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Foreclosure and the Failures of Formality, or Subprime Mortgage Conundrums and How to Fix Them

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The subprime mortgage crisis was not only an economic disaster but posed challenges to traditional rules of property law. Banks helped create the crisis by marketing mortgages through unfair and deceptive practices. They induced many consumers to take out high-priced loans they could not afford and then passed the risk to investors who were fooled into thinking these were safe investments. These practices violate traditional norms underlying both consumer protection and securities regulation statutes. In addition, U.S. banks greased the wheels of the mortgage securitization process by creating a privatized mortgage registration system that has undermined the clarity and publicity of property titles. Because of securitization procedures and the lax record-keeping practices, the banks have undermined the property recording system; we no longer have clear public titles to real property in the United States. To fix the mess they left us, we must adopt norms to govern the mortgage market that will protect both homeowners and investors from predatory loans while promoting legitimate property transactions. We also need to fix the mortgage registration system so we have a legal infrastructure for property that both works well and reflects the norms of a free and democratic society.

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Foreclosure and the Failures of Formality, or Subprime Mortgage Conundrums and How to Fix Them^{*}

JOSEPH WILLIAM SINGER^{**}

ולפני עור לא תתן—משכל.

*Do not put a stumbling block before the blind.*¹

—Leviticus (Vayikra) 19:14

*For prevention of many fraudulent Practices . . . All Leases Estates Interests of Freehold or Termes of yeares or any uncertaine Interest of in to or out of any Messuages Mannours Lands Tenements or Hereditaments made . . . by Parole and not putt in Writeing . . . shall have the force and effect of Leases or Estates at Will onely and shall not either in Law or Equity be deemed or taken to have any other or greater force or effect*²

—An Act for Prevention of Frauds and Perjuryes,
England, 1677

I. INTRODUCTION

The subprime crisis shattered both the world economy and our illusions. In that innocent time before the crisis, New Deal government policy made mortgages widely available and relatively affordable while,

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¹ *Leviticus* (Vayikra) 19:14.

² An Act for Prevention of Frauds and Perjuryes, 1677, 29 Car. 2, c. 3 (Eng.).

over time, both state property laws and common practice imposed minimum standards on transactions that protected homeowners from onerous, discriminatory, unfair, or deceptive mortgage terms.³ Those who could not afford to buy housing either rented or relied on alternative government programs to obtain it. To be sure, we had poverty, homelessness, discrimination, and injustice, and the quality of housing for low-income families left much to be desired. Things were far from perfect. But state recording statutes and real estate practices worked tolerably well, both clarifying property titles and making that information publicly available.⁴ Beginning around 1980, however, a new era of banking deregulation unleashed vast changes in the ways mortgages were sold, marketed, and recorded.⁵ After 1990, these developments eventually led to the widespread sale and securitization of subprime mortgages.⁶ Cheered on by President George W. Bush's call for an "Ownership Society,"⁷ these mortgages helped fuel a housing bubble that burst in 2007, plunging us into the worst recession since the Great Depression.⁸ Now in 2013, we find ourselves still living with the effects of the subprime crisis and cleaning up the mess it left us in.⁹

³ See Peter W. Salsich, Jr., *Homeownership—Dream or Disaster?*, 21 J. AFFORDABLE HOUSING 17, 25–26 (2012) (outlining how the federal government "made home loans affordable for millions of Americans" by requiring "participating lenders [to] offer fully amortizing loans with level monthly payments, fixed interest rates, and low down payments").

⁴ See JOSEPH WILLIAM SINGER, PROPERTY LAW: RULES, POLICIES, AND PRACTICES § 12.3.3.1, at 876–77 (5th ed. 2010) (describing the recording system and its interplay with real estate transactions generally).

⁵ KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS 16 (2011).

⁶ See ANDREW DAVIDSON, ANTHONY SANDERS, LAN-LING WOLFF, & ANNE CHING, SECURITIZATION: STRUCTURING AND INVESTMENT ANALYSIS 287–88, fig.15.1 (2003) (recognizing that securitization and "the overall size of the private-label market has more than doubled since 1994"); Yuliya Guseva, *Evolutionary Developments in Mortgage Securitization: Financial Law Reforms, Putative Beneficiaries, and Archetypal Economic Risks*, 21 TRANSNAT'L L. & CONTEMP. PROBS. 395, 435–36, 464 (2012) ("Throughout the 1990s and the first few years of this century, the volume of public and private securitization transactions alike increased . . .").

⁷ Press Release, White House Office of the Press Sec'y, America's Ownership Society: Expanding Opportunities (Aug. 9, 2004), available at <http://georgewbush-whitehouse.archives.gov/news/releases/2004/08/20040809-9.html>; see also ENGEL & MCCOY, *supra* note 5, at 21 (commenting that President Bush "advocate[ed] that everyone should own a home as part of his vaunted 'Ownership Society'"); Press Release, White House Office of the Press Sec'y, President Hosts Conference on Minority Homeownership (Oct. 15, 2002), available at <http://georgewbush-whitehouse.archives.gov/news/releases/2002/10/20021015.html> (explaining President Bush's "efforts to address the homeownership gap and increase the number of minority homeowners in America").

⁸ See Raymond C. Niles, *Eighty Years in the Making: How Housing Subsidies Caused the Financial Meltdown*, 6 J.L. ECON. & POL'Y 165, 175–76 (2010) (explaining that the decline in residential property values as a result of the collapse of the housing market was "unprecedented, exceeding even the decline seen during the Great Depression").

⁹ For analyses of the subprime crisis, see generally ENGEL & MCCOY, *supra* note 5; MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010); ROBERT J. SHILLER, THE SUBPRIME SOLUTION: HOW TODAY'S GLOBAL FINANCIAL CRISIS HAPPENED, AND WHAT TO DO ABOUT IT (2008).

One of the striking features of the subprime era is that banks acted without adequate regard for state property law. They were intent on serving the national and international financial markets with new and more profitable products, and they treated state property law as an obstacle to get around rather than a foundation on which to build. Rather than sell mortgages to families that could afford them, they hoodwinked the vulnerable by picking their pockets. Rather than honestly disclose the high risks associated with subprime loans, they paid rating agencies to give them AAA ratings, inducing investors to take risks they neither were prepared for nor understood.¹⁰ The banks made huge amounts of money marketing mortgages to people who could not afford to pay them back while offloading the risks of such deals onto hapless third parties.¹¹ And rather than observe longstanding laws and customs designed to clarify property titles, banks evaded requirements of publicity and formality that traditionally governed real estate transactions.¹² In short, the banks misled both borrowers and investors while undermining property titles. This was both a clever and a profitable way to engage in business, but it was neither honorable nor responsible.

The participants in this scheme viewed existing practices and legal requirements governing real estate transactions as inefficient, costly, archaic, and unnecessary technicalities that prevented them from selling valuable financial products desired by homeowners and investors alike. So they invented ways to get around these laws and practices. It is clear they did not think through the myriad legal implications of what would happen if the housing market crashed. Nor did they pay sufficient attention to the

See also Brooksley Born, *Foreword: Deregulation: A Major Cause of the Financial Crisis*, 5 HARV. L. & POL'Y REV. 231, 233 (2011) (explaining the "devastating role that inadequate regulation played in causing the financial crisis").

¹⁰ See ENGEL & MCCOY, *supra* note 5, at 48–49 ("[T]he SEC began allowing arrangers to pay the rating agencies for rating the securities they were underwriting."); see also LEWIS, *supra* note 9, at 129 ("Wall Street firms had conspired with the rating agencies to represent [subprime mortgage-backed securities] as a diversified collection of assets . . .").

¹¹ See Alan M. White, *The Case for Banning Subprime Mortgages*, 77 U. CIN. L. REV. 617, 633–34 (2008) (recounting how the expansion of subprime lending led to increased "predatory lending," whereby lenders made available mortgage loans "which [were] not suitable or appropriate for the borrower, through fraud or deception"); Gregory Zuckerman, Susanne Craig, & Serena Ng, *U.S. Charges Goldman Sachs With Fraud—SEC Alleges Firm Misled Investors on Securities Linked to Subprime Mortgages; Firm Vows to Fight the Charges*, WALL ST. J., Apr. 17, 2010, at A1 ("Goldman is one of the few the U.S. has accused of misleading investors in the subprime-mortgage debacle As the housing market sank in 2007 and 2008, . . . Goldman was paid about \$15 million . . .").

¹² See, e.g., ENGEL & MCCOY, *supra* note 5, at 24 (describing a common bait-and-switch scheme, whereby lenders would describe loan terms to borrowers, only to later "change the terms after the borrowers were psychologically and financially invested in the loans"). Engel and McCoy go on to observe: "This was countenanced by federal disclosure laws, which only prohibited lenders from changing loan terms if they had made binding offers. In the subprime market, offers were almost never binding." *Id.*

details of state property law or the implications of their new marketing practices on the clarity of property titles. They did not do so either because they did not anticipate that anything would go wrong or because they thought others would bear the losses. But then the housing market crashed—as some predicted it would¹³—and the system they invented came crashing down with it. In dealing with the debris left by the crash, many state courts are now holding that the marketing and titling mechanisms the bankers invented did *not* comply with state property laws.¹⁴ These laws include statutes regulating consumer protection, recording, foreclosure, and negotiable instruments, as well as the statute of frauds.

In bypassing and undermining traditional legal rules and practices, the banks have created enormous problems for courts, market participants, and society as a whole. By selling adjustable-rate mortgages to millions of people who could not afford to pay them back, the banks inflicted novel individual and systemic risks.¹⁵ Borrowers and investors participated in these markets because they were led to believe the investments were safer than they actually were. The ones who created that impression of safety were the bankers that issued the loans and sold the securities.¹⁶ These new

¹³ See LEWIS, *supra* note 9 (detailing the stories of several investment fund managers and a Wall Street trader who separately and openly anticipated the crash of the mortgage-backed securities market).

¹⁴ See, e.g., *Boschma v. Home Loan Ctr., Inc.*, 129 Cal Rptr. 3d 874, 893–94 (Cal. Ct. App. 2011) (holding that a bank's misleading teaser rates violated state property law); *Commonwealth v. Fremont Inv. & Loan*, 897 N.E.2d 548, 556–61 (Mass. 2008) (explaining bank practices for lending were unfair and thus violated state property law).

¹⁵ One study argues, to the contrary, that predatory lending accounted for few defaults relative to non-predatory lending. Sumit Agarwal, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet & Douglas D. Evanoff, *Predatory Lending and the Subprime Crisis* 4 (Ohio St. Univ. Fisher Coll. of Bus. Working Paper Series, WP 2012-03-008, 2012), available at <http://ssrn.com/abstract=2055889>. However, the analysis is weak since it is not based on a comparison of similarly-situated borrowers who obtained subprime loans versus those who did not or who obtained prime loans, but instead on a comparison of defaults in an area regulated by an Illinois state-mandated lender-funded counseling process for risky borrowers seeking risky loans versus defaults on similar loans in an unregulated area. *Id.* at 11–14. While many subprime lenders exited the market in the regulated area, the percentage of defaults in the regulated area was only a little bit higher than in the nonregulated area. *Id.* at 23–24. The study's authors conclude that predatory lending did not contribute substantially to increased default rates, *id.* at 4, but the study is not capable of supporting such a conclusion. Instead, the study merely shows that loans precluded because of the increased closing costs created by the regulation would have had a slightly higher default rate than the loans that were actually made. Only by labeling the precluded loans as “predatory” is the study able to make its claim regarding predatory lending. The problem with this definition is that by almost any measure (including the fact that they triggered mandatory counseling) the loans that were actually made would also be deemed predatory. Thus, the study is not actually comparing predatory and non-predatory loans, but predatory loans that were still profitable to originate even with mandatory lender-funded counseling and those that were not. The study does not actually tell us about the effect of predatory lending on default rates.

¹⁶ See *New York Sues Credit Suisse over Mortgages*, N.Y. TIMES, Nov. 21, 2012, at B4 (reporting on a lawsuit filed against bank alleging that investors were misled about mortgage-backed securities).

marketing practices require courts to reinterpret the meaning of longstanding consumer protection laws prohibiting unfair or deceptive business practices. They also require legislators and regulators to consider what changes may be needed to prevent these practices in the future.

There is one institution neither the banks nor the subprime market could alter and that is the courts. Judges are now confronting a number of crucial questions arising from the subprime markets. First, courts must interpret and apply laws prohibiting unfair and deceptive conduct in consumer transactions. Some courts may be reluctant to characterize subprime mortgages as unfair or deceptive on the grounds that “everyone was doing it.” Other courts are recognizing that many mortgage brokers and banks actively misled both homeowners and investors about the benefits and stability of subprime mortgages.¹⁷ Some courts go further in finding that high interest adjustable rate mortgages were not suitable over the long run for people who could not afford them.¹⁸ For the same reason, they would be justified in finding that the securities based on these risky subprime mortgages were not suitable for investors, such as municipalities and pension funds, that depend on safe investments.¹⁹ The bankers appear to have assumed that subprime mortgages were lawful because no law specifically prohibited them. But they forgot that formal rules are always supplemented by equitable standards such as consumer protection and securities regulation statutes that prohibit unfair or deceptive business practices.²⁰ They should not have been so quick to assume that it was lawful to saddle borrowers with mortgages they could not repay and investors with mortgages that were, in truth, ticking time bombs. The courts are confronting hard normative and legal questions about the applicability of consumer protection statutes to these transactions.

Second, courts have been forced to determine how to respond to the massive and systemic failure of many banks to keep careful written records of mortgage assignments as required by the statute of frauds in every state. In attempting to lower the costs of mortgage transactions, the banks devised a privatized form of recording mortgage agreements known as Mortgage Electronic Registrations Systems (MERS), which allowed them

¹⁷ See Ben Protess, *U.S. Accuses Bank of America of a ‘Brazen’ Mortgage Fraud*, N.Y. TIMES, Oct. 24, 2012, at A1 (explaining allegation that Bank of America acted recklessly in issuing and forcing tax payers to guarantee billions in bad loans).

¹⁸ See, e.g., *Commonwealth v. Fremont Inv. & Loan*, 897 N.E.2d 548, 556, 558 (Mass. 2008) (finding mortgage lending practices unfair because bank knew or should have known that the borrower would default on the loan).

¹⁹ See Jessica Silver-Greenberg, *2 Banks to Settle Case for \$417 Million*, N.Y. TIMES, Nov. 17, 2012, at B1 (explaining settlements reached as a result of legal action taken over banks’ misstatements to investors in risky mortgage securities).

²⁰ See, e.g., Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2225–32 (2007) (detailing a variety of statutes which prohibit unfair or deceptive business practices in the area of mortgages).

to be prolific about securitizing those mortgages but complacent about formalizing mortgage assignments.²¹ The result was that the banks made many, many mistakes in keeping track of these transactions.²² Formal records of mortgage transfers are often incomplete or incorrect; the chain of title for many properties appears to be irretrievably broken.²³ The new procedures invented by the banks created title problems that the courts had never confronted before, and on such a massive scale as to have the potential to destabilize the entire housing market as well as the general economy. Not only have underwater mortgages helped prevent recovery from the recession,²⁴ but the banks' collective failure to comply with traditional property law has left real estate titles in shambles.

Worse still, the new procedures the banks established made it impossible for potential buyers to consult public recording offices to determine the state of title on any piece of property. The *privatization* of mortgage transactions impedes the alienability of land. In bypassing public recording systems, the banks have wrecked the well-functioning U.S. recording systems that had supported our property infrastructure since the offices were first established in the mid-seventeenth century colonial Massachusetts Bay.²⁵

Because the banks combined new procedures with sloppy record keeping, the courts now find themselves between a rock and a hard place. Traditional rules were intended to clarify property titles, but the banks' combination of cleverness and incompetence means that property titles will be clouded whether the courts strictly enforce the statute of frauds or relax its formality requirements. The traditional rules and requirements created a legal infrastructure that enabled property markets to work well. The banks' willful evasion of those practices and laws created precisely the

²¹ Nolan Robinson, Note, *The Case Against Allowing Mortgage Electronic Registration Systems, Inc. (MERS) to Initiate Foreclosure Proceedings*, 32 CARDOZO L. REV. 1621, 1622–23 (2011).

²² See David A. Dana, *Why Mortgage "Formalities" Matter*, 24 LOY. CONSUMER L. REV. 505, 505–06 (2012) (noting myriad mistakes in foreclosure procedures); Elizabeth Renuart, *Property Title Trouble in Non-Judicial Foreclosure States: The Ibanez Time Bomb?*, 4 WM. & MARY BUS. L. REV. 111, 119–24 (2013) (reviewing evidence of inadequate documentation of mortgage transactions); Alan M. White, *Losing the Paper—Mortgage Assignments, Note Transfers and Consumer Protection*, 24 LOY. CONSUMER L. REV. 468, 475–76, 488 (2012) (documenting failures to correctly handle note and mortgage assignments, as well as rampant inaccuracies in MERS records).

²³ See Dana, *supra* note 22, at 512–13 (identifying factors contributing to an “unresolved chain-of-title problem in both notes and mortgages”).

²⁴ See John Vogel, Editorial, *Thinking Outside the Housing Bubble*, U.S. NEWS & WORLD REP. ECON. INTELLIGENCE BLOG (June 17, 2013), <http://www.usnews.com/opinion/blogs/economic-intelligence/2013/06/14/housing-bubble-or-credit-bubble-it-matters> (“It is an oversimplification to focus solely on the housing market as either the cause of the Great Recession or the only reason for the slow recovery. However, it did play a large role in both and we need to take steps to prevent this pattern from happening again.”).

²⁵ See Christopher L. Peterson, *Foreclosure, Subprime Mortgage Lending, and the Mortgage Electronic Registration System*, 78 U. CIN. L. REV. 1359, 1364 (2010) (“[I]n 1636 the General Court of Massachusetts’ Plymouth Bay Colony adopted its first recording law . . .”).

results the tradition would have predicted: titles have become clouded and even unmarketable.²⁶ But, contrary to first instincts, we cannot solve the problem simply by strictly enforcing the traditional rules. The evasion of property law was so pervasive that rigid enforcement of the statute of frauds would destabilize property titles as badly as relaxing it would do. We would be cutting off our noses to spite our faces. The fix for the banks' failure to follow the rules of formality cannot be to wholly ignore transactions that did not follow those rules; this would leave existing owners with titles that are clouded rather than clear.²⁷ Courts adjudicating foreclosure cases are left with conundrums that have no easy resolution.

All this means that courts must reinterpret existing rules to fit the current circumstances. It also means that we may need legislatures to enact changes to banking and negotiable instruments law as well as to mortgage and foreclosure law. More fundamentally, participants in the real estate market need to change their attitude toward property law. The bankers approached the law the way Holmes's "bad man" would, seeking to get away with everything they could on the assumption that anything that is not expressly prohibited must be lawful.²⁸ It would have been better if they had acted responsibly by considering the purpose behind the law, instead of just examining the letter of the law to determine what they could get away with. That would require understanding the history of mortgage law and the reasons for the regulations we have.

Courts have historically assumed the role of monitoring mortgages to ensure fundamental fairness and to avoid unnecessary forfeiture of property.²⁹ They have done so not only to protect borrowers but also to ensure that the property system as a whole functions in an appropriate manner. The history of mortgage law from the Middle Ages on is one of strict regulation, followed by efforts to avoid regulation, followed by new regulation, *ad infinitum*.³⁰ Property law is intended to clarify title and the rules of the game; it protects owners while unleashing property development and transfer. But those rules cannot provide a safe harbor to actions that lead to substantial injustice or disorder.³¹ While property law

²⁶ See Renuart, *supra* note 22, at 137 (noting the profound difficulty in accurately identifying the proper party in a foreclosure proceeding under modern practices and systems).

²⁷ On the complicated normative relationships between formalism and equity, see Nestor M. Davidson, *New Formalism in the Aftermath of the Housing Crisis*, 93 B.U. L. REV. 389, 393–94 (2013).

²⁸ See Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 459 (1897) ("If you want to know the law and nothing else, you must look at it as a bad man, who cares only for the material consequences which such knowledge enables him to predict, not as a good one, who finds his reasons for conduct, whether inside the law or outside of it, in the vaguer sanctions of conscience.").

²⁹ See, e.g., Ann M. Burkhardt, *Lenders and Land*, 64 MO. L. REV. 249, 266, 289 (1999) (providing examples of intervention by courts to prevent the "harshness of strict foreclosure" and "abusive" or "uncontrolled" forfeiture).

