar. 25, 2009).

66. For a discussion of digital recording, see David E. Ewan et al., *It's the Message,* Not *the Medium!: Electronic Record and Electronic Signature Rules Preserve Existing Focus of the Law on Content, Not Medium of Recorded Land Title Instruments*, 60 BUS. LAW. 1487, 1502–05 (2005) (discussing the interplay between UETA and URPERA); Gaudio, *supra* note 60, at 275–84 (providing a model structure for an electronic land recording system); Stonefield, *supra* note 62, at 237–43 (recommending the creation of task forces to stimulate the transition to electronic real estate documents); Dale A. Whitman, *Are We There Yet? The Case for a Uniform Electronic Recording Act*, 24 W. NEW ENG. L. REV. 245, 259–68 (2002) (suggesting the elements that should be included in a uniform recording act); Dale A. Whitman, *Digital Recording of Real Estate Conveyances*, 32 J. MARSHALL L. REV. 227, 264–66 (1999) (calling for the NCCUSL to adopt a uniform digital recording statute).

67. *See, e.g.*, First Citizens Nat'l Bank v. Sherwood, 817 A.2d 501 (Pa. Super. Ct. 2003) (suggesting that because computerization lessens the burden of document searches, purchasers may be required to look beyond the index to conduct a diligent search), *rev'd*, 879 A.2d 178, 182 (Pa. 2005) (holding that constructive notice exists where a mortgage is properly recorded even if the mortgage is improperly indexed).

68. MERSCORP, Inc. v. Romaine, 861 N.E.2d 81, 83 n.2 (N.Y. 2006); Phyllis K. Slesinger & Daniel McLaughlin, *Mortgage Electronic Registration System*, 31 IDAHO L. REV. 805, 807 (1995); Brenda M. Williamson, *New York's Highest Court Requires County Clerks to Record MERS Mortgages, Assignments, and Discharges*, 35 REAL EST. REV. 5 (2007).

69. *MERSCORP, Inc.*, 861 N.E.2d at 83.

70. *Id.*

71. *Id.*

A MERS mortgage is recorded with the particular county's office of the recorder with "'Mortgage Electronic Registration System, Inc.' named as the lender's nominee or mortgagee of record" on the mortgage.[72] The MERS member who owns the beneficial interest may assign those beneficial ownership rights or servicing rights to another MERS member.[73] These assignments are not part of the public record, but are tracked electronically on MERS's private records.[74] Mortgagors are notified of transfers of servicing rights, but not of transfers of beneficial ownership.[75]

MERS facilitates an efficient secondary market in mortgages by allowing the easy transfer of beneficial rights.[76] After the initial recording in the local clerk's office, subsequent transactions can be done quickly at a low cost from a central location utilizing modern technology without the need for local recording of paper assignment documents.[77] Such a process facilitates the flow of global capital, bringing investment funds into areas without local mortgage financing. Potential homeowners, as well as those seeking the most favorable rates, can benefit from MERS.

Unfortunately, some judicial decisions during the recent spike in subprime and conventional foreclosures have questioned MERS.[78] Consider, for example, the September 2008 case *Landmark National Bank v. Kesler*,[79] decided by the Kansas Court of Appeals. That case involved the foreclosure of a first mortgage by Landmark National Bank (Landmark) where there was also a second mortgage given by the borrower to secure a loan from Millenia Mortgage Corporation (Millenia).[80] The second mortgage showed the MERS entity (MERS, Inc.) as the mortgagee "solely as nominee for Lender."[81] Millenia then assigned its interest to Sovereign Bank.[82] When Landmark, the first mortgagee, foreclosed, it did not join MERS, Inc in the action.[83] After foreclosure was entered, MERS, Inc. sought to overturn the foreclosure, claiming that it was a necessary party that Landmark did not join.[84] The Kansas Court of Appeals

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72. *Id.*
73. *Id.*
74. *Id.*
75. *Id.*
76. *See* Slesinger & McLaughlin, *supra* note 68, at 811.
77. *See id.*
78. *See, e.g.*, *MERSCORP, Inc.*, 861 N.E.2d at 85 (requiring county clerks to record mortgages, assignments, and discharges where the MERS entity was listed as the mortgagee).
79. 192 P.3d 177 (Kan. Ct. App. 2008).
80. *Id.* at 178.
81. *Id.* at 179.
82. *Id.* at 178–79.
83. *See id.* at 179.
84. *Id.*

rejected this claim.[85] It noted that MERS, Inc. was simply an agent of the lender, did not hold title to the loan, and did not even service the mortgage.[86]