³⁰ See *generally id.* (providing an excellent history of mortgage law).

³¹ For a description of the banks' continuing efforts to seek such safe harbors, see Peter Eavis,

cannot work unless it is tolerably predictable, it also cannot work if it immunizes actors from consequences for irresponsible schemes. Experience and history prove that our need to manage property as a basic part of the infrastructure of social and economic life requires flexibility as well as formal structures if we are to manage human affairs in a tolerable way. The boundless nature of human ingenuity means that we need nuance rather than rigidity if we want legal mechanisms that can protect the vulnerable from schemes designed to pick their pockets while offloading the social costs of exploitation onto the rest of us. And formality requirements, while crucial to the efficient functioning of property markets, can wind up biting us in the face if we do not apply them with some flexibility when they fail.

In Part II, I will explain the failures that arose in the origination, transfer, and foreclosure stages of the subprime mortgage market. The main problems were: (1) unfair and deceptive consumer practices; (2) failure to formalize mortgage assignments; and (3) privatization of the title and recording system.

In Part III, I will develop principles to guide our response to this attack on property law. Fundamentally, we need a change in attitude about regulation. Contrary to what the bankers thought, property law is not a regulatory impediment to efficiency; it is the foundational infrastructure that allows property and property markets to exist. I will argue that mortgage law is governed by two basic principles: (1) protect consumers; and (2) ensure that we have a secure legal infrastructure for our property system. I will propose some remedies for our current conundrums that promote these norms. I will suggest ways courts might handle some of the perplexing foreclosure cases still in the pipeline, and I will propose some legislative changes that might prevent these problems from recurring in the future. I will leave for others to handle needed changes in banking, securities, and negotiable instruments law, instead focusing on consumer protection, mortgage, and foreclosure law.

Part IV concludes by noting that the foreclosure crisis reminds us that we have an obligation to act responsibly and honorably, not only because we have a moral and legal obligation to treat others with due respect, but in order to preserve the infrastructure of our property system that is the foundation of our wealth and tranquility.

II. SUBPRIME MORTGAGE CONUNDRUMS

To understand the dilemmas courts currently face in foreclosure cases, we must understand the bank practices that bypassed or undermined traditional property law rules. Those include: (1) unfair and deceptive

Banks Seek a Shield in Mortgage Rules, N.Y. TIMES, Dec. 18, 2012, at B1.

consumer practices; (2) failures to formalize mortgage assignments in clear written records; and (3) privatization of public land records related to mortgages.

A. *Unfair and Deceptive Consumer Practices*

The subprime crisis was not just a typical market bubble. It happened because banks developed a business model that exploited vulnerable people by leading them to take out loans they could not afford. If they had had adequate information about what they were getting themselves into, they would have run the other way. And even if they understood and were willing to take those risks, subprime loans posed undue risks to third parties.³² Subprime mortgages were an innovation designed to fail, harming both those who bought them and the rest of us as well.

Once upon a time, banks would not lend money to people who could not pay it back. You had to *qualify* for a loan. The banks cared about your income, your credit history, and even your reputation in the community. If you could not make your mortgage payments, the bank would have to foreclose, and banks historically lost half their investment if they had to foreclose.³³ But then the banks figured out a way to make money by loaning it to people who could not pay it back. They took advantage of the fact that property values were rising and that mortgages could be bundled and securitized. The banks made money, not by slowly recouping mortgage payments over thirty years, but by selling the mortgage rights immediately to someone else, thereby off-loading the risk of nonpayment onto a third party.³⁴ The bank would make its money immediately while transferring the risk to someone who might or might not understand how great the risk was.³⁵ For all this work, people had to be convinced to take out loans they could not pay back and investors had to be convinced that the loans were safe. How to accomplish all this?

The loans were made affordable initially by using adjustable interest rates.³⁶ Borrowers felt comfortable paying the initial low interest rates. They either did not know about the later, higher rates, or they were assured that rising property values meant that they could either refinance the loan or sell the property at a profit when the higher interest rates kicked in.³⁷

³² On the link between predatory lending practices and predatory securitization practices, see Peterson, *supra* note 20, at 2220.

³³ ENGEL & MCCOY, *supra* note 5, at 4.

³⁴ White, *supra* note 22, at 471.

³⁵ See ENGEL & MCCOY, *supra* note 5, at 41 (explaining how securitization gave lenders the benefit of being paid in advance, while most borrowers were ill-informed on the loans they were taking).

³⁶ *Id.* at 10.

³⁷ *Id.*

The system was, for a time, self-reinforcing. Promoting investment in real estate by making mortgage loans to borrowers who could not have previously qualified for them helped fuel a housing bubble.³⁸ Greater demand for housing led to steadily increasing housing values, which would enable high-risk borrowers to sell or refinance when adjustable rate mortgages raised monthly payments to unaffordable levels.³⁹

Investors bought securities in subprime loans because they earned high rates of interest. They were induced to do so because the banks took advantage of mixed messages and inconsistent arguments. On one hand, the securities paid high rates because the loans were risky. On the other hand, the banks suggested that the risk was apparent rather than real. The loans were not really risky because rising property values made them a sure thing. And even if some defaults might happen, securitization spread the risk because the loans would not all default at once. The cherry on top was the AAA rating given by trusted, professional rating agencies that investors relied upon in making their investment decisions.⁴⁰

Little did the investors know that the banks hired the rating agencies, thereby making the rating agencies' fees dependent on doing what the sellers of the securities wanted; obviously what they wanted was AAA ratings for the securities to induce investors to buy the securities in the mortgage bundles.⁴¹ Rather than doing a complete evaluation of the mortgage-backed securities they were being asked to rate, the rating agencies relied on the securities arrangers to conduct "due diligence."⁴² Worse still, the arrangers found the securities to be sound, not because they were safe investments deserving of a AAA rating but merely because the packaged loans adhered to the lender's guidelines.⁴³ The rating agencies

³⁸ Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177, 1180–82 (2012).

³⁹ *Id.* at 1182.

⁴⁰ ENGEL & MCCOY, *supra* note 5, at 5–6 (“[M]any investors relied on rating agencies’ grades of the quality of mortgage-backed bonds, in the belief that investment grade bonds were good investments.”); David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 1012–14, 1022–24 (2006) (explaining the role of the rating agencies in promoting subprime mortgages).

⁴¹ ENGEL & MCCOY, *supra* note 5, at 49–51.

⁴² *Id.* at 48.

⁴³ *Id.* at 46; see Andrew Ross Sorkin & Mary Williams Walsh, *U.S. Accuses S. & P. of Fraud in Suit on Loan Bundles*, N.Y. TIMES, Feb. 5, 2013, at A1 (reporting on the Justice Department’s civil suit against Standard & Poor’s for defrauding or misleading investors by making investments in mortgage-related securities seem safer than they actually were); Mary Williams Walsh & Ron Nixon, *S. & P. E-Mails on Mortgage Crisis Show Alarm and Gallows Humor*, N.Y. TIMES, Feb. 6, 2013, at A1 (discussing rating agency correspondence suggesting agency knowledge that mortgage-related securities being rated as safe were actually of low quality); see also John M. Griffin & Dragon Yongjun Tang, *Did Subjectivity Play a Role in CDO Credit Ratings?*, 67 J. FIN. 1293, 1325–26 (2012) (explaining that even when a rating agency revised its views about the safety of mortgage-backed securities (CDOs), it failed to reclassify older issues as less than AAA).

also helped the arrangers game the system by telling them what they needed to do to get a AAA rating, and it was possible to arrange the loans in a manner that satisfied the rating agencies' AAA formula without a reasonable belief that the securities were actually safe.⁴⁴ What all this meant was that a AAA rating no longer meant a safe investment; what it actually meant was "buyer beware."

Banks therefore changed the substantive terms on which they made mortgage loans in conjunction with the way they made money from mortgages. The entire business model switched from long-term repayment of mortgage loans by those who were likely to be able to make the payments (with foreclosure available as an unusual and secure backup in case of default) to a short-term market dependent on risky borrowers and compliant investors.⁴⁵ None of this would have been possible unless both homeowners and investors had been misled into believing these investments were safer than anyone had a right to believe.⁴⁶

Nor was any of this unforeseeable. There were individuals who understood that subprime mortgages were bound to fail.⁴⁷ The banks scoffed at the skeptics but we know now that it was the bankers, and not the skeptics, who were living in a dream world where black is white. *The bankers should have known better.* And that means that the subprime mortgage market was built on fraudulent or quasi-fraudulent business practices. The banks used procedures for mortgage creation and marketing that obscured the real terms of the mortgages as well as their inherent risk.⁴⁸ They misled both borrowers and investors not by outright lies but by a combination of puffery and misdirection.⁴⁹ They thought they were safe as long as they did not lie or make affirmative misstatements. They thought they were acting within the bounds of the law as long as they could not find any clear, formal legal regulation that prohibited their conduct.

They felt comfortable doing this because the ideology of freedom of

⁴⁴ ENGEL & MCCOY, *supra* note 5, at 50.

⁴⁵ See JAMES R. BARTH, TONG LI, WENLING LU, TRIPHON PHUMIWASANA, GLENN YAGO, *THE RISE AND FALL OF THE U.S. MORTGAGE AND CREDIT MARKETS: A COMPREHENSIVE ANALYSIS OF THE MARKET MELTDOWN 50–51* (2009) (describing the shift in the mortgage market from long-term, risk sensitive borrows to short-term, risk ignorant borrowers).

⁴⁶ See Born, *supra* note 9, at 23–24 (determining that one reason banks lent to risky borrowers was because they "passed on the risks of the loans and had little incentive to maintain high lending standards").

⁴⁷ See, e.g., ENGEL & MCCOY, *supra* note 5, at 61 ("The truth is, many saw it coming . . ."); LEWIS, *supra* note 9, at 15 (recounting how Steve Eisman correctly foresaw the subprime crisis ten years before it happened by understanding the implications of loaning money to people who could not pay it back).

⁴⁸ See BARTH ET AL., *supra* note 45, at 51, 53, 55 (describing the marketing efforts of lenders to entice borrowers into loans that they could not afford if home prices declined).

⁴⁹ See, e.g., LEWIS, *supra* note 9, at 17 (recounting an example of a bank charging a 12.5% interest rate but telling the consumer it was an "effective interest rate" of 7%).

contract suggests that we view the agreements as voluntary. No one forced anyone to take out these mortgages; if the borrowers and investors wanted to invest in risky loans, who was to say they should not have the freedom to do so, as long as no law prohibited the transaction? The problem, of course, is that the banks acted like Holmes's "bad man" who wants to know what the formal law prohibits and then is content to "walk the line" and engage in behavior that contravenes the spirit of the law.⁵⁰ This problem leads courts and legislatures to protect both consumers and the public interest by making the edges of rules fuzzy.

Federal securities law prohibits any misleading communication in connection with the sale of securities and requires disclosure in order to avoid being misleading.⁵¹ In addition, both state consumer protection laws and the Federal Trade Commission Act prohibit "unfair or deceptive practices."⁵² Those laws had not previously been applied to mortgage loans, but they were in force at the time the subprime market got off the ground, and some courts have found it to be "unfair" to sell someone a mortgage you know cannot pay it back.⁵³ The banks wrongly adopted a formalistic conception of law. They thought that whatever was not clearly prohibited must be allowed. They treated the law as a rule-based system that created a safe harbor for their questionable activities and failed to engage in the moral reflection required of the standards-based law that was applicable to their conduct.⁵⁴

In addition to misleading both borrowers and investors, the banks failed to prepare adequately for the results of the massive foreclosures that resulted from the market they created. As foreclosures multiplied and the housing bubble burst and lowered property values, the banks began to own many housing properties that they could not sell.⁵⁵ The banks were not

⁵⁰ Holmes, *supra* note 28, at 459.

⁵¹ See Securities Exchange Act of 1934, 15 U.S.C. § 78j (2012) (stating that it is unlawful to use any "manipulative or deceptive device or contrivance" in connection with the sale of any security); 17 C.F.R. § 240.10b-5 (2004) (stating that it is unlawful, in connection with the sale of any security, to "defraud" or "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading").

⁵² 15 U.S.C. § 45(a)(1) (2012); *e.g.*, MASS. GEN. LAWS ch. 93A, § 2(a); see Joseph William Singer, *Subprime: Why a Free and Democratic Society Needs Law*, 47 HARV. C.R.-C.L. L. REV. 141, 155 (2012) ("Every state has a consumer protection law that prohibits unfair and deceptive acts and practices by businesses.").

⁵³ *Commonwealth v. Fremont Inv. & Loan*, 897 N.E.2d 548, 556–61 (Mass. 2008).

⁵⁴ See Seana Valentine Shffrin, *Inducing Moral Deliberation: On the Occasional Virtues of Fog*, 123 HARV. L. REV. 1214, 1214–17, 1219–29 (2010) (arguing that vague standards can guide action through inducing moral reflection); see also Jeremy Waldron, *Vagueness and the Guidance of Action* 11–19 (N.Y.U. Sch. of Law, Pub. Law Research Paper No. 10-81, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1699963 (same).

⁵⁵ See, *e.g.*, VIRAL V. ACHARYA, MATTHEW RICHARDSON, STIJN VAN NIEUWERBURGH & LAWRENCE J. WHITE, *GUARANTEED TO FAIL: FANNIE MAE, FREDDIE MAC, AND THE DEBACLE OF*

equipped to handle the situation. They normally had few foreclosures and were able to sell properties quickly after foreclosure. However, now they were forced by economic circumstances to hold onto properties after foreclosure, and they were not prepared to undertake the legal obligations of real estate owners. The banks became landlords for the foreclosed homeowners or their tenants, but many failed to comply with local housing codes and the warranty of habitability.⁵⁶ They denied that they were “landlords,” but of course they were. They sometimes violated the legal rights of tenants to have habitable housing and housing code compliance.⁵⁷

When foreclosed properties became vacant, the banks were not equipped to ensure their upkeep and safety. Many properties were allowed to deteriorate—causing nuisances in many areas and harming the interests of neighboring property owners and the municipalities in which those properties were located.⁵⁸ The banks’ failure to foresee the results of the subprime crisis not only led them to ignore the substantive rights of tenants to safe and habitable housing but the rights of neighboring owners to be free from nuisances. And of course, the whole thing wrecked the world economy, diminishing the amounts in many private college and pension funds and the value of stocks held by universities and private investors. The loss of jobs and the continuing recession have caused untold suffering. The failure to foresee the consequences of misleading consumer marketing has unfairly wreaked havoc on many lives.

To respond to these problems, we need both more and less formality. We need *more* formality because clearer disclosure requirements might induce fewer people to enter risky transactions like these. This is one of the goals championed by Senator Elizabeth Warren: better disclosure

MORTGAGE FINANCE 84–86, 92–94 (2011) (discussing the widespread drop in home prices across the country from 2004 to 2010, the resulting losses being borne by creditors, and their inability to sell these homes); see also ENGEL & MCCOY, *supra* note 5, at 70 (“By spring 2007, it was official: the United States was in a housing bust. In the first quarter of 2007, housing prices declined nationwide For borrowers facing difficulty making monthly payments, falling home prices severely limited their options. . . . Another solution was to pay off the loan by selling the home, but falling home prices eliminated that option for many people as well.”).

⁵⁶ Aarti Shahani, *With Banks as Landlords, Some Tenants Neglected*, NPR (Feb. 23, 2012), <http://www.npr.org/2012/02/23/147160871/with-banks-as-landlords-some-tenants-neglected>; see Creola Johnson, *Fakers, Breachers, Slackers, and Deceivers: Opportunistic Actors During the Foreclosure Crisis Deserve Criminal Sanctions*, 40 CAP. U. L. REV. 853, 867–69, 876 (2012) (labeling banks as “Slackers” for intentionally failing to maintain foreclosed properties in violation of local housing codes in many instances, which caused crime to fester in the surrounding communities).

⁵⁷ See Johnson, *supra* note 56, at 867–69 (discussing a judge’s method of using civil contempt to compel “slacker” banks and real estate speculators to comply with local housing codes for foreclosed properties that they own); Shahani, *supra* note 56 (“Some banks are failing to follow local and state housing codes, leaving tenants to live in squalor . . .”).

⁵⁸ ENGEL & MCCOY, *supra* note 5, at 143 (“When far-off entities end up owning homes after foreclosure, they often lack incentives to adequately maintain the property.”).

requirements for consumer debt transactions.⁵⁹ Beyond disclosure requirements, we may need to protect consumers, banks, and the general public from toxic loans likely to harm the whole society by regulating mortgage transactions to ensure they are sold only to those who can afford them.

On the other hand, we need *less* formality because we need businesses like banks to understand that practices that are not clearly prohibited by formal laws might *nonetheless be unlawful*. Consumer protection laws *deliberately* use vague and normatively charged language, outlawing all “unfair practices.” They do so in order to induce businesses to imagine whether they can justify themselves to a jury or a judge.

B. *Failures to Formalize Transactions and Clarify Title*

The subprime crisis has been hard to fix because of myriad failures to comply with basic formal requirements of state real property law. The procedures for transferring interests in property—including mortgages—were simple and clear. First, put property transactions in writing. Second, record them in the registry of deeds for the county in which the property is located. How hard could that be? These rules have been in effect in the United States for hundreds of years. The first statute of frauds was passed in England in 1677.⁶⁰ The General Court of Massachusetts’ Plymouth Bay Colony established its first recording law in 1636.⁶¹ These legal regulations should be neither surprising nor controversial. Their purpose is to clarify title to property and to make a public record of that title available so potential purchasers and government entities know who claims an interest in any piece of real estate. Clear titles are essential because we will be deterred from using or developing property if we do not know who owns it. We will neither buy property from someone who may not own it, nor sell our own property if we cannot assure buyers that they will get what we purport to give them.

Recording of property transactions is generally not required to effect a transfer of title or to grant a mortgage in property.⁶² A deed or a mortgage validly created and delivered effects a transfer of property rights.⁶³ The same is true of subsequent sales or assignments of the mortgage.

⁵⁹ See Elizabeth Warren, *Unsafe at Any Rate*, DEMOCRACY, Summer 2007, at 9–10, available at <http://www.democracyjournal.org/pdf/5/Warren.pdf> (arguing that just as buyers of consumer products enjoy regulatory protection from the marketing of dangerous tangible goods, consumers of financial products are entitled to similar protection from unreasonable levels of risk and misleading advertising or contractual terms).

⁶⁰ JOHN F. BAKER, A TREATISE ON THE LAW OF SALES OF GOODS, WARES AND MERCHANDISE AS AFFECTED BY THE STATUTE OF FRAUDS 2 (1887).

⁶¹ Peterson, *supra* note 25, at 1364.

⁶² SINGER, *supra* note 4, § 12.3.3.1, at 877.

⁶³ *Id.* § 9.3.1.1, at 779.

Nonetheless, the rules governing the recording system create strong incentives to record interests in real property because doing so protects the buyer from fraudulent or duplicate transfers or encumbrances.⁶⁴ For similar reasons, mortgages are ordinarily recorded.

Mortgage assignments, however, constitute a special case. Mortgages create a security interest in property to ensure payment of an underlying debt that is formalized in a note.⁶⁵ Negotiable instruments law in Article 3 of the Uniform Commercial Code may cover most mortgage notes,⁶⁶ although the law in this respect is amazingly unclear. Those notes may be transferred the way one transfers rights in a personal check. One can endorse the note by signing it and giving the note to the transferee, endorse it to the order of a particular person; or endorse it in blank with the name of the transferee to be filled in later.⁶⁷ Alternatively, one can simply transfer the note without endorsing it while providing independent evidence that the recipient is being granted the right to enforce the note.⁶⁸ If the right to enforce the note is transferred, the transferee would also want to be able to use the mortgage foreclosure process to enforce that obligation. In general, whoever has rights in the note also has rights to the mortgage method of enforcing the note (i.e., foreclosure).⁶⁹ If one were careful about all this, a mortgage assignment would be drafted and recorded while the note would be endorsed and delivered to the mortgage assignee. But the banks were not careful about any of this.

While the incentive to record deeds has always been strong, the incentive to record mortgage assignments has been less strong in many states.⁷⁰ That is because the states allow the possessor of the note (or someone who can show they are entitled to enforce the note) to foreclose on the property even if there is no mortgage assignment.⁷¹ The subprime market involved numerous transfers of mortgages. If the banks had foreseen the millions of foreclosures that would occur, they might also have foreseen that courts would seek assurances that the bank seeking to foreclose had a right to do so. If they had foreseen that, they would have

⁶⁴ *Id.* § 9.3.3.1, at 783.

⁶⁵ 59 C.J.S. *Mortgages* §§ 4–5 (2009).

⁶⁶ *See* U.C.C. § 3-104 (2011) (outlining the requirements for a mortgage note to constitute a negotiable instrument).

⁶⁷ *See id.* § 3-205 (describing different types of endorsements).

⁶⁸ Dale A. Whitman, *A Proposal for a National Mortgage Registry: MERS Done Right*, 78 MO. L. REV. (forthcoming 2013) (manuscript at 29) (on file with author).

⁶⁹ *See id.* at 16 (“[U]nder traditional mortgage law, having the right to foreclose depends on holding the obligation represented by the note, not on having an assignment of the mortgage, recorded or not.”).

⁷⁰ *Id.* at 22.

⁷¹ *See* Christopher J. DeCosta, *US Bank v. Ibanez: The Mortgage Industry’s Documentation Practices in Focus*, 55 BOS. B.J. 23, 23 (2011) (highlighting “widespread” use of post-foreclosure mortgage assignments).

kept careful records of mortgage assignments; they would have ensured easy and assured access to the underlying note, either by keeping it themselves or giving it to a custodian who could find the note when needed; they would have endorsed the notes correctly and completely; and they would have recorded mortgage assignments to give homeowners a way to find out who currently held rights in their mortgages and the notes to facilitate negotiation in cases of default. But none of that happened.

Property arrangements are among society's most formal transactions. Because of the importance of clear title to property, the law requires or encourages a high degree of formality to property transactions. By both custom and law, property transfers must be reduced to a writing and ownership interests should be made public through use of the recording system. We generally assume that formalities promote clarity and avoid misunderstandings and disputes. We assume that people know the law and comply with it, and that, if they do not, they suffer the consequences of having failed to adequately formalize their transactions. Holding people to the rules is thought to be a powerful incentive to induce them to learn what the law and comply with it. That, in turn, will promote clear and mutually understood contractual and property arrangements.

But formalities often fail. Why? While ignorance of the law is no excuse, it is extremely common for people to ignore or fail to comply with the statute of frauds. Sometimes this happens because of negligence. A building contractor may misread building plans or put the borders of property in the wrong place. Sometimes it happens because of the cost or difficulty of finding out what the law is or because social custom diverges from legal requirements. A home purchaser may not hire a surveyor when purchasing property to ensure that the written records accord with the borders on the ground. It may not be customary to pay for such a survey. Moreover, oral agreements among neighbors about borders may be the norm; indeed, seeking to reduce such understandings to writing may insult the neighbor and indicate mistrust. I myself talked to my neighbor about where our border was before building a fence around our backyard, both of us agreeing to eschew the costs of a formal survey. Property law recognizes the disjunction between possession and formal title through myriad doctrines such as adverse possession, prescriptive easements, oral agreement, acquiescence, and estoppel.

The banks did not have any of these excuses. The rules were simple and clear: put your transaction in writing and, if you want to ensure that there are no disputes about who owns what, keep track of the writing and record your interest. Yet this simple, clear system failed. The rules were clear but the bankers did not follow them. They wanted to make money through securitization, which requires multiple transfers of multiple mortgages. That would be costly and cumbersome if each mortgage assignment had to be reduced to writing sufficient to satisfy the statute of

frauds and a fee paid to record each in the relevant local registry of deeds. So the banks invented MERS, the Mortgage Electronic Registration Systems.⁷² This corporation was designed to stand in for the real parties in interest in mortgage transactions and allow them to avoid recording mortgage assignments every time those mortgages were transferred.⁷³ In the olden days, if you borrowed money from Bank of America to buy a house, you signed a note that constituted a contract between you and the bank stating the amount of the loan and the repayment terms. You also gave the bank a mortgage to the property, allowing the lender to foreclose on the property in either a judicial or a nonjudicial proceeding if you defaulted on your mortgage payments. That mortgage document would name Bank of America as the mortgagee and it would be recorded. If Bank of America assigned its rights in the mortgage to another bank, a written mortgage assignment would be drafted, signed, and recorded, and the note would be endorsed (signed) and transferred to the possession of the new mortgage holder. While it is true that recording of the mortgage assignment was not required, it was advisable to do so both to protect against fraudulent transfers and to ensure public notice of encumbrances attached to the land.

Instead of doing this, the MERS system allowed the original mortgage to be placed in the name of MERS rather than Bank of America.⁷⁴ If you went to the public registry of deeds to see if there were any liens or encumbrances on the property, all you would see was that the owner had granted a mortgage to MERS as “nominee” for Bank of America (the original lender).⁷⁵ Theoretically, MERS would keep an electronic database that would list Bank of America as the real mortgagee of the property; it would also list the name of any loan servicer hired by Bank of America to collect the mortgage payments from the homeowner.⁷⁶ When Bank of America transferred the note and mortgage to a second bank—say, Cambridge Trust—the theory was that Cambridge Trust would notify MERS and MERS would change the name of the mortgagee for that property on its books. Nothing would need to be changed in the public

⁷² See White, *supra* note 22, at 486 (explaining how MERS operates); Robinson, *supra* note 21, at 1621–23 (explaining the creation of MERS).

⁷³ *About Us*, MORTGAGE ELECTRONIC REGISTRATION SYS., INC., www.mersinc.org/about-us/about-us (last visited on Sept. 22, 2013).

⁷⁴ See Robinson, *supra* note 21, at 1623–24 (discussing capacity for foreclosure in MERS’s name instead of actual owners’ names); *Frequently Asked Questions*, MORTGAGE ELECTRONIC REGISTRATION SYS., INC., www.mersinc.org/about-us/faq#whatdoesmersasoriginal (last visited on Sept. 22, 2013) [hereinafter *MERS FAQs*] (explaining MERS mortgage contracts to grant mortgagee rights and status to MERS itself).

⁷⁵ Christopher L. Peterson, *Two Faces: Demystifying the Mortgage Electronic Registration System’s Land Title Theory*, 53 WM. & MARY L. REV. 111, 118 (2011); White, *supra* note 22, at 485; Robinson, *supra* note 21, at 1622.

⁷⁶ White, *supra* note 22, at 485; Robinson, *supra* note 21, at 1623.

registry of deeds, however; since MERS was holding the mortgage as the “nominee” for the real owner, no new recording would be needed.⁷⁷ Yet MERS also maintained, inconsistently, that it was both the mortgagee and merely the “nominee” (a limited agent) for the real mortgagee.⁷⁸ This system effectively created a national electronic registry for mortgages, bypassing the need for new paper assignments recorded in the various state registries of deeds with their attendant fees. Using this method, the banks thought they could both comply with state recording acts and avoid the costs and complexity associated with them.

The MERS system failed in several ways, all predictable from the start.⁷⁹ First, the banks apparently did not carefully research state property law. They operated in the context of a national or international securities market, and did not focus on the fact that property law is state law.⁸⁰ Every state has a Uniform Commercial Code that regulates negotiable instruments, and many courts interpret those laws to apply to most housing loan notes.⁸¹ Every state has statutes that allow for and regulate the recording of real property titles and mortgages. Every state has statutes that regulate the foreclosure process. The states’ laws are not uniform.⁸² It might be possible to develop a business model that would satisfy the rules of every state, which the banks that established MERS clearly thought they had accomplished. In retrospect, it is clear that they did not understand or research the complexities of state foreclosure law. Foreclosure litigation is now revealing that the MERS system, as implemented by the banks, often

⁷⁷ Dustin A. Zacks, *Standing in Our Own Sunshine: Reconsidering Standing, Transparency, and Accuracy in Foreclosures*, 29 QUINNIPIAC L. REV. 551, 559–60 (2011).

⁷⁸ See *id.* at 559–85 (analyzing conflicting theories about MERS’s role in the mortgage transactions); see also Peterson, *supra* note 75, at 118–25 (explaining the problems that arise from these inconsistent claims); Robinson, *supra* note 21, at 1645 (“[F]rom a legal standpoint, MERS cannot simultaneous [sic] be both principal and agent . . .”).

⁷⁹ See David Waks, *Mortgage Electronic Registration Suspense: What’s Happening* 4, 9, 11–12, 17, 19 (unpublished manuscript, Feb. 1, 2011), available at <http://ssrn.com/abstract=2197135> (detailing myriad foreclosure issues generated by the MERS system).

⁸⁰ See generally *id.* (highlighting the extreme differences among state courts’ handling of MERS litigation).

⁸¹ See, e.g., *In re Walker*, 466 B.R. 271, 282 (Bankr. E.D. Pa. 2012) (“There is abundant legal authority for the proposition that mortgage notes, such as the one involved in this matter, [for a residential real estate property] are negotiable instruments governed by article 3 of the U.C.C.”); *In re Edwards*, No. 11-23195, 2011 Bankr. LEXIS 5065, at *12–17 (Bankr. E.D. Wisc. Dec. 23, 2011) (finding a promissory note to be a negotiable instrument as per the U.C.C.); *Army Nat’l Bank v. Equity Developers, Inc.*, 774 P.2d 919, 930 (Kan. 1989) (holding Article 9 of the U.C.C. to apply to mortgages); David C. Hill, *Assignment of Mortgage Notes Under the Uniform Commercial Code*, MICH. REAL PROP. REV., Summer 2012, at 11, 12 (“[T]he enforcement of negotiable instruments . . . arises under Article 3 of the U.C.C., which has been adopted, in some variation, by every state.”).

⁸² See Andra Ghent, *America’s Mortgage Laws in Historical Perspective* 1 (Jan. 20, 2013) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166656 (detailing differences among state mortgage laws).

did not comply with the requirements of the laws of the several states.⁸³

Second, the MERS system made the banks complacent. They thought that if they ever had to foreclose, then MERS could either bring the foreclosure proceedings itself or MERS could assign the mortgage to the real party in interest and that party (or the loan servicer) could conduct the foreclosure.⁸⁴ The banks did not think there was a reason to have a clear chain of title showing the written mortgage assignments from the first mortgagee to the current one that was seeking to foreclose.⁸⁵ Nor were they sufficiently careful about endorsing and storing the underlying note so that it would be accessible if needed for foreclosure.⁸⁶ The banks also securitized and transferred so many mortgages that they made mistakes in record keeping.⁸⁷ Their records are incomplete in some cases and inaccurate in others.⁸⁸ They failed to carefully document all the mortgage transfers and they lost or misplaced notes.⁸⁹ They overly relied on the MERS mechanism. In the past, the courts had always been solicitous of the banks.⁹⁰ Most homeowners never contested foreclosures because they were indeed behind in their payments and neither the borrowers nor the courts had any reason to question whether the foreclosing bank had a right to do so.⁹¹

The subprime crisis changed all of this. When people stopped being able to pay the higher interest rates associated with adjustable rate mortgages and the housing bubble burst, making refinancing impossible,

⁸³ See, e.g., *Montgomery Cnty. v. MERSCORP, Inc.*, 904 F. Supp. 2d 436, 443–45 (E.D. Pa. 2012) (holding that MERS title system violated Pennsylvania recording statutes); *U.S. Bank Nat'l Ass'n v. Ibanez*, 941 N.E.2d 40, 53 (Mass. 2011) (finding foreclosure to be improper when a bank could not demonstrate clear chain of title to mortgages); Gretchen Morgenson, *Guilty Pleas in Foreclosure Fraud Cases*, N.Y. TIMES, Nov. 21, 2012, at B5 (detailing a foreclosure processing company founder that pleaded guilty to a charge of fraudulently preparing false documents to evict troubled borrowers from their homes).

⁸⁴ Zacks, *supra* note 77, at 552.

⁸⁵ See David E. Woolley & Lisa D. Herzog, *MERS: The Unreported Effects of Lost Chain of Title on Real Property Owners*, 8 HASTINGS BUS. L.J. 365, 401 (2012) (claiming banks were aware of gaps in the chain of title and intentionally sought protection from liability for invalid title).

⁸⁶ See Joshua J. Card, *Homebuyer Beware: MERS and the Law of Subsequent Purchasers*, 77 BROOK. L. REV. 1633, 1634 (2012) (noting that the “likelihood that MERS cannot identify the true owner of a particular mortgage note is quite substantial”).

⁸⁷ Woolley & Herzog, *supra* note 85, at 367.

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ See Dana, *supra* note 22, at 510 (noting the difficulty in getting courts to take seriously the question of noncompliance by banks with mortgage formalities).

⁹¹ See Timothy A. Froehle, *Standing in the Wake of the Foreclosure Crisis: Why Procedural Requirements Are Necessary to Prevent Further Loss to Homeowners*, 96 IOWA L. REV. 1719, 1738 (“[M]ost foreclosures go uncontested.”); see also *id.* at 1739–40 (highlighting the difficulty courts have in determining the rights of a bank to foreclose and obtaining proper relief for the homeowner).

defaults and foreclosures skyrocketed.⁹² For the first time, homeowner/borrowers started questioning whether the bank bringing the foreclosure action was entitled to recover the property to pay off the debt. It is a settled principle of real property law that a peaceable possessor is entitled to remain in possession unless someone can prove they have a better title.⁹³ But when MERS began bringing foreclosure proceedings, homeowners' lawyers began to focus on the inconsistent statuses MERS claimed for itself.⁹⁴ The mortgage documents suggested that MERS occupied both the role of mortgagee and the role of nominee for the mortgagee.⁹⁵ These roles are inconsistent; one cannot be both the principal and the agent. This is a form of property right that is not recognized by the courts; it is confusing and contradictory. The courts, therefore, were put to the task of determining what role MERS actually had.

It became clear that MERS was not the mortgagee, but merely an agent for the real mortgagee. But an agent's powers cannot exceed those of the principal. For MERS to foreclose, it had to show that it was an agent for the real mortgagee.⁹⁶ But how could it do that? It would have to show a clear chain of title to the mortgage from the original mortgagee to the current mortgagee or it would have to be able to produce the note.⁹⁷ Because its records were unclear or incomplete, it could not always do that.⁹⁸ Because it was not designed to be a document custodian, it did not have possession of the note. Moreover, like public recording systems, its information was only as good as the information it received. If banks did not notify it of mortgage assignments, then its records would be inaccurate or incomplete. That is in fact what occurred in many cases.

⁹² See Kathryn E. Johnson & Carolyn E. Waldrep, *The North Carolina Banking Institute Symposium on the Foreclosure Crisis: Overview*, 14 N.C. BANKING INST. 191, 198–99 (2010) (highlighting statistics showing the severe increase in delinquent loans and foreclosures).

⁹³ See, e.g., *Garlock v. Fulton Cnty.*, 176 A. 38, 39 (Pa. Super. Ct. 1935) (“Possession standing alone but unimpeached is evidence of title. It is the lowest kind of title, but is good against any one not having a better one.”).

⁹⁴ See Peterson, *supra* note 75, at 118 (“In litigation all across the country, attorneys representing MERS frequently take inconsistent positions on the legal status of the company, depending on the legal issue at hand.”).

⁹⁵ Whitman, *supra* note 68, at 39, 43.

⁹⁶ *Bain v. Metro. Mortg. Grp., Inc.*, 285 P.3d 34, 46 (Wash. 2012) (en banc) (“MERS offers no authority for the implicit proposition that the lender’s nomination of MERS as a nominee rises to an agency relationship with successor noteholders. MERS fails to identify the entities that control and are accountable for its actions. It has not established that it is an agent for a lawful principal.” (footnote omitted)).

⁹⁷ See Whitman, *supra* note 68, at 15–17 (indicating that title examiners may desire to locate a “recorded chain of title” in order to establish that the “party foreclosing the mortgage is the person with the right to do so”).

⁹⁸ But see Card, *supra* note 86, at 1662–63 (arguing that courts should accept MERS as the agent for the current mortgagee); Dustin A. Zacks, *MERS Is Dead: Long Live MERS*, 44 CONNTEMPORATIONS 62, 68 (2012) (arguing that courts’ decisions that “hold that language in MERS mortgages appointing MERS as agent of nominee is sufficient to permit MERS to foreclose”).

Some states have allowed MERS to bring foreclosure proceedings in its own name.⁹⁹ They view the MERS system as beneficial to the real estate market and feel that the homeowner has agreed to let MERS act as an agent for the real mortgagee—whoever that was. So they shifted the burden of proof onto the homeowner to show that MERS was not acting on behalf of the real party in interest.¹⁰⁰ Other courts, however, have refused to let MERS bring foreclosure proceedings on the ground that it had no title to the property or any interest whatsoever.¹⁰¹ If you are going to eject someone from their home, you have to show you have a better right to their property than they do. But MERS has no property rights of any kind; it does not own the mortgage or have a right to enforce the note, and it is not the one to whom the loan is owed.¹⁰² Those courts found that MERS could not be both the mortgagee and the nominee, and held that it was merely a nominee.¹⁰³ Because MERS is not the mortgagee, it has no power to assign rights in the mortgage to the real owner of the mortgage to enable it

⁹⁹ See MINN. STAT. § 507.413 (2012) (If “a mortgage is granted to a mortgagee as nominee or agent for a third party identified in the mortgage” then “[a]n assignment, satisfaction, release, or power of attorney to foreclose is entitled to be recorded in the office of the county recorder . . . and is sufficient to assign, satisfy, release, or authorize the foreclosure of a mortgage”); *Gomes v. Countrywide Home Loans Inc.*, 121 Cal. Rptr. 3d 819, 826–87 (Cal. Ct. App. 2011) (MERS may initiate nonjudicial foreclosure under deed of trust); *Mortg. Elec. Registration Sys., Inc. v. Revoredo*, 955 So. 2d 33, 34 (Fla. Dist. Ct. App. 2007) (MERS may foreclose as agent of the note holder); *Residential Funding Co. v. Saurman*, 805 N.W.2d 183, 183 (Mich. 2011) (MERS had sufficient “interest in the indebtedness” to initiate nonjudicial foreclosure proceedings); *Jackson v. Mortg. Elect. Registration Sys., Inc.*, 770 N.W.2d 487, 494 (Minn. 2009) (applying MINN. STAT. § 507.413 allowing MERS to initiate foreclosure proceedings); *cf. Culhane v. Aurora Loan Servs. of Neb.*, 708 F.3d 282, 291–93 (1st Cir. 2013) (MERS possesses a legal interest in the mortgage enabling it to transfer the mortgage to the holder of the beneficial interest or the bank that owns the right to foreclose to secure the underlying debt).

¹⁰⁰ *Mort. Elec. Registration Sys., Inc. v. Azize*, 965 So.2d 151, 154 (Fla. Dist. Ct. App. 2007) (noting that MERS’s status as agent for the mortgagee or note holder was sufficient to allow it to bring a foreclosure action as long as no proof was presented persuasively contesting its right to act as the agent for the mortgagee or note holder).

¹⁰¹ *E.g., LaSalle Bank Nat’l. Ass’n v. Lamy*, No. 030049/2005, 2006 WL 2251721, at *1 (N.Y. Sup. Ct. Aug. 7, 2006); *Fed. Home Loan Mortg. Corp. v. Schwartzwald*, 979 N.E.2d 1214, 1220 (Ohio 2012); *Bain*, 285 P.3d at 36–37; *cf. Mortg. Elec. Registration Sys., Inc. v. Sw. Homes of Ark., Inc.*, 301 S.W.3d 1, 3–5 (Ark. 2009) (stating that MERS has no standing to be involved in foreclosure proceedings because it has no interest in the property and can only act as an agent if directed to do so by a principal).

¹⁰² See Zacks, *supra* note 98, at 66 (explaining that MERS does not own the indebtedness and is unable to enforce the note).