Results such as that in *Kesler* would devastate the effectiveness of MERS.[87] Moreover, the *Kesler* court refused to deal with modern technological and market realities and with the benefits MERS provides to borrowers and society. Instead, the court chose to hide behind a narrow approach to the case:

> We do not attempt in this opinion to comprehensively determine all of the rights or duties of MERS as a nominee mortgagee. . . . In this case, we are only required to address whether the failure to name and serve MERS as a defendant in a foreclosure action in which the lender of record has been served is such a fatal defect that the foreclosure judgment must be set aside. We hold that it is not.[88]

An unarticulated concern over residential owners losing their homes or hard-pressed borrowers in general may underlie anti-MERS rulings. If so, courts and legislatures need to address these issues directly. Judicial and legislative remedies should not be so broad that they will destroy the benefits of MERS to individual borrowers and to society.[89]

3. *Transparency and Market Efficiency*

I have previously written of the importance of transparency in the recording system.[90] Current and potential participants in land transfer and finance transactions need information so markets can operate efficiently and fairly, thus benefiting those particular players as well as society.[91] There is therefore a legitimate concern if unrecorded mortgage assignments in secondary market

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85. *Id.* at 182.

86. *Id.* at 179.

87. For an example of a court allowing foreclosure by a MERS entity, see *Mortgage Electronic Registration Systems, Inc. v. Azize*, 965 So. 2d 151, 152 (Fla. Dist. Ct. App. 2007).

88. *Id.* at 181–82.

89. *See, e.g.*, MERSCORP, Inc. v. Romaine, 861 N.E.2d 81, 88 (N.Y. 2006) (Kaye, C.J., dissenting in part) ("The benefits of the system to MERS members are not insubstantial. Through use of MERS as nominee, lenders are relieved of the costs of recording each mortgage assignment with the County Clerk . . . . [and t]ransfers of mortgage instruments are faster . . . ."). Decision makers need to consider whether the government monopoly of the recording system is beneficial or merely rent-seeking. *See id.*

90. *See* Korngold, *supra* note 35, at 1564.

91. *See id.* (citing GERALD KORNGOLD & PAUL GOLDSTEIN, REAL ESTATE TRANSACTIONS: CASES AND MATERIALS ON LAND TRANSFER, DEVELOPMENT AND FINANCE 244–45 (4th ed. 2002)).

transactions are not placed on the public record.[92] In the dissenting opinion in *MERSCORP, Inc.*, Chief Judge Kaye of the New York Court of Appeals expressed a concern that MERS only discloses the current servicer and not the assignee of the mortgage. She wrote:

> The lack of disclosure may create substantial difficulty when a homeowner wishes to negotiate the terms of his or her mortgage or enforce a legal right against the mortgagee and is unable to learn the mortgagee's identity. Public records will no longer contain this information as, if it achieves the success it envisions, the MERS system will render the public record useless by masking beneficial ownership of mortgages and eliminating records of assignments altogether. Not only will this information deficit detract from the amount of public data accessible for research and monitoring of industry trends, but it may also function, perhaps unintentionally, to insulate a noteholder from liability, mask lender error and hide predatory lending practices.[93]

Actually, this is an issue that predates MERS, and is reflected in the holder in due course doctrine of the law of negotiable instruments. Some background is necessary for an understanding of the issue and the policy choices that are implicated today as we reevaluate the rules governing secondary market mortgages. There are three lessons that our experience with the law of negotiable instruments can impart to our approach to secondary market assignments.

The modern law of negotiable instruments developed in the eighteenth century to reflect changes and aspirations in the world's trade and monetary systems.[94] In order to make notes the equivalent of cash—a step necessary to increase commerce and general well being—certain traditional claims and defenses against holders in due course for the payment of negotiable notes were relaxed.[95] At the same time, protections were retained to deny payment to the holder in due course in cases of fraud of which the holder should have been

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92. *See, e.g.*, Nosek v. Ameriquest Mortgage Co. (*In re* Nosek), 386 B.R. 374, 385 (Bankr. D. Mass. 2008) (imposing a sanction upon the mortgagee for attempting "to jettison the obligation to be forthright and diligent with the Court and the Debtor" by hiding behind its servicing agreement).

93. MERSCORP, Inc., 861 N.E.2d at 88 (Kaye, C.J., dissenting in part).

94. *See, e.g.*, Kurt Eggert, *Held up in Due Course: Codification and the Victory of Form over Intent in Negotiable Instrument Law*, 35 CREIGHTON L. REV. 363, 366–74 (2002) (offering alternative narratives as well).