¹⁰³ See, *e.g., LaSalle Bank*, 2006 WL 2251721, at *1–2 (“[T]his court and others have repeatedly held that a nominee of the owner of the note and mortgage, such Mortgage Electronic Registration Systems, Inc. (MERS), may not prosecute a mortgage foreclosure action in its own name as nominee of the original lender because it lacks ownership of the note and mortgage at the time of the prosecution of the action.”).

to foreclose unless it is acting as the agent for some principal.¹⁰⁴ If it is serving as the agent (nominee) for the real mortgagee, it cannot serve in that capacity without a clear record of who its principal is.¹⁰⁵ For the same reason, some courts refused to allow loan servicers to foreclose unless they can show a chain of mortgage assignments giving them the right to foreclose as agents for the mortgagee.¹⁰⁶ They are also agents for a principal and unless they can show that the principal has rights in the mortgage, they are in no better a position than MERS.¹⁰⁷

That left the current mortgagee to bring the foreclosure proceeding itself. But again, in the case of judicial foreclosures, some courts started insisting on proof that the mortgagee actually possessed rights in the property at the time the foreclosure proceedings began.¹⁰⁸ Because of the sloppy record keeping and the undue reliance on the MERS system, some banks could not make that showing.¹⁰⁹ In the case of nonjudicial foreclosures, the bank would conduct the foreclosure; usually it would buy the property itself at the foreclosure sale. At that point, title shifted from the mortgagor or the deed of trust owner to the foreclosure purchaser (usually the bank that thought it held the mortgage). That new owner would then try to evict the homeowner who no longer had title to the property. In these cases, once again, some courts put brakes on the whole affair.¹¹⁰ If the foreclosure was conducted by someone who was not the

¹⁰⁴ *Id.* at *2–3; *Bank of N.Y. v. Silverberg*, 926 N.Y.S.2d 532, 539 (N.Y. App. Div. 2011). *But see In re Relka*, No. 09-20806, 2009 WL 5149262, at *4–5 (Bankr. D. Wyo. Dec. 22, 2009) (noting that MERS has power to assign the note and mortgage).

¹⁰⁵ *Bank of N.Y. v. Alderazi*, 900 N.Y.S.2d 821, 824 (N.Y. Sup. Ct. 2010) (“A party who claims to be the agent of another bears the burden of proving the agency relationship.”). On the difficulty of figuring out what happens when the principal is unclear, see *Bain*, 285 P.3d at 50.

¹⁰⁶ *See In re Maisel*, 378 B.R. 19, 22 (Bankr. D. Mass. 2007) (holding that an agent cannot foreclose without proof of its agency relationship and a showing of the chain of mortgage assignments giving its principal a right to foreclose).

¹⁰⁷ *See Robinson*, *supra* note 21, at 1644 (“[A]n agent cannot augment or reduce the legal rights of its principal.”).

¹⁰⁸ *See, e.g., In re Foreclosure Cases*, 521 F. Supp. 2d 650, 653 (S.D. Ohio 2007) (no right to foreclose without possession of properly endorsed note); *Gee v. U.S. Bank Nat’l Ass’n*, 72 So. 3d 211, 213–14 (Fla. Dist. Ct. App. 2011) (assignee of a mortgage cannot foreclose when it failed to establish how its predecessor became the successor in interest to the prior holder of the mortgage); *Deutsche Bank Nat’l Trust v. Mitchell*, 27 A.3d 1229, 1231 (N.J. Super. Ct. App. Div. 2011) (same as *Gee*).

¹⁰⁹ *See, e.g., White*, *supra* note 22, at 474–77, 495 (arguing that sloppy treatment of notes was widespread, making it difficult for lenders to show properly endorsed notes to prove they had a right to foreclose and noting the “extensive inaccuracy of MERS” records). *See generally* Bradley T. Borden, David J. Reiss & W. KeAupuni Akina, *Show Me the Note!*, 19 WESTLAW J. BANK & LENDER LIAB. 1 (2013) (discussing competing state court rulings on the question of whether foreclosure can be avoided if the foreclosing party cannot produce the note on which the mortgage is based).

¹¹⁰ *See Bevilacqua v. Rodriguez*, 955 N.E.2d 884, 893–97 (Mass. 2011) (stating that if nonjudicial foreclosure is invalid because the foreclosing party could not prove it possessed the right to foreclose, then the purchaser at the foreclosure sale cannot transfer good title to a third party); *U.S. Bank Nat’l Ass’n v. Ibanez*, 941 N.E.2d 40, 49–51 (Mass. 2011) (holding that foreclosure is invalid unless the foreclosing party proved a right to possession of the property before the foreclosure occurred, so the

real mortgagee, then it had no right to foreclose on the mortgage.¹¹¹ You can foreclose on your own mortgage but not on someone else's mortgage. I can give you a deed to the Empire State Building and you would get what I have the right to sell—which is nothing, since I do not own the Empire State Building. It is a staple of real property law that, absent a statute to the contrary (such as recording acts), you cannot convey more than you own.¹¹² So if the bank that conducted the foreclosure did not own the mortgage, it could not foreclose and certainly could not transfer title to itself as foreclosure buyer. Since it obtained no title, it now has no right to eject the homeowner because it cannot prove it has a better title to the property than the peaceably possessing homeowner.

What to do now? Courts could strictly enforce the statute of frauds and hold that the banks simply cannot foreclose if they cannot prove that they “own the mortgage” through showing a clear chain of mortgage assignments, possession of an endorsed note, or proof that they are entitled to enforce the note, simply cannot foreclose. They would lose their interest in all such properties. Is that a viable solution to this problem? One problem is that this would reduce the market value of mortgages the bank cannot prove it owns to zero. That, in turn, would reduce the capital held by the bank and require it to replace that capital if it needed to meet regulatory requirements to have a certain amount of money on hand. If it cannot replace that capital, there is a chance that the bank could become insolvent. If this is a problem many banks face, and if many of them become insolvent, we could plunge the economy into a second major recession unless we bail out the banks a second time.

A second major issue that would arise is that the mortgagee might lose its interests in the mortgage, but this would not necessarily clear title for the borrower/mortgagor. There would still appear to be an undischarged mortgage on the books in MERS's name. That means that the property still appears to be encumbered by a mortgage. Just because the current mortgagee cannot prove it has title does not mean a prior assignee of the mortgage could not show a complete chain of title. So the current mortgagee could go back to the bank it purchased the mortgage from and get a written assignment, but it would have to get information about the

subsequent purchaser could not prove that it acquired good title sufficient to claim rights against the current possessor).

¹¹¹ Grant S. Nelson & Dale A. Whitman, *Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act*, 53 DUKE L.J. 1399, 1500 (2004) (“A sale is also void when the foreclosing party did not own the note . . .”); see also Robinson, *supra* note 21, at 1637 (stating that the law in most states requires the foreclosing party to show proof of ownership before beginning foreclosure proceedings).

¹¹² See, e.g., 26A C.J.S. *Deeds* § 277 (2011) (“A landowner cannot convey by deed a greater interest in property than he or she possesses.”); Adam J. Levitin, *The Paper Chase: Securitization, Foreclosure, and the Uncertainty of Mortgage Title*, 63 DUKE L.J. (forthcoming 2013) (manuscript at 16) (on file with author) (stating that in contract and property law a transferee acquires only the rights that the transferor had in the contract or property).

full chain of title for this to work. What would induce the prior bank to give the new written assignment? Suppose the prior bank also does not have a full chain of title; what happens then? Suppose it grants an assignment; how is that proof that that bank was entitled to give the assignment? Unless a full chain of mortgage assignments is granted, we are still not able to clear title. Alternatively, someone might find and produce the underlying note. But because contract arrangements might have identified someone other than the possessor of the note to be the party entitled to enforce the note, we cannot be assured that the possessor is the party with the right to foreclose.¹¹³ The fact that two documents are used (the note and the mortgage) and the fact that one may be entitled to enforce the note either because of possession of the note or because of contractual arrangements that give one the right to enforce it, the existing legal rules do not clearly identify the party in charge of the mortgage when records of mortgage assignments and note endorsements are not complete and accurate.

Now suppose that the prior bank sits on its laurels, happy that it has a mortgage it thought it had sold; after all, the transfer was null because it was not in writing, or in a writing anyone can find, or which is sufficiently detailed to prove the assignment was made. That bank received money for selling the mortgage and now has the mortgage back, as it were, for free. Would the bank that bought that mortgage accept this? No, it would sue the earlier bank either for an order to execute a mortgage assignment or it would sue the earlier bank for unjust enrichment for taking money for a mortgage that it never in fact sold. And how would the current mortgagee ensure that it could get that money? It might bring a lawsuit against the earlier bank and the homeowner and try to slap a lien on the property to ensure payment of that obligation. Thus, we would have a new encumbrance on the property arising out of the unjust enrichment lawsuit. Title is no closer to being cleared than it was before.

Suppose the borrower/homeowner is fed up by all this and just wants to bring a quiet title action against everyone who might have an interest in the property to determine who, if anyone, has a mortgage in it. Under the due process clause, that requires notice to all concerned.¹¹⁴ But the homeowner has no way of knowing who those parties are. The public records in the registry of deeds say that the mortgage is held by MERS.¹¹⁵

¹¹³ See David P. Weber, *The Magic of the Mortgage Electronic Registration System: It Is and It Isn't*, 85 AM. BANKR. L.J. 239, 245–46 (2011) (describing the difficulty of determining the party with the right to foreclose due to the resale of notes to parties that are not the mortgagee of record).

¹¹⁴ *Mullane v. Cent. Hanover Bank & Trust Co.*, 339 U.S. 306, 313 (1950).

¹¹⁵ *Merscorp, Inc. v. Romaine*, 861 N.E.2d 81, 83 (N.Y. 2006) (explaining that MERS is recorded as the mortgagee of record in the public records, but subsequent assignments are not publicly recorded and are tracked by MERS in its private system).

The homeowner could call up MERS and ask for the information on its books about the chain of mortgage assignments, but until recently all MERS would tell the homeowner was the name of her loan servicer, not the current mortgagee or prior holders of the mortgage.¹¹⁶ Because of litigation limiting its power to foreclose, MERS changed its policy several years ago and will now “usually” tell the homeowner the identity of the bank that MERS records show is the current mortgagee if it has that information.¹¹⁷ In some cases, its records show, not the name of the mortgagee, but the “investor” or the entity that pooled the mortgages to create mortgage-backed securities. In that case, MERS cannot reveal the name of the mortgagee because all it knows is the identity of the company that financed the securitization.

The 2009 amendments to the Truth in Lending Act (TILA) require borrowers to be notified when mortgages are assigned.¹¹⁸ But MERS will not generally reveal the chain of title to show all the mortgage assignments from the original to the current mortgagee.¹¹⁹ It is not its policy to do so and even if it agreed to do so, because of the banks’ failures to adequately track and formalize these transactions or to notify MERS of the assignments, that chain is likely to be broken. So if the homeowner cannot find out all the parties who claim an interest in the property, what can she do? Perhaps she can sue MERS and the current mortgagee seeking to foreclose (if she knows who that is) or any prior mortgagees she can find out about. She can also post a notice in the newspaper trying to notify all others about her claim. Perhaps this will satisfy due process requirements for notice before losing a property right.

But now we face another problem. This lawsuit is being brought by the homeowner who defaulted on her loan. Where does she get the money to hire a lawyer and pay for the lawsuit? Perhaps a potential purchaser would be willing to pay the cost. That would only make sense if the increased costs for the property associated with a lawsuit, as well as the time needed to prosecute a quiet title action, would still make the property attractive to the potential buyer. Perhaps the buyer could simply purchase title insurance to facilitate the deal. That requires a title insurance company willing to ensure the title to property for which there are no public records of mortgage assignments, i.e., for an unknown risk. Any of these solutions increases the costs associated with the property and decreases its market value. All of this impedes alienability.

The result is that the title to the property is under a significant cloud. The property seems to be subject to a mortgage in MERS’s name, but since

¹¹⁶ Robinson, *supra* note 21, at 1652.

¹¹⁷ *MERS FAQs*, *supra* note 74.

¹¹⁸ 15 U.S.C. § 1641(g) (2012).

¹¹⁹ Levitin, *supra* note 112, at 29–30.

MERS cannot be the mortgagee, the encumbrance on the property cannot be clearly identified.¹²⁰ Because the banks did not strictly comply with the statute of frauds and customary practice under the recording acts, they often cannot produce a properly endorsed note. And because the possessor of the note may not be the person entitled to enforce it, some mortgagee at some point could come forward and claim rights in the property under the note and mortgage through a full chain of title. Until that happens, however, the property has an uncertain encumbrance. In conjunction with the costs of a quiet title suit or enhanced title insurance, we have impediments to the title that could render the property unmarketable.¹²¹

This creates a situation in which both the homeowner and the current purported mortgagee have some bargaining power over each other. The mortgagee may want to foreclose or renegotiate the mortgage payments since it needs the money from the property to fulfill its capitalization requirements and to lessen any loss of profits from its investment in the property. The homeowner needs to clear title so she can sell the property or get a new loan and to fix her credit rating. They have an incentive to reach an agreement since both would like to clarify title. But, of course, negotiations between them could fail for any number of reasons: they mistrust each other; they are mad at each other; they overestimate the other side's reserve price. And if the mortgage is held by a trust as part of a securitization, that trust may be subject to contractual limitations on its ability to renegotiate mortgages, while the thousands of investors in the securities have no ability to contact each other, much less agree on a course of action.¹²² Moreover, even if the current mortgagee and mortgagor reach an agreement, under the law, the two of them cannot divest a prior mortgagee of any persisting interest in the property. Remember that if we strictly enforce the statute of frauds, the current mortgagee who cannot show a full chain of mortgage assignments or who cannot prove that it is entitled to enforce the note owns nothing and the homeowner cannot free herself from an existing mortgage in someone else simply by saying so. An agreement between them would not discharge the rights of a prior mortgagee.

What to do? The courts get around all this by allowing the current bank to file an affidavit swearing that it is the current lawful holder of the mortgage and the note, while public notice of foreclosure serves to place

¹²⁰ MERS's website takes the contradictory positions that MERS is the "original mortgagee" and that it is the "agent" for the "owner of the loan" as well as the "mortgage lender." *MERS FAQs*, *supra* note 74. This waffling in legal positions is part of what has confused the courts about MERS's legal status.

¹²¹ See Woolley & Herzog, *supra* note 85, at 367 (noting that MERS may make various titles unmarketable).

¹²² Robert C. Hockett, *Paying Paul and Robbing No One: An Eminent Domain Solution for Underwater Mortgage Debt*, 19 CURRENT ISSUES IN ECON. & FIN. 1, 6-7 (2013).

prior mortgagees on notice that they may lose their rights if they do not appear to assert them.¹²³ But once again, in an effort to save costs, some banks hired people to sign hundreds of affidavits a day.¹²⁴ They did so with no research whatsoever.¹²⁵ This “robo-signing” was not only a fraud on the court but it constituted perjury.¹²⁶ For this to work the way it is supposed to, the banks actually have to research each mortgage, find the note, and explain the evidence that leads the bank to believe that it actually has the right to foreclose on the property.¹²⁷ But if there is no clear chain of title and the note has been lost, what evidence would suffice? By definition, we are only in this position because the written chain of evidence is broken or incomplete. The affidavit constitutes a bank’s sworn statement, but it must be backed up by objective facts and evidence. It is not clear the banks have sufficient ability to carry this out. But if they do come up with reliable evidence and we allow them to claim the mortgage by an affidavit, we have fixed the title problem by relaxing the statute of frauds. We are forgiving the bank for failing to comply with formality requirements, and we are doing so because strict adherence to formality would muddy property titles rather than clarify them.

An alternative to relying on the mortgage assignments is to rely on the note as the basis for foreclosure. Whoever possesses that note (or has a contract making it the agent of the note holder) arguably has the rights in the accompanying mortgage. Traditionally, “the mortgage follows the note.”¹²⁸ The note is the primary legal obligation and the mortgage is simply a device to protect the interests of the note holder.¹²⁹ Traditionally, when the mortgage is assigned to another bank, the note should be endorsed and transferred along with it.¹³⁰ But what if that does not happen? This was a common occurrence in the subprime mortgage market. Some courts hold that the mortgage and the note cannot be owned

¹²³ Gloria J. Liddell & Pearson Liddell, Jr., *ROBO SIGNERS: The Legal Quagmire of Invalid Residential Foreclosure Proceedings and the Resultant Potential Impact upon Stakeholders*, 16 CHAP. L. REV. 367, 378 (2012); White, *supra* note 22, at 479–80, 491–92.

¹²⁴ Liddell & Liddell, *supra* note 123, at 367–69; White, *supra* note 22, at 469–70.

¹²⁵ White, *supra* note 22, at 469–70.

¹²⁶ Liddell & Liddell, *supra* note 123, at 367–69.

¹²⁷ See White, *supra* note 22, at 472–73, 477 (noting that demonstrating possession of the physical note is the primary evidence of ownership and that the “touchstone of proper acquisition . . . is physical delivery of the original note”).

¹²⁸ Chase Home Fin., LLC v. Fequiere, 989 A.2d 606, 611 (Conn. App. Ct. 2010); White, *supra* note 22, at 489; see RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 5.4(c) (1996) (“A mortgage may be enforced only by, or in behalf of, a person who is entitled to enforce the obligation the mortgage secures.”).

¹²⁹ SINGER, *supra* note 4, § 12.4.1.1, at 894.

¹³⁰ See *Carpenter v. Longan*, 83 U.S. 271, 274 (1872) (“The note and mortgage are inseparable; the former as essential, the latter as an incident. An assignment of the note carries the mortgage with it, while an assignment of the latter alone is a nullity.”).

by different parties.¹³¹ But what happens if they are separated? Other courts say that the note holder's rights are primary and the mortgage holder holds those rights for the benefit of the note holder.¹³² Still other courts say the holder of the mortgage owns it and along with it the rights under the note on the ground that a mortgage assignment intends to transfer rights in the note.¹³³ Some states hold that the foreclosing party must possess both the mortgage and the note or be in an agency relationship with the note holder.¹³⁴ Some states had clear rules about this prior to the subprime crisis but others did not.¹³⁵

The prevailing view seems to be that most mortgage notes are negotiable instruments governed by Article 3 of the Uniform Commercial Code (U.C.C.) and that mortgage obligations are owed to the "person entitled to enforce the note" within the meaning of U.C.C. section 3-301; that person may be different from the person who "owns" the note and has the ultimate right to the economic value of the note.¹³⁶ To make things even more complicated, Article 9 of the U.C.C. was amended recently and

¹³¹ *E.g.*, *Saxon Mortg. Servs., Inc. v. Hillery*, No. C-08-4357 EMC, 2008 WL 5170180, at *5 (N.D. Cal. Dec. 9, 2008) ("[F]or there to be a valid assignment, there must be more than just assignment of the deed alone; the note must also be assigned." (citing *Carpenter*, 83 U.S. at 274)).

¹³² *See, e.g., Fequiere*, 119 Conn. App. at 610–12 (noting that Connecticut General Statutes § 49-17 "codifies the common-law principle of long standing that 'the mortgage follows the note,' pursuant to which only the rightful owner of the note has the right to enforce the mortgage"); *Mortg. Elec. Registration Sys., Inc. v. Coakley*, 838 N.Y.S.2d 622, 623 (N.Y. App. Div. 2007) (holding that a mortgage passed "as an incident to the promissory note" and therefore, the note holder had the right to foreclose). Note also that a party may hold the note for the benefit of another party and act as an agent for that party, thus occupying a status as a person entitled to enforce the note although the proceeds of any such enforcement action belong to the principal who "owns" the note. *See BAC Home Loans Servicing, LP v. Kolenich*, No. CA2012-01-001, 2012 WL 5306059, at *6 (Ohio Ct. App. Oct. 29, 2012) (reasoning that the mortgage can be foreclosed by the holder of a negotiable note, even if the note is "owned" by a different party); Card, *supra* note 86, at 1651 (granting primary rights to the note holder under New York law).

¹³³ *See, e.g., Crum v. LaSalle Bank, N.A.*, 55 So.3d 266, 270 (Ala. Civ. App. 2009) (holding that there was no "genuine issue of material fact that MERS assigned to the assignee all the rights formerly held by it and the lender"); *Wells Fargo Bank, N.A. v. Marchione*, 69 A.D.3d 204, 207 (N.Y. App. Div. 2009) ("In order to commence a foreclosure action, the plaintiff must have a legal or equitable interest in the mortgage."); *Wells Fargo Bank, N.A. v. Byrd*, 897 N.E.2d 722, 726 (Ohio Ct. App. 2008) (holding that a bank without the right to foreclose "cannot cure its lack of standing by subsequently obtaining an interest in the mortgage").

¹³⁴ *See In re Agard*, 444 B.R. 231, 254 (Bankr. E.D.N.Y. 2011) (analyzing the inconsistencies of assigning a mortgage when a party has no interest in the note); *Eaton v. Fed. Nat'l Mortg. Ass'n*, 969 N.E.2d 1118, 1121 (Mass. 2012) (discussing the fact that a foreclosure sale must comply with all applicable statutory provisions).

¹³⁵ On the complexity of the issues involved in determining the relation between the note and the mortgage, see Levitin, *supra* note 112, at 22; Recent Case—U.S. Bank National Ass'n v. Ibanez, 941 N.E.2d 40 (Mass. 2001), 125 HARV. L. REV. 827, 831–33 (2012).

¹³⁶ U.C.C. § 3-301 (2011); REPORT OF THE PERMANENT EDITORIAL BD. FOR THE UNIF. COMMERCIAL CODE, APPLICATION OF THE UNIFORM COMMERCIAL CODE TO SELECTED ISSUES RELATING TO MORTGAGE NOTES 4, 8 (2011), available at <http://www.ali.org/00021333/PEB%20Repo rt%20-%20November%202011.pdf>.

its relationship to Article 3 has generated disputes among both practicing lawyers and scholars about the rules governing the transfer of notes issued to finance real property transactions.¹³⁷ Nor is the relationship clear between the U.C.C. and state recording and foreclosure statutes as to how to regulate the assignment of mortgages and rights in the note and the rules governing the evidence sufficient to start a foreclosure procedure.¹³⁸ The failure of the banks to assign MERS the role of holding the notes and ensuring their endorsement either in blank or with the series of mortgage transfers endorsed on them has created another, independent problem in clarifying who has the right to foreclose.

The U.C.C. rules governing notes associated with mortgages were not clear at the time of the subprime mortgage debacle.¹³⁹ If law professors and experts in the field of real estate cannot agree on what the rules mean, then perhaps the banks could be forgiven for not knowing the law.¹⁴⁰ The architects of the Article 9 revisions thought that this would validate mortgage securitizations because Article 9 seems to recognize contracts that purport to transfer the beneficial interest in negotiable instruments but fail to adhere to the requirements of Article 3 that the notes be endorsed or the requirements of state mortgage law that may require mortgage assignments to be in writing and recorded before a foreclosure can occur.¹⁴¹ In a sense then, the banks relied not on clear legal authority but on the assumption that the courts would roll over and protect the banks' interests regardless of the legal uncertainties surrounding the transactions. They believed that, as in the past, the courts would assume that foreclosing entities had the right to foreclose and that defaulting homeowners deserved to lose their homes. They assumed that multiple sources of legal authority would benefit them rather than muddy the waters.

The opposite has turned out to be the case. Because the banks diverged so sharply from prior practice by creating MERS, they took a risk that the courts would interpret state law to validate their arrangements. Their undoing stemmed from a lack of care in documenting mortgage

¹³⁷ Levitin, *supra* note 112, at 40; White, *supra* note 22, at 473; *see also* John Patrick Hunt, Richard Stanton & Nancy Wallace, *Rebalancing Public and Private in the Law of Mortgage Transfer* 10–11 (U.C. Davis Legal Studies, Research Paper No. 327, 2013), *available at* <http://ssrn.com/abstract=2117555> (analyzing the ambiguous relationship between Article 9 and state recording and foreclosure statutes). *But see* Whitman, *supra* note 68, at 26 (positing that Article 9 determines who owns the economic benefit of the note while Article 3 determines who has the power to enforce the note).

¹³⁸ *See* Levitin, *supra* note 112, at 22 (discussing the conflict of the U.C.C. Article 3 and state land record systems for recording a mortgage title); White, *supra* note 22, *passim* (recognizing that assignments in mortgages and notes followed different rules).

¹³⁹ Levitin, *supra* note 112, at 28; White, *supra* note 22, at 471–72.

¹⁴⁰ *But see* Levitin, *supra* note 112, at 40–41 (arguing that banks created this ambiguity by lobbying to amend Article 9 in a manner that made the rules unclear).

¹⁴¹ *Id.* at 43.

transfers and keeping track of notes. They did not anticipate that courts would both hold them to traditional statutory formality requirements and burdens of proof and rule in favor of homeowners and against the banks' interests. Because of the failures to clearly document mortgage assignments, keep clear custody of notes, and transfer them in proper ways, and because of the robo-signing scandal,¹⁴² many judges no longer trust the banks.

The old system worked because the courts trusted the banks, and now that that trust is gone, we are beset by dilemmas. The banks did not realize that an efficient and well-working market system depends on trust, both among market actors and contracting parties and between market actors and government regulators, including judges. The banks cut corners and many judges today are in no mood to cut them slack. To make matters worse, many states allow nonjudicial foreclosure—a much less expensive system than judicial foreclosure¹⁴³—which is especially dependent on courts' and legislators' trust in banks to exercise their powers appropriately. But now that trust in banks has been shattered, eviction lawsuits following nonjudicial foreclosure are reintroducing the costs that nonjudicial foreclosure was supposed to avoid.

Amazingly, over the last ten years, the banks have wrecked a property recording system that worked relatively well for hundreds of years.¹⁴⁴ It is astonishing that they did this and tragic that we are suffering the price of their arrogance. We are left today with clouded titles, rampant litigation, and insecure property rights. All of this inhibits the use and alienability of land. The banks' practices violated core norms underlying private property law.¹⁴⁵ The banks thought they could make money by getting around the rules or even by ignoring them. We had clear rules, but the banks ignored them. Clear rules did not lead to either clear titles or predictable results.

That leaves us with a paradox. If we do not have a writing requirement for property transactions, then property rights will not be clear; people can always claim they acquired rights by informal arrangements or oral contracts and it is easy to lie about such things. But if we strictly enforce the writing requirement, title will also not be clear; because of the massive refusal to comply with the writing requirement and because of the importance of mortgages to the banks' capital structure and bottom line,

¹⁴² *Id.* at 1, 6.

¹⁴³ *Id.* at 21.

¹⁴⁴ For a detailed explanation of various title problems MERS created, see Woolley & Herzog, *supra* note 85, at 382–83.

¹⁴⁵ See Joseph William Singer, *Democratic Estates: Property Law in a Free and Democratic Society*, 94 CORNELL L. REV. 1009, 1023 (2009) (acknowledging that traditional core of property law is the promotion of alienability); Joseph William Singer, *The Rule of Reason in Property Law*, 46 U.C. DAVIS L. REV. 1369, 1371 (2013) [hereinafter Singer, *Rule of Reason in Property Law*] (noting that property law aims to achieve clear titles).

strict enforcement of the writing requirement will either cause a new recession or generate massive lawsuits to renegotiate property rights. We're damned if we do and damned if we don't. Rigid rules, including rules governing formalities, do not necessarily lead to clear property rights even if you attempt to apply them mechanically. Rules do not promote predictability or clear property rights if people do not follow them; this turns out to be a far more serious problem that we may have thought.

C. Privatization of Public Land Records

The MERS system failed not only because it led to careless record keeping and was carried out in a manner that violated the real property law of many states, but because it *privatized* information about mortgages.¹⁴⁶ State recording acts generally promote but do not require interests in real property to be recorded to be valid.¹⁴⁷ A few states, like Pennsylvania, do require that real property interests be in writing, and also recorded, to be legally valid.¹⁴⁸ Most states rely on the self-interest of mortgage lenders to record mortgages to ensure that they have priority over later interests. The system not only promotes a clear record of who owns property and what encumbrances attach to it, but makes that information available to the general public. This means that anyone who wants to buy property or provide a loan secured by a mortgage in the property can determine who owns the property and what prior liens exist on it. Making the information public serves the old-fashioned goals of property law by promoting the alienability of land. While mortgage assignments were not always recorded before the subprime crisis, MERS complicated things enormously by seeking to occupy an ambiguous status in the mortgage system and by inducing privatization of mortgage information.

Because only MERS's name and that of the original lender appear in the public records, publicly available information about who owns particular mortgages no longer exists; that information is all on MERS's private computers.¹⁴⁹ Until recently, MERS did not even make that

¹⁴⁶ See Levitin, *supra* note 112, at 30 (describing the "MERS' database functions as a do-it-yourself private mortgage recordation system").

¹⁴⁷ Whitman, *supra* note 68, at 51.

¹⁴⁸ See *Montgomery Cnty. v. MERSCORP, Inc.*, 904 F. Supp. 2d 436, 444–45 (E.D. Pa. 2012) (interpreting a Pennsylvania statute, 21 PA. CONS. STAT. § 351 (2011), to require recording for transfers of interests in land to be valid); cf. *Hooker v. N.W. Tr. Servs.*, No. 10-3111-PA, 2011 WL 2119103, at *3 (D. Or. May 25, 2011) (interpreting OR. REV. STAT. § 86.735 (2010) to conclude that nonjudicial foreclosure is not available in Oregon unless all mortgage assignments are recorded); *PHH Mortg. Servs. Corp. v. Perreira*, 200 P.3d 1180, 1186 (Idaho 2009) (interpreting IDAHO CODE ANN. § 45-1505 (2008) and holding that a trustee cannot foreclose on a trust deed unless the trust deed and any of its assignments are recorded).

¹⁴⁹ MERS's website misleadingly asserts that it does not "hide the mortgage note owner" because all MERS mortgages "are recorded in the public land records" while acknowledging that the purpose of the MERS system is to make it unnecessary for lenders to record mortgage assignments. *MERS FAQs*,

information available to the homeowners who were obligated to pay the mortgages; all MERS would tell homeowners was the name of the loan servicer hired to collect their payments.¹⁵⁰ For that reason, the homeowner who wanted to avoid foreclosure by negotiating with the beneficial owner of the mortgage could not find out who that was by searching either public records or by consulting MERS.¹⁵¹ MERS has now partially changed that policy, but it still does not make mortgage ownership information available to the public; it will not tell strangers who owns the mortgage in a particular piece of real estate.¹⁵² Nor will MERS reveal the chain of title so potential buyers of land can determine if the current mortgage holder could foreclose on the property if it sought to do so.

What effects does this new secrecy of property titles have? For one thing, homeowners seeking to renegotiate their mortgages could not do so when MERS would not tell them who owned the mortgage. MERS would only tell them the name of the loan servicer and loan servicers often had incentives to foreclose rather than renegotiate.¹⁵³ The loan servicers' contracts often gave them more money that way and sometimes the contracts prohibited them from renegotiating the deal.¹⁵⁴ But even though MERS has changed that policy, neither the homeowner nor others can determine what encumbrances exist on the property. Because of past business practices by MERS and the banks, neither homeowners, potential buyers, the banks, nor the courts have any reason to treat MERS records as either complete or accurate. And since they cannot trust those records, they seek information about the actual chain of transactions affecting the property. But MERS treats its computers and the information on it as private property from which it has the right to exclude outsiders. The result of all this has been to destroy our public recording system. *We no longer have trustworthy public records of property title in the United*

supra note 74. "Because MERS is a common agent for its members, recording an assignment of the mortgage is not necessary when ownership of the promissory note or servicing rights transfer between members." *Id.*; see also Peterson, *supra* note 25, at 1400–04 (noting the negative effect of MERS on public land title records).

¹⁵⁰ Tanya Marsh, *Foreclosures and the Failure of the American Land Title Recording System*, 111 COLUM. L. REV. SIDEBAR 19, 23 (2011).

¹⁵¹ Robinson, *supra* note 21, at 1638.

¹⁵² See Marsh, *supra* note 150, at 23 (describing how when a mortgage is sold and "the conveyance information is registered in MERS, but no assignment is recorded," it is difficult to tell who actually owns the mortgage); see also Complaint at ¶ 150(b), *Mass. v. Bank of Am., N.A.*, No. 11-4363-BLS1, 2012 WL 6062747 (Mass. Super. Ct. Dec. 3, 2011) (noting that when a promissory note is sold, the transaction is supposed to be tracked in the MERS database, but MERS members are responsible for entering information into the system, and only these members can access this information).

¹⁵³ Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1, 4 (2011) (analyzing the servicing industry and how the economics of the industry often discourage the restructuring of defaulted loans).

¹⁵⁴ ENGEL & MCCOY, *supra* note 5, at 131; White, *supra* note 22, at 496.

States.

Property scholars have long argued that property rights cannot work if they are not clear.¹⁵⁵ They have also recently emphasized that they cannot work if they are not *publicly known*. Henry Smith's work on the in rem nature of property rights emphasizes the information cost benefits of knowing who the gate keeper for property is.¹⁵⁶ Privatizing information in property rights requires us to trust MERS to accurately determine who the current mortgagee is. But we have no reason to trust MERS because the records are not public and because the MERS system induced banks to keep incomplete and inaccurate records of mortgage assignments. Moreover, monopolies have a tendency to abuse their power unless they are subject to oversight.

While freedom of contract is traditionally assumed to be the core value of our contract law system, promoting the alienability of land is traditionally assumed to be the core value of our property law system.¹⁵⁷ That policy supports giving owners robust powers over their property and it requires clear rules about who owns what—meaning public notice of who owns land and how it is encumbered. In their zeal to make money, the banks have broken the foundational structures on which our property law system sat. They viewed regulations as costly interferences with their pursuit of profit and they failed to understand how those regulations were necessary for the property market to work well in the first place.

III. HOW TO FIX THEM

How should courts respond to the problems the subprime market has presented to them? What laws should legislatures pass to avoid these problems in the future? Answering these questions requires us not only to identify broad normative principles for mortgage law and policy but to consider the various options that might best deal with both current litigation and future transactions. To that end, it will help to identify the basic institutional design principles that should guide fair mortgage markets.

¹⁵⁵ See, e.g., Abraham Bell & Gideon Parchomovsky, *Reconfiguring Property in Three Dimensions*, 75 U. CHI. L. REV. 1015, 1022 (2008) ("There cannot be ownership in land without some clear idea of who owns the land, what land is owned, and what rights accrue to the owner as a result of her status."); Steven J. Eagle, *Private Property, Development and Freedom: On Taking Our Own Advice*, 59 SMU L. REV. 345, 352 (2006) ("Individuals working to grow their assets must be supported by clear laws defining their property rights . . .").

¹⁵⁶ Henry E. Smith, *Exclusion v. Governance: Two Strategies for Delineating Property Rights*, 31 J. LEGAL STUD. S453, S454–55 (2002); see Henry E. Smith, *Property and Property Rules*, 79 N.Y.U. L. REV. 1719, 1797 (2004) ("Property rules have informational advantages.").

¹⁵⁷ See Henry E. Smith, *Property as the Law of Things*, 125 HARV. L. REV. 1691, 1710–11 (2012) (discussing how the exclusion strategy and a modest governance strategy help facilitate the alienability of property).

Part A below identifies two basic normative principles for mortgage law. First, protect *consumers*. Second, create a secure *legal infrastructure* for property. The consumer protection norm means that we must protect potential and existing homeowners from unfair and deceptive practices in the mortgage market. We must also protect them—and the rest of us—from unreasonable systemic risk. The legal infrastructure norm means that we must ensure that property titles are both clear and public and that the processes by which mortgages are sold, transferred, and securitized work smoothly and enable the market to continue into the future.¹⁵⁸

Part B below develops the implications of these norms for how courts should handle foreclosure cases currently in the pipeline and for how legislatures and regulators should reform mortgage laws to create a secure legal infrastructure for the future.

A. *Institutional Design Principles*

1. *Consumer Protection*

The subprime crisis could have been avoided (or mitigated) if the banks had not saddled homeowners with unaffordable loans and if the government had promoted homeownership through viable and appropriate means rather than deregulation and promotion of subprime mortgages. This suggests that a fundamental principle guiding a just and efficient property system is the protection of consumers from unfair or deceptive practices.¹⁵⁹ Indeed, every state has a consumer protection statute that prohibits such business practices.¹⁶⁰ The Federal Trade Commission Act similarly prohibits “unfair or deceptive acts or practices in or affecting commerce.”¹⁶¹ Consumer protection law not only promotes the values of treating people with respect and dignity but provides a useful barrier against schemes that can spin out of control and undermine the infrastructure of the economic system. Unfair or deceptive property transactions effectively defraud consumers out of their hard-earned wealth

¹⁵⁸ See *Bain v. Metro. Mortg. Grp., Inc.*, 285 P.3d 34, 39 (Wash. 2012) (en banc) (“First, the nonjudicial foreclosure process should remain efficient and inexpensive. Second, the process should provide an adequate opportunity for interested parties to prevent wrongful foreclosure. Third, the process should promote the stability of land titles.”); see also Mortg. Fin. Working Grp., *Building a New Infrastructure for the Secondary Mortgage Market*, CTR. FOR AM. PROGRESS (Dec. 3, 2012), <http://www.americanprogress.org/issues/housing/news/2012/12/05/47073/building-a-new-infrastructure-for-the-secondary-mortgage-market/> (identifying principles for the mortgage market that center on liquidity, stability, transparency and standardization, affordability and access, and consumer protection).

¹⁵⁹ See Peterson, note 20, at 2190 (noting that existing consumer protection has been rendered obsolete and arguing that the law must be updated using limited assignee liability and imputed liability theories to address the problems associated with predatory lending and finance).

¹⁶⁰ See Singer, *supra* note 52, at 155 n.45 (listing state consumer protection statutes).

¹⁶¹ 15 U.S.C. § 45 (2012).

and make them worse off than before while causing enormous negative externalities that have the potential to undermine the world economy. We protect consumers from unjust business practices (1) to protect them from fraud and deception, (2) to protect them from unfair arrangements, and (3) to protect innocent third parties from undue systemic risk.

First, deceptive practices induce people to enter agreements they would not make if they had adequate information. They are a species of fraud and the opposite of the freedom of contract.¹⁶² We are free to make contracts with others, but we are also free *not* to make contracts. Agreements make both parties better off than they were before the agreement because each is getting something they want and giving up something they are willing to exchange for what they get. Deception in the contracting process induces agreements that are not in the best interests of both parties. Both fraud (lying about a material fact to induce agreement) and deception (making misleading statements or failing to reveal information the other side would want to know) undermine any sense that contract enforcement promotes the will or the interests of both parties. They are akin to diverting someone's attention so you can pick his pocket. For that reason, deception is a form of theft. It not only contravenes freedom of contract norms but violates the property rights of the victim.

There was a lot of deception in the subprime mortgage market. Borrowers were often misled about the interest rates they would be paying.¹⁶³ Even educated borrowers were commonly surprised by sudden rises in mortgage payments. This happened because the mortgage documents were so complicated and the mortgage brokers failed to clearly explain what the borrowers were getting into. If the borrowers had clearly understood what the real interest rate was, some would not have agreed to the loan at all. As Federal Reserve Board Governor Ned Gramlich noted, "Why are the most risky loan products sold to the least sophisticated borrowers? The question answers itself—the least sophisticated borrowers are probably duped into taking these products."¹⁶⁴ Mortgage brokers who did explain the intricacies of adjustable rate mortgages probably assured borrowers that they could refinance when the interest rates increased. They probably did not explain, however, that this ability to refinance would disappear if housing prices stalled or plummeted. They induced borrowers to ignore such real concerns. Similarly, banks misled investors in securitized mortgages by giving AAA ratings to subprime mortgages held by people who could not afford to pay them back if housing prices

¹⁶² See Peterson, *supra* note 20, at 2229 (explaining that in some states deceptive lending practices are governed by the law of fraud).

¹⁶³ Stan Liebowitz, *New Evidence on the Foreclosure Crisis*, WALL ST. J., July 3, 2009, at A13.

¹⁶⁴ Edward M. Gramlich, *Booms and Busts: The Case of Subprime Mortgages*, FED. RES. BANK KANS. CITY: ECON. REV., 4th Quarter 2007, at 105, 110.

decreased.¹⁶⁵

Subprime mortgage marketing rested on *mixed messages*. Subprime borrowers were told that they had to pay high interest rates because they posed a high credit risk, but they were then told they would never have to pay those high, unaffordable rates because they could refinance.¹⁶⁶ They were not told or did not understand that this would only work if property values continued to rise *forever*—something that had never happened before in human history. Similarly, investors in mortgage-backed securities were told that they paid high returns because subprime loans were so risky, but then the bankers arranged for them to have AAA ratings, suggesting that they posed no risk at all.¹⁶⁷ High return, low risk. This message was too good to be true. The consumers and investors relied on the bankers' reassurances that the loans were suited to subprime borrowers and safe for risk-averse investors. The banks took advantage of mixed messages because they knew that their customers would trust them. Mixed messages are deceptive because they are designed to induce people to hear the bad news and then ignore it. They are designed to promote trust while violating it.