95. *See, e.g.*, U.C.C. § 3-305 (2002) (stating that a holder in due course takes an instrument free from all claims and many defenses). *See generally* KORNGOLD & GOLDSTEIN, *supra* note 91 (providing an overview of the holder in due course doctrine).

aware.[96] The English courts and then the American legislatures accepted this trade-off in order to accomplish social goals.[97] This is the first lesson for today from our history with the holder in due course doctrine: rules must be crafted to meet commercial realities and social needs.

The holder in due course rule is attractive to purchasers of loans in the secondary market because it makes the notes more equivalent to cash and reduces legal impediments to collection.[98] But some of the requirements to become a holder in due course, such as the need to take physical possession of the note, may no longer be viable in secondary markets.[99] Notes are assigned often and through various intermediaries; there are business, speed, and environmental reasons for paperless transactions in our digital world. This is the second lesson: we need to develop a set of rules that meets the twenty-first century commercial practices of lenders who take advantage of the technological revolution. At the same time, the system must make the ownership of mortgage rights transparent so that these interests can be bought and sold in markets. It appears that in the run-up to the recent financial crisis, major institutions did not know what financial instruments they owned, let alone what instruments potential trade partners held.[100]

The third lesson is that the holder in due course doctrine may no longer be suitable for borrowers in a modern era and may require adjustments to protect borrowers. Under traditional law, there is no requirement for the holder in due course or original lender to give notice to the borrower of an assignment from the lender to the holder in due course.[101] The assignment of the mortgage need

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96. *See, e.g.*, U.S. Fin. Co. v. Jones, 229 So. 2d 495, 497–98 (Ala. 1969) (denying holder in due course status because the purchaser had notice of transferor's past practice of fraudulent loans); U.C.C. § 3-302 (2002) (stating that to be a holder in due course, the transferee must, among other things, acquire a negotiable note in good faith and without notice of defenses); U.C.C. § 3-305 (allowing a defense of fraud against a holder in due course).

97. *See, e.g.*, Eggert, *supra* note 94, at 376 (noting that one such social goal in the seventeenth and eighteenth centuries was "to create a currency substitute," which was greatly needed at that time).

98. *See, e.g.*, *id.* ("Another function of the holder in due course doctrine was to make negotiable instruments more easily transferrable by removing a great barrier to their transferability, the fear that the maker of a note will have a defense to it.").

99. *See, e.g.*, Kurt Eggert, *Held up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 566 (2002) ("Some have argued that the advent of securitization has effectively eliminated the holder in due course doctrine, stating that the process of indorsing each of the hundreds or thousands of notes that make up a mortgage pool would be so time consuming as to be impractical.").

100. *See, e.g.*, Drew DeSilver, *Big Dreams of WaMu Dashed by Risky Loans*, SEATTLE TIMES, Sept. 21, 2008 ("[M]ortgage-backed securities[] were sliced up, repackaged and resold so many times that, as often as not, institutional investors weren't sure entirely what they owned.").

101. 13 THOMPSON ON REAL PROPERTY, THOMAS EDITION § 104.10(b)(5), at 633 (David A. Thomas ed., 1994).

not be recorded,[102] and in any case a recording would only give notice if the borrower checked the record on a daily basis (a significant burden). Despite the lack of notice regarding the transfer of the note and mortgage, if the borrower then pays the original lender, the law will still require the borrower to pay the holder in due course.[103] Because mortgages are now so commonly and repeatedly assigned on the secondary market,[104] this puts borrowers at risk of having to pay twice.[105] The law could alleviate this risk, however, by simply holding that the borrower can pay the original lender until the borrower receives notice of the assignment.[106] Thus, even without MERS and Chief Judge Kaye's objections, there is a problem for borrowers with the lack of transparency regarding the transfers of notes and mortgages.

Transparency is not the only issue, however, that needs attention. First, where there are multiple owners of an interest, it may be unclear who has the authority to modify the instrument and arrive at a workout of a troubled loan with the borrower.[107] Even if the servicing agreement empowers the servicer to do workouts, servicers may refuse to do so out of fear that beneficial owners of the mortgage may second-guess the modification decision and attempt to hold the servicer liable for deviating from the initial note.[108] Moreover, transaction costs may also increase in order to track holders in due course and to arrive at agreements.[109] Additionally, holder in due course immunity should not extend to predatory lending activities by the original lender if the assignee—using ordinary due diligence—knew or should have known about such activities.[110] Hopefully, our decisionmakers can find a way to protect the benefits of the secondary market but also the expectation of fairness of borrowers in the post-subprime bust era.