We could of course debate how much deception there was or what forms of market practice are acceptable. One could argue that borrowers and investors made free choices to invest in risky purchases, made high returns for taking those risks, and voluntarily took on the risk. If all this is true, borrowers and investors have no one to blame but themselves for their misfortune. They assumed the risk and we have no good reason to depart from the traditional doctrine of caveat emptor. This argument has merit for some consumers and some transactions, but it does require distinguishing between acceptable and unacceptable business practices. The law not only prohibits outright fraud; it also prohibits "deceptive . . . practices."¹⁶⁸ The federal securities laws that protect shareholders who invest in stocks prohibit not only misleading statements, but also omissions that convey a false impression about facts investors would want to know in deciding whether to invest in a company's stock.¹⁶⁹ One could argue for repealing

¹⁶⁵ Floyd Norris, *Grumbles Follow Plan to Raise Bank Capital*, N.Y. TIMES, July 12, 2013, at B1.

¹⁶⁶ Alex M. Johnson, Jr., *Preventing a Return Engagement: Eliminating the Mortgage Purchasers' Status as a Holder-in-Due-Course: Properly Aligning Incentives Among the Parties*, 37 PEPP. L. REV. 529, 563 (2010).

¹⁶⁷ See Jeffrey Friedman, *Bank Pay and the Financial Crisis*, WALL ST. J., Sept. 24, 2009, at A21 (describing a study that found eighty one percent of mortgage-backed securities were given AAA ratings); Richard H. Thaler, *Underwater, but Will They Leave the Pool?*, N.Y. TIMES, Jan. 24, 2010, BU3 (noting that investors bought mortgage-backed securities because they wanted to gain high returns).

¹⁶⁸ 15 U.S.C. § 45 (2012).

¹⁶⁹ See Securities and Exchange Act, 15 U.S.C. § 78j (2012) (stating that it is unlawful to use any "manipulative or deceptive device or contrivance" in connection with the sale of any security); 17 C.F.R. § 240.10b-5 (2013) (stating that it is unlawful, in connection with the sale of any security, to

state consumer protection laws and federal trade and securities regulations, but the truth is that both consumers and sophisticated investors *want* protection from deceptive practices. These laws do not interfere with freedom of contact; rather, *they ensure that people get what they want when they buy or invest.*¹⁷⁰ In so doing, they also protect private property by ensuring that businesses cannot take your money on false or misleading pretenses.

Second, in addition to preventing fraud or deception, consumer protection laws promote *fairness* in market transactions. Or at least they prohibit “unfair” transactions.¹⁷¹ This principle protects consumers and requires businesses to treat customers with dignity. While the prohibition on deception focuses on giving the consumer what she wants, fairness requires more than this; it holds businesses to minimum standards in market relationships to protect the justified expectations of those with whom they do business.

Scholars often worry about minimum wage and other regulatory laws because they increase the costs of doing business and hurt those at the bottom of the economic ladder.¹⁷² While it is true that regulations increase the costs of providing consumer goods and services, we do not help the poor by eliminating regulations that the rest of us need. We could lower the costs of housing by eliminating all building code regulations and allowing people to live in shacks. This would decrease the costs of housing but would deprive everyone of the security of living in safe housing. Instead, we ensure that market transactions provide consumers with what they have a right to expect and we protect the poor in ways *other* than removing regulations that protect the rest of us.

Legislation that articulates these minimum standards not only ensures that people get what they want out of market transactions, but that people are treated with minimum levels of respect. The Supreme Judicial Court of the Commonwealth of Massachusetts held that it constitutes an “unfair practice” in violation of the state’s consumer protection statute to grant a mortgage to a borrower who cannot pay it back if it is structured in a

“defraud” or “to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . .”).

¹⁷⁰ Singer, *supra* note 52, at 157.

¹⁷¹ See 15 U.S.C. § 45 (prohibiting “unfair or deceptive acts or practices in or affecting commerce”).

¹⁷² See Harry Hutchinson, *Toward a Critical Race Reformist Conception of Minimum Wage Regimes: Exploding the Power of Myth, Fantasy, and Hierarchy*, 34 HARV. J. ON LEGIS. 93, 109 (1997) (explaining the theory behind how a minimum wage regulation could increase the cost of business because employers have to pay employees at higher rates, and as a result, employers may choose to lay off existing workers thus leaving many low skilled workers without employment).

manner that would make it impossible to refinance if housing values fell.¹⁷³ This is at least true when it is clear that housing values are starting to level off or fall. In such a case, it is not true that it is better to have owned and lost than never to have owned at all—and the bank knows it.¹⁷⁴ Selling a loan to such a buyer is the moral equivalent of picking the consumer's pocket.

Consumers are not making a mistake when they trust businesses to treat them fairly. They are entitled to believe that businesses like banks know what they are doing and that the products they sell will operate as advertised. Trusting customers are doing nothing wrong. The banks that take advantage of mixed messages or that sell products designed to impoverish the customer are not engaged in free commerce; they are manipulating consumers to strip them of their wealth. We have consumer protection laws not because people are stupid or foolish; we have such laws because pressures to pursue profits can induce businesses to sell what they should not sell. In such cases, it is the sellers, not the buyers, who are morally responsible for unfair outcomes. We do not, after all, blame people when thieves pick their pockets; we do not say “shame on you for carrying money around on your person.” No, we blame the thief.

Banks understandably may wish to be free of vague obligations to consumers and investors. They want clear rules and the power to “walk the line” offering products and services as long as they are not clearly prohibited. While we need some clear rules to outlaw the worst practices, we also need banks to realize that those laws do not immunize them from regulation of unfair and deceptive practices. We want banks to imagine whether they can convince a judge or a jury that their conduct was lawful and appropriate.

To achieve these goals, we may need to abolish or modify the holder-in-due-course doctrine that immunizes note holders from fraud claims based on acts by note originators.¹⁷⁵ That doctrine promotes negotiability of loans while also promoting fraud; several scholars have argued to extend the FTC “holder-notice rule” to home mortgages so as to preserve consumer claims and defenses when notes are transferred.¹⁷⁶ Such a law

¹⁷³ *Commonwealth v. Fremont Inv. & Loan*, 897 N.E.2d 548, 558–59 (Mass. 2008); Joseph William Singer, *Property Law as the Infrastructure of Democracy: The Fourth in the Wolf Family Lecture Series on the American Law of Real Property*, in 11 *POWELL ON REAL PROP.*, Part V, at WFL11-1, 11-14 to 11-15 (Michael Allen Wolf ed., 2013); Singer, *supra* note 52, at 159.

¹⁷⁴ ENGEL & MCCOY, *supra* note 5, at 41 (“Without a doubt, most borrowers with subprime loans would have been better off with loans on better terms or with no loans at all.”).

¹⁷⁵ *Id.* at 235.

¹⁷⁶ Peterson, *supra* note 20, at 2257, 2274; see ENGEL & MCCOY, *supra* note 5, at 235 (arguing that the holder-in-due-course doctrine has unfair consequences for borrowers and should be eliminated); Johnson, *supra* note 166, at 536 (advocating for eliminating the holder-in-due-course doctrine to provide incentives to parties and reform the existing residential mortgage market); see also 16 C.F.R. § 433.2 (2013) (preserving consumer claims and defenses by requiring all consumer credit

reform will not hamper negotiability as long as banks refrain from deceptive practices—something they should be doing anyway. Indeed, the holder-in-due-course doctrine does not protect the transferee of a note where there is “fraud in the factum.”¹⁷⁷ This exists where the signer does not know the “character” or “essential terms” of the instrument and “lack[s] a reasonable opportunity to obtain this knowledge.”¹⁷⁸ In other words, the fraud induces the consumer to sign the agreement. Fraud in the factum may exist where oral representations are made that diverge from the written terms of the agreement and the signer reasonably relied on those oral representations, something that was common in subprime mortgage transactions.¹⁷⁹

Third, the sale of loans to people who could not pay them back and of mortgage-backed securities to investors who thought they were AAA safe had the side effect of causing a worldwide recession in 2008, the effects of which are still much in evidence now in 2013. The third party effects were both enormous and unfair. Banks made money in a manner that imposed undeserved losses on innocent third parties, resulting from millions of foreclosures combined with a stalled housing market and a depressed economy. Those losses included lost jobs, diminished pension and college funds, lower stock prices, depressed public services, and lower property values.¹⁸⁰ Even if one believes that subprime borrowers got what was coming to them, innocent third parties had no part in causing the harms they suffered.

We must protect people from avoidable losses associated with conduct that creates unreasonable systemic risk. Never again will it be difficult for me to explain to my property law students why we regulate the packages of property rights you are allowed to create. All I have to do is utter the words “subprime crisis” to remind them that property rights impose externalities on others and some of those externalities have the potential to go so far as to wreck the world economy. We need to set minimum standards for market transactions, not only to ensure that people are treated fairly, but to protect the general public from the negative effects of unduly

contracts to state, “ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES . . .”); JAMES J. WHITE, ROBERT S. SUMMERS & ROBERT A. HILLMAN, 2 UNIFORM COMMERCIAL CODE § 18:1, at 223–24 (6th ed. 2013) (noting that the FTC abolished the holder-in-due-course doctrine for most consumer credit transactions). Contrary to some fears, this has not substantially restricted the flow of credit to consumers. The FTC rule does not extend to mortgage transactions. *Id.* § 18:26, at 281–85.

¹⁷⁷ U.C.C. § 3-305 cmt. 1 (2011).

¹⁷⁸ WHITE ET AL., *supra* note 176, § 18:31, at 295–97.

¹⁷⁹ U.C.C. § 3-305 cmt. 1.

¹⁸⁰ See Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 967 (2009) (noting that stocks in the U.S. fell by \$10 trillion from October 2007 to February 2009, and that 4.4 million Americans lost their jobs).

risky schemes.

Now that the banks have become landlords and neighbors by taking properties in foreclosure and keeping them until they can be profitably resold on the market, they cannot complain when they find that they are subject to the same rules as other landlords. They may have skirted the statute of frauds, the recording acts, and the foreclosure laws, but that does not mean they are entitled to ignore housing codes, zoning laws, or landlord-tenant law. Both tenants and neighbors have a right to be treated with human dignity and that entails compliance with minimum standards for housing and real estate construction and maintenance. If you want your neighbors to maintain their houses so that neighborhood values are preserved, you cannot claim a right to violate those regulations yourself.

2. *A Secure Legal Infrastructure for Property*

The subprime disaster has taught us a valuable lesson about the institution of private property. Property cannot work without regulation. Since another name for “regulation” is the “rule of law,” we can say that the infrastructure of our property system includes laws establishing and clarifying property rights. While those rules impose costs on market actors, property cannot exist without them. And the benefits of the institution of private property outweigh its costs.

The banks wanted to reduce the costs of formalizing and recording mortgages. There is nothing wrong with the impetus to reduce costs and improve efficiencies. New technology has allowed faster, cheaper ways of disaggregating, formalizing, and exchanging property rights, and the mortgage industry was right to take advantage of it. But the mortgage industry was entranced by the technology and by the idea of cost reduction and assumed that things that *could* be done *should* be done. By establishing MERS, they went gangbusters into new technological and institutional frameworks for mortgage law without adequate consideration for whether they were complying with existing real property law rules or what the effects might be on the infrastructure of property. They assumed that costs to them were costs to society; they did not understand that the benefits associated with property law rules might outweigh their costs, not only to society but to the banks themselves.

We need to ensure that owners have clear title to their property. Without such clarity, they can neither use their property nor sell it. To ensure clear title we have ancient rules that require real estate transactions, including mortgages, to be reduced to a clear writing and publicly recorded. Such rules protect homeowners by enabling them to use and sell their property; they also promote purchase by ensuring buyers they will get what they think they are purchasing. The formality and publicity rules skirted by the banks are not archaic relics of a primitive society; they are the foundation of our property system and can be avoided only when doing

so is necessary to avoid systemic risk or substantial injustice. The banks must learn from the past as well as the lawsuits complaining of misrepresentation, robo-signing, and sloppy record keeping.¹⁸¹

The banks also forgot that while securities markets are global, property law is (mostly) local. It is not clear that the banks sought or received high quality advice from real estate lawyers about the legality of MERS or its practices. The banks' failure to assess correctly state property law rules designed to protect homeowners and ensure clear title—or to understand their purpose and importance—has meant that the banks' technological and institutional innovations have not only failed to achieve their purposes but have had potentially devastating consequences on the security, alienability, and publicity of land titles in the United States. The mess they have left us with suggests either that we renew compliance with traditional legal forms and principles or that we figure out how to modify those forms to take advantage of new technologies while preserving the benefits of traditional regulations.

Some Americans instinctively see government regulation as an interference with our freedom. This value underlies the norm of freedom of contract and it can blind us to the benefits of the rule of law, otherwise known as “regulation.” We cherish the freedom to use markets to redefine and exchange new forms of property, through securitization or other means. At the same time, we must not forget that neither markets nor property can exist without a legal framework. We have legal rules governing the creation, transfer, recording, and enforcement of property rights because without these rules, property cannot exist as an institution. Neither the statute of frauds nor state recording acts are pointless technicalities or regulatory impediments to freedom or efficiency. Rather, they are part of the infrastructure that allows property to exist. Rules that clarify title and protect the core rights of owners are the foundation on which markets operate.

¹⁸¹ See Chris Isidore, *Bank of America Sued for Alleged Mortgage Fraud*, CNNMONEY (Oct. 25, 2012), <http://money.cnn.com/2012/10/24/news/companies/bank-of-america-lawsuit/index.html> (describing the alleged fraud of Bank of America in its mortgaging scheme); Silver-Greenberg, *supra* note 19 (explaining cases involving bank deception regarding the sale of distressed mortgages); Jessica Silver-Greenberg, *Banks Face Wave of New Mortgage-Securities Suits*, BOS. GLOBE, Dec. 10, 2012, at B7 [hereinafter Silver-Greenberg, *Banks Face Wave of New Mortgage-Securities Suits*] (discussing the plethora of upcoming lawsuits that have and will continue to result from the mortgage fraud during the financial crisis); see also Donald J. Kochan, *Certainty of Title: Perspectives After the Mortgage Foreclosure Crisis on the Essential Role of Effective Recording Systems*, 66 ARK. L. REV. 267, 267–75 (2013) (examining the outstanding effects of the mortgage foreclosure debacle).

B. *Protecting Consumers*

1. *By Disclosure and Qualification*

Banks should protect consumers from unduly burdensome mortgages by not granting mortgages to people who cannot pay them back. This is so obvious now that banks are refraining from giving mortgages to people who cannot pay them back.¹⁸² One way to achieve this goal is to enact better *disclosure* requirements, so that borrowers understand what they are committing themselves to when they take out a loan.¹⁸³ Luckily, the new Consumer Financial Protection Bureau (CFPB) will enact regulations of this sort.¹⁸⁴

At the same time, better disclosure requirements will not completely solve the problem.¹⁸⁵ It is sometimes thought that all we have to do is ensure that consumers have proper information and then let them make whatever decisions they want to make on the ground that stopping them from doing so constitutes inappropriate paternalistic interference with their autonomy.¹⁸⁶ It is sometimes thought, on the other hand, that we need regulation of consumer contracts because consumers are either not smart enough to understand the contracts they are signing or that they are irrational and psychologically incapable of appreciating the real risks involved in the arrangement.¹⁸⁷

In truth, we regulate consumer contracts not because consumers are stupid or irrational but because *sellers* are too easily drawn in to money-making schemes that cannot be defended from a moral point of view. Banks are in the business of lending money to people who need it and can

¹⁸² Richard Finger, *Banks Are Not Lending Like They Should, and with Good Reason*, FORBES (May 30, 2013), <http://www.forbes.com/sites/richardfinger/2013/05/30/banks-are-not-lending-like-they-should-and-with-good-reason/2/>.

¹⁸³ See Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073, 1084–85, 1147–50 (2009) (advocating for better disclosure requirements).

¹⁸⁴ See *About Us*, CONSUMER FIN. PROTECTION BUREAU, www.consumerfinance.gov/the-bureau/ (last visited Sept. 25, 2013) (“Our mission is to make markets for consumer financial products and services work for Americans . . .”).

¹⁸⁵ See Jean Braucher, *Form and Substance in Consumer Financial Protection*, 7 BROOK. J. CORP., FIN. & COM. L. 107, 107–11 (2012) (explaining forthcoming regulations of the CFPB that will go beyond disclosure requirements to prevent abusive practices); Peterson, *supra* note 20, at 2255–57 (discussing the various changes in consumer protection law that may be needed to fully protect homeowners from predatory finance); Dee Pridgen, *Putting Some Teeth in TILA: From Disclosure to Substantive Regulation in the Mortgage Reform and Anti-Predatory Lending Act of 2010*, 24 LOY. CONSUMER L. REV. 615, 616, 627–39 (2012) (explaining why disclosure is insufficient to protect consumers).

¹⁸⁶ See Braucher, *supra* note 185, at 107–08 (describing the failure of past regulatory schemes that have attempted to simply inform consumers and let them decide based on the provided data).

¹⁸⁷ See Bar-Gill, *supra* note 183, at 1075 (“[T]he problem is that lenders hid these high prices and borrowers underappreciated them.”); *id.* at 1079 (“Myopic borrowers unduly focus on the short-term dimensions of the loan contract and pay insufficient attention to the long-term dimensions.”).

pay it back with reasonable security from assets they own. Banks should not lend to those who cannot pay back the loan because they should not be in the business of selling mortgages for the sole purpose of stripping the owner's equity from the home.¹⁸⁸ As Joseph Stiglitz explained: "There was no point of putting someone in a home for a few months and then tossing him out after having stripped him of his life savings. But that was what the banks were doing."¹⁸⁹ We have consumer protection statutes that prohibit unfair or deceptive practices not because consumers are irrational but to ensure that businesses treat their customers like customers rather than marks who can be easily parted from their wallets. Consumer protection laws are not paternalistic interferences with freedom of contract; *they protect the property rights of consumers.*

Banks and mortgage brokers need to develop a better appreciation that they are not legally entitled to defraud or mislead borrowers about the transactions they are entering. Nor are they entitled to hook borrowers into arrangements that they are very likely to regret. The subprime crisis has, to some extent, brought banks to their senses. The old-fashioned practice of determining whether someone *qualifies* for a mortgage has returned. The trauma associated with the subprime crisis might have led us to imagine that no new regulations might be needed to go back to this practice. At the same time, history shows that the temptation to bleed the vulnerable may require appropriate regulations at either the federal or state level to ensure that people who cannot afford mortgages are steered to obtaining housing in other, more appropriate ways.

Recent applications of consumer protection and securities regulation laws are a step in this direction.¹⁹⁰ Their injunction to avoid "unfair" as well as "deceptive" practices goes beyond common law fraud and puts banks on notice that they neither have—nor are entitled to—a safe harbor when they sell products they cannot defend to a judge or jury. Importantly, the Mortgage Reform and Anti-Predatory Lending Act of 2010, passed as one part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, makes ability to repay a condition for granting a residential mortgage.¹⁹¹ Final regulations have now been issued that prevent granting high-priced mortgages to those who cannot afford them and provide presumptive protection for "qualified mortgages" that meet certain

¹⁸⁸ Braucher, *supra* note 185, at 119 ("The essence of predatory lending is extending credit to those who can be expected to default, and creditors who fail to evaluate creditworthiness know that they are setting up some of their customers for a fall.").

¹⁸⁹ JOSEPH E. STIGLITZ, FREEFALL: AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY 11 (2010).

¹⁹⁰ See *Commonwealth v. Fremont Inv. & Loan*, 897 N.E.2d 548, 556–61 (Mass. 2008) (stating that a loan that the borrower cannot repay is "unfair").

¹⁹¹ 15 U.S.C. §§ 1602, 1631 (2012).

affordability criteria.¹⁹² These regulations are not perfect but they are a very welcome step. At the same time, those regulations leave in place state and federal laws that prohibit “unfair and deceptive practices” in the mortgage industry.