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102. 66 AM. JUR. 2D *Records and Recording Laws* § 50 (2001) (citing Nat'l Live Stock Bank v. First Nat'l Bank, 203 U.S. 296, 310 (1906)).

103. 13 THOMPSON, *supra* note 101.

104. *See, e.g.*, Schill, *supra* note 63, at 271 ("The growth of residential mortgage-backed securities has been phenomenal.").

105. 13 THOMPSON, *supra* note 101.

106. The *Restatement* adopts this position. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 5.5 (1997). Requiring the lender to produce the note before the borrower makes a payment would protect the borrower (and may have been adequate protection in an earlier period), but the requirement is impractical in modern borrowing transactions where payments are sent monthly by mail. *See id.* cmt. a.

107. *See* Eggert, *supra* note 99, at 562–63; Gretchen Morgenson, *Work out Problems with Lenders? Try to Find Them*, N.Y. TIMES, July 20, 2008, at A14.

108. *See* Eggert, *supra* note 99, at 560–61.

109. *Id.* at 561.

110. *Cf.* Doyle v. Resolution Trust Corp., 999 F.2d 469, 473 (10th Cir. 1993) (stating that a purchaser who takes an instrument in good faith and without notice of the unauthorized alteration is entitled to holder in due course status).

4. Foreclosure Proceedings

Courts have also responded to the current financial crisis by using technical rules of foreclosure to protect mortgagors where the underlying note and mortgage have been assigned.[111] In an opinion that received much attention,[112] Federal District Court Judge Christopher A. Boyko of the Northern District of Ohio denied Deutsche Bank National Trust Company's foreclosure of fourteen mortgages that it owned by assignment.[113] The court held that a copy of the executed assignment of the note and mortgage was required to be attached to the complaint in order for the court to have jurisdiction.[114] Apparently the documents were not available because the sale of the note and mortgage was made without such documentation in a secondary market transaction.[115] The court was unimpressed with explanations that the secondary market did not allow for strict compliance with conveyancing formalities:

> Neither the fluidity of the secondary mortgage market, nor monetary or economic considerations of the parties, nor the convenience of the litigants supersede those obligations.
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> . . . .
>
> Plaintiff's, "Judge, you just don't understand how things work," argument reveals a condescending mindset and quasi-monopolistic system where financial institutions have traditionally controlled, and still control, the foreclosure process.[116]

Judge Boyko further asserted that while increasing the fluidity of the market and securitization was worth "X dollars," the preservation of the "jurisdictional integrity of United States District Court [was] [p]riceless."[117]

Judge Boyko applied the legal rule to the facts before him in a case dealing with the loss of property—a constitutionally protected right.[118] The problem for

111. *See, e.g.*, *In re* Foreclosure Cases, 521 F. Supp. 2d 650, 654–55 (S.D. Ohio 2007) (requiring a recorded copy of the mortgage, all assignments of the mortgage, and an affidavit that the plaintiff is the owner of the note and mortgage in order to permit foreclosure); Bayview Loan Servicing, L.L.C. v. Nelson, 890 N.E.2d 940, 943 (Ill. App. Ct. 2008) (holding that a servicing company was not the proper plaintiff in the foreclosure of an assigned mortgage).

112. *See* Gretchen Morgenson, *Foreclosures Hit a Snag for Lenders*, N.Y. TIMES, November 15, 2008, at C1.

113. *In re* Foreclosure Cases, No. 1:07-cv-02282, 2007 WL 3232430, at *3 (N.D. Ohio Oct. 31, 2007).

114. *Id.* at *1.

115. *See id.*

116. *Id.* at *2, *3 n.3.

117. *Id.* at *3 n.3 (internal quotation marks omitted).

118. *See* U.S. CONST. amend. V.

lenders is that the rules may not have adequately changed with the times. Hopefully, as we move past the immediacy of the financial crisis, we can arrive at legislative and market solutions that not only give us legal rules and procedures that are both predictable and fair to borrowers, but also reflect market realities.

IV. FINAL THOUGHTS

We are living through unprecedented turmoil in our financial and mortgage markets. The complete history has yet to be lived, let alone written. But it is none too early to begin thinking about how we can alter the regulation of markets and the law of mortgages to ensure a brighter future ahead.