2. *By Safeguarding the Homeowner’s Equity*

We should remember that the historical origin of mortgage regulation was designed to achieve the dual goals of ensuring repayment of the loan while protecting the homeowner’s equity. The abolition of strict foreclosure ensured that the lender got back its loan with agreed-upon interest upon foreclosure but that any excess value in the real property, e.g., the “equity,” belonged to the homeowner.¹⁹³ This homeowner equity principle takes a back seat in times like ours when property values have plummeted and we are beset by “underwater” mortgages that exceed the current value of the mortgaged property. At the same time, homeowner protection underlies the multiple efforts over the last five years to limit foreclosures by both federal and state officials.¹⁹⁴

One way we can protect the equity of homeowners in a time of decreasing property values is by ensuring that foreclosures only occur when they are the best way to protect the banks’ financial interest in recouping their loans. Many banks adopted general policies not to negotiate with homeowners to extend the term of the loan or to change the payment schedule;¹⁹⁵ they assumed that such a blanket policy would save the transaction costs of evaluating the loans on a case-by-case basis and allow them to clear their books of bad loans. There are many barriers to renegotiation beyond transaction costs—such as incentive structures for loan servicers and the terms of the contracts associated with the loan servicer and securitization—that discourage loan modification.¹⁹⁶

¹⁹² See 12 C.F.R. pt. 1026 (2013) (amending Regulation Z, which implements the Truth in Lending Act); see *Ability to Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z)*, CONSUMER FIN. PROTECTION BUREAU, <http://www.consumerfinance.gov/regulations/ability-to-repay-and-qualified-mortgage-standards-under-the-truth-in-lending-act-regulation-z/> (last visited Sept. 23, 2013) (containing information to help consumers understand the changes to Regulation Z and their implications).

¹⁹³ Burkhardt, *supra* note 29, at 270–71 (noting the abolition of strict foreclosure in the United States).

¹⁹⁴ See Frank S. Alexander, Dan Immergluck, Katie Balthrop, Philip Schaeffing, & Jesse Clark, *Legislative Responses to the Foreclosure Crisis in Nonjudicial Foreclosure States*, 31 REV. BANKING & FIN. L. 341, 351–62 (2011) (summarizing the major federal and state programs to limit foreclosures, which largely focused on homeowner protection).

¹⁹⁵ Eric A. Posner & Luigi Zingales, *A Loan Modification Approach to the Housing Crisis*, 11 AM. L. & ECON. REV. 575, 577 (2009) (“[M]any banks appear to have a policy of either not renegotiating loans or doing so only in unusual circumstances.”).

¹⁹⁶ See ENGEL & MCCOY, *supra* note 5, at 131 (identifying lost files and financial incentives as barriers to renegotiation); Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of*

In some instances, renegotiation of the loan repayment terms would be economically better than foreclosure for both the lender and the borrower (as well as the investors).¹⁹⁷ The principle of protecting the homeowner's equity, as well as avoiding the individual and social harms caused by widespread displacement from one's home, is part of what accounts for the various state laws requiring mediation between the bank and the homeowner before foreclosure can occur.¹⁹⁸ A new Massachusetts law requires lenders to compare the anticipated net recovery from foreclosure with what they would receive from a mortgage modification to payment levels the borrower can afford.¹⁹⁹ The 2009 federal Home Affordable Mortgage Program (HAMP) created incentives for banks to modify loans for borrowers who were paying more than thirty one percent of their income toward housing costs when modification was economically more advantageous than foreclosure to the lender.²⁰⁰ Banks may view these laws as increasing their cost of doing business but they are intended to promote payment modifications only when it benefits both the borrower and the lender.

A second way to protect homeowner equity is to ensure that foreclosures only occur when the foreclosing party can prove its legal right to foreclose. Courts have begun to insist on better proof that the foreclosing bank actually owns the mortgage encumbering the property.²⁰¹ They have done so by renewed insistence on the formalities that give the

Mortgages in Bankruptcy, 2009 WIS. L. REV. 565, 576, 624 (identifying practical impediments and the psychology of financial distress as obstacles).

¹⁹⁷ On the various barriers to negotiation, see Levitin, *supra* note 196, at 576.

¹⁹⁸ See Alexander et al., *supra* note 194, at 366 (noting that one goal of mediation programs is to allow homeowners to remain in their homes).

¹⁹⁹ MASS. GEN. LAWS ch. 244, § 35B(b) (2012); see also Alexander et al., *supra* note 194, at 388 (explaining the California Foreclosure Prevention Act of 2009 temporarily imposed a ninety-day delay for foreclosure unless the bank modified the loan when the "expected recovery from modification was greater than the expected recovery from foreclosure" (citing CAL. CIV. CODE §§ 2923.52–.53 (West 2011) (repealed 2011))).

²⁰⁰ ENGEL & MCCOY, *supra* note 5, at 128–29; Daniel P. Lindsey, *The Subprime Mortgage Mess: A Chicago Perspective*, 24 LOY. CONSUMER L. REV. 455, 460 (2012); Salsich, *supra* note 3, at 45–49. On the benefits of loan modifications and what would be needed to make them work more generally, see NAT'L CONSUMER LAW CTR., AT A CROSSROADS: LESSONS FROM THE HOME AFFORDABLE MODIFICATION PROGRAM (HAMP) 53–63 (2013), available at http://www.nclc.org/images/pdf/foreclosure_mortgage/loan_mod/hamp-report-2013.pdf.

²⁰¹ See, e.g., *U.S. Bank Nat'l Ass'n v. Ibanez*, 941 N.E.2d 40, 55 (Mass. 2011) (concluding that the bank did not prove that they held the mortgages at the times of foreclosures); *Fed. Home Loan Mortg. Corp. v. Schwartzwald*, 979 N.E.2d 1214, 1220 (Ohio 2012) (finding that the lender failed to establish an interest in the mortgage and thus could not invoke the court's jurisdiction); see also Richard H. Martin, *Proving Standing to Foreclose a Florida Mortgage*, 85 FLA. B.J. 31, 31 (2011) (stating the Florida judiciary's requirement that "the [bank] must usually show, through admissible evidence, that it holds the note and mortgage" in order to prove standing).

best evidence of title.²⁰² The banks have lost the trust of many courts by failing to adequately formalize mortgage transfers and by adopting the MERS system that privatizes this information. Banks argue that formalities are technicalities;²⁰³ they effectively seek to reverse the burden of proof, allowing foreclosures to happen unless homeowners can prove the bank is not the current mortgage holder.²⁰⁴ But the loss of trust in the title system has led some courts to insist on a showing of chain of title of mortgage assignments.²⁰⁵

Even if the banks cannot make this showing, they at least should be able to present enough evidence to show why they believe they are the lawful, current assignee of mortgage rights in the property. The records may be incomplete; they may not satisfy the statute of frauds. But the evidence must show, at least by a preponderance of the evidence, that the bank is the current lawful assignee of the original mortgage. A bank that cannot make this showing has no right to foreclose. We protect the homeowner's equity, not just because it represents wealth, but because of the harmful consequences of displacing a family from its home.²⁰⁶ In judicial foreclosure states, this means that the foreclosure process has heightened (or restored) the burden of proof on the foreclosing bank to prove its legal rights by written evidence sufficient to satisfy the statute of frauds.²⁰⁷ In the majority of states that allow nonjudicial foreclosure, it means that homeowners may be able to resist eviction after foreclosure if the foreclosing bank cannot satisfy the court that it had the legal right to foreclose.²⁰⁸ This possibility may allow borrowers to force banks to negotiate for loan modifications before foreclosure. While all this may

²⁰² See Dana, *supra* note 22, at 514–15 (explaining the court's decision in *Ibanez* to rule in favor of the defaulting homeowners because the foreclosing party "failed to establish it had been assigned the mortgages at issue prior to issuing the foreclosure notice and conducting the foreclosure sale"); Nestor M. Davidson, *New Formalism in the Aftermath of the Housing Crisis*, 93 B.U. L. Rev. 389, 403 (2013) (noting that a "new formalism" has emerged in recent court decisions).

²⁰³ See Dana, *supra* note 22, at 505–07 (explaining and arguing against the opinion that "there is no good reason to insist on adherence to . . . procedural requirements for effecting a valid foreclosure as long as the economic substance behind the foreclosure is what it should be").

²⁰⁴ See *id.* at 515–16 (describing two cases in which the courts were "essentially uninterested in the standing" of the foreclosing banks).

²⁰⁵ See *id.* at 514–15 (describing the "lack of documentation for previous alleged assignments of the mortgages in the alleged chains of title" as a factor in the *Ibanez* court's holding (citing *Ibanez*, 941 N.E.2d at 52)).

²⁰⁶ Levitin, *supra* note 196, at 568–70.

²⁰⁷ See Alexander et al., *supra* note 194, at 344–45 (noting that in contrast to judicial foreclosure systems, nonjudicial systems "tend to impose fewer duties on the part of the lender and place the burden on the borrower to . . . challenge the foreclosure process").

²⁰⁸ See Alexander et al., *supra* note 194, at 343–44 ("To stop a foreclosure sale in a nonjudicial state, the homeowner must file an affirmative court action.").

increase the costs of nonjudicial foreclosure,²⁰⁹ it is justified because banks that cannot prove ownership of the mortgage by convincing evidence have no right to make a family homeless.²¹⁰

While some banks refuse to negotiate with homeowners to modify the terms of existing loans, others may have an incentive *not* to foreclose on underwater properties, hanging onto them until property values rise again. Foreclosure is costly and banks typically lose a large percentage of the value of the loan in the process.²¹¹ Banks may delay foreclosure to avoid recording a loss of value on their books. But because such homeowners cannot refinance their mortgages (because the property is worth less than the outstanding loan), they cannot sell or move. This drag on the real estate market also inhibits the movement of labor among states; this may not only further depress property values and prevent the housing recovery, but may also have a broader dampening effect on the whole economy. Underwater mortgages thus pose a systemic problem for the larger economy as well as inhibiting individual autonomy.²¹²

A potential solution to this problem is to alter the current law regarding mortgages in bankruptcy. As is, first mortgages on family homes are among the few debts that cannot be modified through bankruptcy.²¹³ Senator Durbin introduced a bill, called the “cramdown” provision, that would have allowed bankruptcy courts to reduce the principal debt to the current fair market value of the property—a proposal for underwater properties that might, in some cases, make loan payments affordable and allow the family to stay in its home.²¹⁴ The provision was controversial

²⁰⁹ See Levitin, *supra* note 196, at 600 (noting that mortgage credit may be more available in states that allow nonjudicial foreclosure (citing Karen M. Pence, *Foreclosing on Opportunity: State Laws and Mortgage Credit*, 88 REV. ECON. & STAT. 177, 180 (2006))).

²¹⁰ See Dana, *supra* note 22, at 507–09 (explaining why “formalities” serve the substantive purpose of protecting stable access to one’s home).

²¹¹ See Levitin, *supra* note 196, at 603–06 (“Foreclosure is widely recognized as an expensive process. Lenders incur legal costs in foreclosures, do not receive interest on defaulted properties (time-value loss), and often are forced to sell the property at a significant loss.”).

²¹² Cf. Brent T. White, *Underwater and Not Walking Away: Shame, Fear, and the Social Management of the Housing Crisis*, 45 WAKE FOREST L. REV. 971, 972 (2010) (“Underwater homeowners . . . would be better off if they walked away from their mortgages.”).

²¹³ 11 U.S.C. §§ 1123(b)(5), 1322(b)(2) (2012); Levitin, *supra* note 196, at 570–71.

²¹⁴ 155 CONG. REC. S4980 (daily ed. Apr. 30, 2009); see Levitin, *supra* note 196, at 580 (“Strip-down is thus the most significant type of modification because it affects the treatment of the principal amount of the creditor’s claim, not just the interest.”). For the potential benefits of principal reduction, see CONG. BUDGET OFFICE, MODIFYING MORTGAGES INVOLVING FANNIE MAE AND FREDDIE MAC: OPTIONS FOR PRINCIPAL FORGIVENESS (2013), available at http://www.cbo.gov/sites/default/files/cbofiles/attachments/44115_PrincipalForgiveness.pdf; Press Release, Cong. Comm. on Oversight and Gov’t Reform, New CBO Report Concludes that Principal Reduction Programs Benefit U.S. Taxpayers, Homeowners, and the Economy (May 1, 2013), available at http://democrats.oversight.house.gov/index.php?option=com_content&view=article&id=5911:new-cbo-report-concludes-that-principal-reduction-programs-benefit-us-taxpayers-homeowners-and-the-economy&catid=3:press-releases&Itemid=49.

because it would reduce the willingness of banks to give mortgages by making their repayment and mortgage rights contingent on the overall movement of housing values. However, it is hard to see how this argument differs from arguments about bankruptcy generally.²¹⁵ Credit is provided even though creditors know debts can be discharged in bankruptcy. Lenders provide such credit because they only loan to people they think can pay the loans back—a principle that has already been adopted in federal law and that should have been a bedrock principle for mortgage lenders in the first place. Cramdown is also unlikely to have a significant effect either on interest rates or willingness to grant mortgages.²¹⁶ And even if it translates into a small increase in interest rates charged for mortgages, the benefits to homeowners and to society outweigh the cost.²¹⁷ That, after all, is the argument for mortgage and foreclosure regulation in the first place. We could reduce the cost of mortgages by reintroducing strict foreclosure, but no one wants to do that precisely because we have a strong policy to protect homeowners from losing their homes unless all else fails.

Cramdown is also effectively the law in states like California that prohibit deficiency judgments; in such states, the only recourse for banks is foreclosure and if the market value of the property goes down, that is all the lender can get out of the debtor.²¹⁸ Deficiency judgments are rare even in states that allow them because borrowers generally do not have other assets to repay the loan. It is therefore not clear whether cramdown in bankruptcy would be different from current economic realities from the banks' perspective.²¹⁹ But cramdown might make a huge difference to homeowners who might get to stay in their homes. It might, in other words, change the identity of *who* occupies the home—an irrelevant fact to the bank but far from irrelevant to the homeowner.

Because the cramdown provision went nowhere in Congress, another

²¹⁵ Joshua Goodman & Adam Levitin, *Bankruptcy Law and the Cost of Credit: The Impact of Cramdown on Mortgage Interest Rates* 4 (Harvard Kennedy Sch., Working Paper No. RWP12-037, 2012), available at <http://ssrn.com/abstract=2128841>; Alex Ulam, *Why a Mortgage Cramdown Bill Is Still the Best Bet to Save the Economy*, NATION (Oct. 20, 2011), available at <http://www.thenation.com/print/article/164096/why-mortgage-cramdown-bill-still-best-bet-save-economy#axzz2eQJfqQ2Z>.

²¹⁶ Levitin, *supra* note 196, at 573 & n.26.

²¹⁷ *Id.* at 599; see also Salsich, *supra* note 3, at 58–59 (discussing “loss mitigation” for mortgages). But see White, *supra* note 212, at 1018–20 (arguing that, instead of cramdown, underwater mortgagors should be encouraged to “walk away” from their mortgages and lenders disabled from using that to affect their credit scores).

²¹⁸ See Philip G. Nichols, *Opinions from California Counsel: Matters of Interest for Out-of-State Lenders*, 118 BANKING L.J. 720, 720 (discussing restrictions on deficiency judgments in California).

²¹⁹ But see Levitin, *supra* note 196, at 600 (noting higher interests rates in some states that do not allow deficiency judgments (citing Mark Meador, *The Effects of Mortgage Laws on Home Mortgage Rates*, 34 J. ECON. & BUS. 143, 146 (1982))).

way out of this problem is for municipalities to take underwater mortgages by *eminent domain* and transfer them at their (depressed) current fair market value to a new lender who will offer a new loan to the homeowner at the current value, making repayment more likely to be affordable to the borrower.²²⁰ In effect, such eminent domain procedures would force a renegotiation that could or should have happened anyway but that is not happening either because the banks do not want to write down losses at this point (undermining their capital position) or because of a collective action problem whereby all banks are waiting for property values to rise, which may be part of what is stopping those values from rising.²²¹ Of course, this may result in losses on the banks' books and a decrease in the number of loans they could be giving out, further dampening economic growth. In some ways, this is a chicken and egg problem that can only be solved by looking at the magnitude of the different problems and the relative economic effects of bank write-downs versus persistent underwater mortgages.

C. *Protecting the Legal Infrastructure of Property*

1. *By Title Formalities and Clear Public Records*

Our property system cannot work unless we have clear, public records of title to property. That includes written records of all encumbrances on the land, such as easements, covenants, liens, mortgages, and court judgments. People cannot use or develop their property if ownership is unclear. Their property cannot be marketed if it is unclear whether the property is subject to an outstanding mortgage and who the identity of the mortgagee is. There are many desirable exceptions to this principle, but they are exceptions.²²² Those exceptions apply in fairly well-defined circumstances and are designed to protect legitimate expectations. With

²²⁰ Robert Hockett, Breaking the Mortgage Debt Impasse: Municipal Condemnation Proceedings and Public/Private Partnerships for Mortgage Loan Modification, Value Preservation, and Local Economic Recovery 29–30, available at <http://www.lawschool.cornell.edu/spotlights/upload/Memorandum-of-Law-and-Finance-21-April-Municipal-Plan.pdf>; Hockett, *supra* note 122, at 4–5.

²²¹ See, e.g., Memorandum from Walter Dellinger, Jonathan Hacker & Matthew Close to the Sec. Indus. & Fin. Mkts. Ass'n, San Bernadino Eminent Domain Proposal (July 16, 2012), available at http://www.sifma.org/uploadedfiles/issues/capital_markets/securitization/eminent_domain/memorandumfrommelvenymyerstosifmaresanbernardinoeminentdomainproposal071612.pdf (criticizing the proposal on legal grounds). None of these criticisms are definitive, and they rest on faulty assumptions about the nature of the rights in question. Space limitations prevent a full analysis of the legal pros and cons of the eminent domain strategy. Suffice it to say that states have traditionally regulated local property rights, that we have a long tradition of regulating mortgages to protect the homeowner's equity, and that the public interest is furthered by overcoming collective action problems that prevent the housing market from working to serve the interests of homeowners and the public alike.

²²² Singer, *Rule of Reason in Property Law*, *supra* note 145, at 1395.

regard to mortgages, knowing who owns property and what mortgages validly attach to it not only makes property alienable but also protects consumer interests in avoiding double payment or liability and knowing with whom to negotiate in the event of default.²²³

The banks tried to save money by creating a national, electronic registry for mortgages. In so doing, they tried to obtain the benefits of a unified national system while (feebly) attempting to comply with the regulatory statutes of the more than fifty jurisdictions that regulate real property in the United States. Their efforts highlight the necessary tension between local and national regulation of the economy and of real property. On one hand, property owners might benefit from uniform national standards and they might save money by enacting a national registration system for real property titles. On the other hand, property has traditionally been governed by state law, and there are significant variations in how the states regulate both mortgages and foreclosures. Having a national takeover of mortgage law would deprive the states of the ability to protect their citizens in the manner they deem best. For example, some states like California ban deficiency judgments; California is willing to live with the higher costs of mortgages that this may entail.²²⁴ Other states allow such recoveries.²²⁵ Some states require judicial foreclosure; others are more interested in the potentially lower costs of nonjudicial foreclosure procedures.²²⁶

Clearly this is not a topic with an easy resolution. We could stay with the current system that grants states the power to regulate negotiable instruments, mortgages, and foreclosures while complying with certain

²²³ White, *supra* note 22, at 494–96; Robinson, *supra* note 21, at 1635–36.

²²⁴ But see Bar-Gill, *supra* note 183, at 1113 (arguing that deficiency actions often cost more than they would achieve, giving little protection to lenders and that therefore, in theory, should not affect the interest rate charged to borrowers); Nelson & Whitman, *supra* note 111, at 1429 (“[I]n practice, deficiency judgments are rare . . .”).

²²⁵ See NAT’L CONSUMER LAW CTR., FORECLOSURE REPORT: SURVEY OF STATE FORECLOSURE LAWS 1–2, 20–21, available at http://www.nclc.org/images/pdf/foreclosure_mortgage/state_laws/survey-foreclosure-card.pdf (last visited Sept. 6, 2013) (analyzing state foreclosure laws and indicating, for example, that Alabama and Delaware impose no limitations on deficiency judgments); see also JOHN RAO & GEOFF WALSH, NAT’L CONSUMER LAW CTR., FORECLOSING A DREAM: STATE LAWS DEPRIVE HOMEOWNERS OF BASIC PROTECTIONS 3 (2009), available at http://www.nclc.org/images/pdf/foreclosure_mortgage/state_laws/foreclosing-dream-report.pdf (“In 36 states and the District of Columbia, mortgage holders can pursue so-called ‘deficiency judgment’ claims against homeowners even after the foreclosed home has been sold at auction.”).

²²⁶ See Alexander et al., *supra* note 194, at 343–49 (explaining the difference between judicial and nonjudicial foreclosure); Dana, *supra* note 22, at 511–12 (“[J]udicial foreclosure is widely perceived to be slower and more expensive [than nonjudicial foreclosure] for foreclosing entities.”); Elizabeth Renuart, *Toward a More Equitable Balance: Homeowner and Purchaser Tensions in Non-Judicial Foreclosure States*, 24 LOY. CONSUMER L. REV. 562, 564–67 (2012) (explaining potential flaws in the nonjudicial foreclosure process); White, *supra* note 22, at 489–93 (explaining the important procedural and substantive differences between judicial and nonjudicial foreclosure).

federal statutes that impose minimum standards on mortgage markets and securities markets. We could seek greater uniformity among states by drafting uniform mortgage laws that actually get passed by state legislatures.²²⁷ Or we could seek greater national unity by federal legislation that either sets minimum standards for state law or by drastic and unprecedented legislation that preempts the field and makes real property law a national, rather than a local, enterprise.²²⁸

It is hard to identify clear value valences that emerge from the choice between federal and state regulation. It seems that people often push for one or the other based not on the superior competence of that level of government but on their views of whether it is more or less likely to regulate in the way they favor. Libertarians who generally prefer “state’s rights” sometimes argue for federal preemption if they believe Congress will pass laws that increase “market freedoms” and toss away state regulations thought to be oppressive.²²⁹ Liberals who generally prefer federal preemption change their mind when they see that states often pass more protective consumer protection laws than those enacted by Congress and the President.²³⁰

The choice is really between uniformity and diversity. And we cannot make this choice wholly separate from our views about the substance of proposed regulations. Uniform federal regulation may reduce costs for businesses and homeowners because banks would not have to comply with the varying legal standards of many jurisdictions. On the other hand, if the United States enacts a regulatory law that prohibits practices that banks want to engage in, they may find that they prefer local regulation that allows them freedom to engage in market practices they favor in the states that allow them. Conversely, consumers may favor either state or federal regulation depending on which gives them the freedoms they want and the protections they seek.

²²⁷ Compare Helen Mason, *No One Saw It Coming—Again: Systemic Risk and State Foreclosure Proceedings: Why a National Uniform Foreclosure Law Is Necessary*, 67 U. MIAMI L. REV. 41, 44 (2012) (arguing for a federal foreclosure statute that preempts state law), with Nelson & Whitman, *supra* note 111, at 1509–13 (arguing for adoption of a uniform nonjudicial foreclosure law).

²²⁸ See Nelson & Whitman, *supra* note 111, at 1509–13 (arguing for federal foreclosure legislation); Woolley & Herzog, *supra* note 85, at 368 (“[Because] there are no federal laws governing private property rights . . . a federal system of title (electronic or otherwise) is not feasible . . .”); *id.* at 397 (“The MERS system is an example of a flawed national system that did not take into account the fact that each state determines its own real property laws and recording system.”).

²²⁹ See Linda S. Mullenix, *Strange Bedfellows: The Politics of Preemption*, 59 CASE W. RES. L. REV. 837, 864 (2009) (discussing how conservative pro-business and libertarian interests align to defend federal preemption to prevent “the harmful influence of local justice”).

²³⁰ See Marin R. Scordato, *Federal Preemption of State Tort Claims*, 35 U.C. DAVIS L. REV. 1, 3 (2001) (stating that liberals, historically, favor a broad doctrine of federal preemption but prefer the conservative, narrow doctrine when states attempt to limit tort liability producing a greater federal foreclosure of state tort claims).

Tradition suggests that property law will continue to be local, meaning that banks must do business in a manner that complies with the property law regimes of the various states. It is not impossible to do this. There is no dispute that if you want to build a house in Cambridge, Massachusetts, you have to comply with the state housing code and local zoning law and building regulations. It should not be surprising to banks that the rules governing mortgage transactions are also local in nature. The bottom line is that states generally want formalized property transactions; they also provide a public recording system for those who want to protect their property rights from other claims.²³¹ The banks would be wise to figure out what those regulations are and how to comply with them. Neither of these obligations is onerous. When mortgages are assigned, the banks will want a record of the assignment. Pure carelessness led to mistakes in keeping track of mortgage assignments.²³² Banks deal in numbers all the time; they are supposed to not make mistakes. It is not unreasonable to expect them to keep clear records of mortgage transactions.

The bottom line is that property titles must be sufficiently *clear* and *public*. There are various ways to achieve these goals. To some extent, the clarity issue is likely to be improved in the future by the banks exercising greater care in documenting mortgage transactions. They have experienced first hand the problems that ensue when they cannot prove they have a right to foreclose on property. Not only does this affect their ability to enforce their rights but it has the potential to affect the banks' capital requirements and poses a risk to the banks' solvency.²³³ So, as with qualification, it may be the case that no law reforms will be necessary, at least in the short term, to induce banks to go back to careful creation of written records for mortgage assignments. At the same time, states should consider adopting the Michigan approach to nonjudicial foreclosures by requiring proof of the "record chain of title . . . prior to the date of sale . . . evidencing the assignment of the mortgage to the party foreclosing the mortgage."²³⁴ State laws may also need to be updated not only to make electronic records more easily available but also to ensure their

²³¹ SINGER, *supra* note 4, § 12.3.3.1, at 876–77.

²³² See Woolley & Herzog, *supra* note 85, at 388–89 (discussing how a property's chain of title can be lost in public records or "severely diluted" as a result of MERS).

²³³ See Renuart, *supra* note 226, at 563 ("[T]he foreclosing parties frequently do not possess the right to foreclose and the resulting sales may be unlawful."); see also Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5, 8 (2009) ("Th[e] financial crisis, marked by a plethora of home foreclosures and illiquid mortgage-related assets which have created a capital hole on the balance sheets of banks and financial institutions, has spilled over into the greater economy . . .").

²³⁴ MICH. COMP. LAWS § 600.3204(3) (2012); see Timothy A. Froehle, Note, *Standing in the Wake of the Foreclosure Crisis: Why Procedural Requirements Are Necessary to Prevent Further Loss to Homeowners*, 96 IOWA L. REV. 1719, 1740 (2011) (recommending adoption of Michigan's requirement by other states).

authenticity.

Given the existence of MERS, one law reform is definitely needed to ensure the publicity of land titles. If we are not going to abolish MERS or replace it with a national public registration system, MERS should at least be required to make its records public.²³⁵ The state recording systems were created to build incentives to induce buyers and lenders to record deeds and mortgages in a public office. This lets any potential buyer determine who owns the property and what encumbrances or restrictions are attached to it. The MERS system privatizes this information. Because the banks were so careless with their records of mortgage assignments and their custody of notes, and because there is evidence that MERS records are often inaccurate,²³⁶ there is no reason to trust the MERS records. The only way to regain trust is to induce banks to be more careful about mortgage assignments and rights in the notes and to make the chain of title accessible to potential buyers. As Alan White argues, “a better system design would incorporate transparent and authoritative registration of mortgage loan ownership throughout the life of the loan, and not just at the point foreclosure is initiated.”²³⁷ Property will not be alienable if buyers cannot trust that they will actually own the property they think they are buying. If that property is possibly subject to outstanding liens of which they are unaware, they will be discouraged from buying the land. If MERS is going to be our repository of information about mortgage transactions, there is no way to achieve these goals without forcing MERS records to become both complete and accessible to the public.

The traditional recording system worked by giving banks an incentive to record their mortgages. The MERS system arguably weakened that incentive by giving banks the impression that it was not necessary to notify MERS whenever mortgages were assigned. Because the courts have not fully accepted the MERS system,²³⁸ we have a renewed incentive for banks to notify MERS about mortgage transfers. That means that MERS must

²³⁵ See Laura A. Steven, *MERS and the Mortgage Crisis: Obfuscating Loan Ownership and the Need for Clarity*, 7 BROOK. J. CORP. FIN. & COM. L. 251, 270 (2012) (arguing for federal legislation requiring MERS to “open its records to the public”); White, *supra* note 22, at 497 (advocating full disclosure of agency relationships and transfer history); Zacks, *supra* note 77, at 607–08 (arguing for greater public transparency in MERS records, including revealing the identity of investors, disclosing when transfers are made, and allowing recording by lenders on the MERS database). Note that the Truth in Lending Act was amended to require homeowners to be notified of changes in beneficial ownership of loans. See *id.* at 593–94 (citing Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, § 404, 123 Stat. 1632, 1658 (2009)).

²³⁶ See Woolley & Herzog, *supra* note 85, at 365 (stating that courts have found the MERS model “wholly inaccurate”).

²³⁷ White, *supra* note 22, at 497.

²³⁸ See Steven, *supra* note 235, at 251 (“[S]tate courts are far from reaching a consensus as to whether MERS, a company that tracks mortgage ownership but has no actual interest in the mortgages themselves, even has the power to initiate a foreclosure.” (citing Peterson, *supra* note 25, at 1378)).

track not only the current mortgage holder, but also the history of assignments from which that entity derives its rights. Traditionally, those assignments would be accomplished both by endorsement of the note and a mortgage assignment. Banks must figure out how to comply with these requirements or seek law reforms that might simplify them. If some states will continue to allow the current mortgagee to foreclose simply by showing an assignment of the mortgage from MERS, we need to establish a requirement that banks register mortgages for them to be valid, either by recording them in public recording offices or by notifying MERS of the transfer. The subprime crisis shows that we need clear, public records of both the original mortgage and subsequent assignments. If MERS cannot be reformed to accomplish these goals, then a federal public agency should be created to take its place. Such an agency could insist on appropriate regulation of mortgage transfers while preserving the accessible, public notice of mortgage liens.

Changes are definitely needed to the U.C.C. and state foreclosure statutes to clarify the relationship between negotiable instruments law and mortgage law. Because it may be useful for one party to hold the note and another to hold the mortgage, we need clearer answers to the question of which party is the principal and which is the agent. We also need clarification of how mortgage transfers should occur. Traditionally, whoever has the right to enforce the note has the right to foreclose to enforce the note, but state law has been less than clear about how mortgage assignments should happen. Banks could have avoided problems by formally endorsing notes, keeping them, and producing and recording mortgage assignments. They failed to ensure adequate formality to these transactions; that is what we need to restore. In some sense, it does not matter how we do so, just that the laws help make this possible and facilitate it. If the states agree on the underlying principles and procedures, then state law could be made uniform (by common law or a uniform act) to effectuate the shared norms. In general, courts assume the mortgage serves the interests of the note holder; the mortgage is security for the loan.²³⁹ They differ on whether the transfer of the mortgage brings the note with it or whether the mortgage holder holds it for the benefit of the note holder.²⁴⁰ They also differ on what acts are sufficient to prove who is an

²³⁹ See RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 4.1 (1996) (discussing the three theories of mortgage law traditionally recognized by American courts); SINGER, *supra* note 4, at 894 (explaining that borrowing money from a bank to finance real property entails obtaining a note and a mortgage to secure repayment of the note); Renuart, *supra* note 226, at 565 (“In most states, a mortgage creates a security interest in the borrower’s real property and permits the mortgagee to foreclose in the event of non-payment or a breach of the note or duties listed in the security agreement.” (citing RICHARD R. POWELL, 1 POWELL ON REAL PROPERTY § 37.03 (Michael Allan Wolf ed., 2013))).

²⁴⁰ Compare RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 5.4 & cmt. a & illus. 4 (proposing an approach that permits the parties to separate a note from a deed of trust), with *Carpenter v. Longan*,

agent for another principal.²⁴¹ The courts are wrestling with these issues now and they are among the issues that were not completely clear before the subprime crisis. Both clarity and uniformity would be desirable in this area.

Various approaches could achieve these goals. Back in 2002, Dale Whitman argued for a uniform electronic recording act.²⁴² He has recently recommended a federally created national mortgage registry to correct the deficiencies in the MERS system.²⁴³ Adam Levitin has argued for a national registry of mortgage notes,²⁴⁴ while Alan White has argued that we should merge the note and the mortgage into a single document that could be more easily tracked.²⁴⁵ Dustin Zacks has suggested that MERS should be “forc[ed] to store actual electronic documents that were previously recorded at the local recording level, such as mortgages and assignments.”²⁴⁶ And Tanya Marsh has argued for nationalizing the title registration system, effectively replacing both state recording offices and MERS with a public federal system of title and mortgage registration.²⁴⁷ Rather than choose among these proposals, I simply want to applaud them for suggesting ways to achieve the ultimate goal: to restore our system of clear, public titles that the banks have destroyed.

How should courts handle foreclosures still in the pipeline? What should they do when the chain of title is broken, the note lost, the statute of frauds violated, and no clear written evidence that the foreclosing bank has a right to foreclose? In some cases, no law reform is needed. After all, the homeowner has an interest in clearing title. If the bank cannot foreclose, this does not free the homeowner from the recorded mortgage in MERS’s name. Potential buyers may be discouraged from buying if they cannot identify which bank holds the mortgage. That means that homeowners have an interest in negotiating with the bank to clear the title. The bank, of course, has an interest either in renegotiating the mortgage or in foreclosing, arranging a short sale, or engaging in some other way to obtain value out of the mortgage it purchased. In the absence of transaction costs, a deal could be struck between the bank and the homeowner. But of course, there are transaction costs and many banks have refused to

83 U.S. (16 Wall.) 271, 274 (1873) (elucidating the traditional rule that “[t]he note and mortgage are inseparable”).

²⁴¹ See, e.g., Dale A. Whitman, *Reforming the Law: The Payment Rule as a Paradigm*, 1998 BYU L. REV. 1169, 1179 (discussing several methods for establishing agent authority).

²⁴² Dale A. Whitman, *Are We There Yet? The Case for a Uniform Electronic Recording Act*, 24 W. NEW ENG. L. REV. 245 (2002).

²⁴³ Whitman, *supra* note 68, at 46.

²⁴⁴ Levitin, *supra* note 112, at 53.

²⁴⁵ White, *supra* note 22, at 498.

²⁴⁶ Zacks, *supra* note 77, at 554.

²⁴⁷ Marsh, *supra* note 150, at 24–26. David Waks has similarly advocated for the creation of an independent federal agency to fulfill this role. Waks, *supra* note 79, at 32.

negotiate with homeowners. That is why many states have passed laws that prohibit foreclosure unless the parties can show they engaged in good faith negotiations, usually through mediation.²⁴⁸ Mediation is easier to implement in judicial foreclosure states than in the majority of states that allow nonjudicial foreclosure.²⁴⁹ At the same time, a few nonjudicial foreclosure states have experimented with programs to promote mediation.²⁵⁰

From the standpoint of potential buyers, the answer may be to purchase title insurance. There have been few disputes among banks as to which banks “own” the mortgage. The problem has been that banks could not show that they complied with the statute of frauds.²⁵¹ The risk of another bank coming in to sweep the title away appears to be low if the parties contract out of the problem. Title insurance companies may be willing to provide insurance because banks and consumers want it and because this might restore the alienability of the property. The risks of title problems may be relatively low in such cases because banks are not likely to claim rights in mortgages they already sold; if they do, other banks could make such claims on them. At the same time, the willingness to sell title insurance may depend on the legal vulnerability insurers face—which is not completely known, given the ongoing litigation about the effects of MERS on property titles.²⁵² There is some evidence that title insurance companies are not willing to insure clouded subprime titles.²⁵³ Even if

²⁴⁸ See, e.g., MASS. GEN. LAWS ANN. ch. 244 § 35B(b) (West 2012) (requiring creditors to make good faith efforts to avoid foreclosure); see also Foreclosure Fairness Act, WASH. REV. CODE ANN. § 61.24.163 (West 2013) (explaining that, prior to initiating foreclosure, lenders must tell homeowners about the availability of state-led mediation services); *Pasillas v. HSBC Bank USA*, 255 P.3d 1281, 1286 (Nev. 2011) (finding that a bank cannot foreclose if it fails to act in good faith to participate in state-mandated mediation with the borrower as required by state law (citing NEV. REV. STAT. ANN. § 107.086 (LexisNexis 2013))); ALAN WHITE, UNIFORM LAW COMM’N, STATE FORECLOSURE MEDIATION LAWS: EXAMPLES AND RESEARCH FOR A UNIFORM STATUTE (May 11, 2012), available at http://www.uniformlaws.org/shared/docs/mortgage%20foreclosure/4_2012may11_RREMFPP_State%20Foreclosure%20Mediation%20Laws%20memo_White.pdf (discussing the adoption of statewide foreclosure mediation programs throughout the United States); Alexander et al., *supra* note 194, at 364–70 (discussing various state mediation programs and identifying considerations for those states contemplating enacting their own programs); Salsich, *supra* note 3, at 59–64 (providing statistics regarding statewide sponsorship of foreclosure mediation programs).

²⁴⁹ Alexander et al., *supra* note 194, at 346–47.

²⁵⁰ See *id.* at 367–69 (analyzing the programs in California and Nevada); *id.* at 355 (noting that the federal Home Affordable Modification Program (HAMP) implemented a procedure for evaluating borrower claims for loan modifications and that the state laws piggy-backed on those standards).

²⁵¹ See *In re Coulliard*, 486 B.R. 481, 486 (Bankr. W.D. Wis. 2012) (“[T]he recording statutes indicate that any conveyance which is not ‘recorded as provided by law’ is void against a subsequent purchaser. As the bank acknowledges . . . the statutory definition of a ‘conveyance’ presupposes compliance with the statute of frauds.” (citation omitted)).

²⁵² Woolley & Herzog, *supra* note 85, at 394–96 (stating that title insurance may not be available for properties with clouded titles).

²⁵³ *Id.* at 395–96.

such insurance is available, it will increase the cost of buying and financing real property.

To clear title and make it marketable, the courts may need to accept affidavits from banks that show why they reasonably believe that they are entitled to foreclose on the property. The banks cannot be allowed to “robo-sign” affidavits without any investigation or presentation of evidence that backs up their claim of ownership of the mortgage. But if the bank can produce reliable evidence of their ownership of the mortgage, then it is not unfair to hold borrowers to the contracts they made, unless the borrower can show that the entire agreement violated the consumer protection statute because it was based on unfair or deceptive practices. In such a case, it would be appropriate for courts to promote renegotiation of the loan terms to approximate the terms the parties would have agreed to if they had not been unfair. It would also be appropriate to require banks to show, by cost-benefit analysis, that foreclosure is superior to loan modification for borrowers who can afford to continue to make modified payments.

2. *By Mitigating Systemic Risk*

Despite the subprime crisis, it is important to remember that securitization is a good thing. Done correctly, it can spread risk, lower the costs of housing finance, and widen access to housing ownership.²⁵⁴ In general, it is desirable to allow property rights to be disaggregated and repackaged to suit human purposes. However, this “freedom of contract” principle works only if it is kept within regulatory boundaries that preserve the infrastructure of the property and market system. That legal infrastructure ensures that transactions are mutually beneficial, rather than vehicles for committing fraud, and manages transactions to mitigate systemic risk.

Just as we have consumer protection in place for mortgage borrowers, we have securities regulations to protect investors in mortgage-backed securities. But existing protections were either insufficient or insufficiently appreciated by securitizers. Banks misled investors about the characteristics of the bonds they were marketing.²⁵⁵ Litigation is proceeding now against various banks for their marketing practices.²⁵⁶ In addition, the rating system for mortgages is broken. The rating agencies turned out to work for the banks marketing the mortgages instead of acting

²⁵⁴ See Steven L. Schwarcz, *The Future of Securitization*, 41 CONN. L. REV. 1313, 1315, 1324 (2009) (recognizing that when securitization is properly utilized it is an efficient tool to allocate risk with capital and allows companies to access capital markets differently).

²⁵⁵ Silver-Greenberg, *Banks Face Wave of New Mortgage-Securities Suits*, *supra* note 181.

²⁵⁶ Isidore, *supra* note 181; Silver-Greenberg, *Banks Face Wave of New Mortgage-Securities Suits*, *supra* note 181.

as professionals expressing objective opinions that investors could trust.²⁵⁷ The conflict of interest between rating agencies and investors means that the ratings no longer fulfill the function they were intended to play.

These problems could be fixed in a number of ways. One solution is better disclosure. The banks should not mislead investors about the quality of the mortgages contained in mortgage-backed securities. And it should be clear what ratings issued by rating agencies mean. If a AAA rating means that the mortgages in the securitized package are what the seller says they are, rather than merely describing it as a relatively safe investment, then that should be crystal clear to investors. If a AAA rating does not mean that the investment is safe, the rating agencies should explain that in no uncertain terms.

An alternative solution is to recreate the goodwill the rating agencies squandered, either by changing the way they are compensated or by replacing them with public agencies whose mission is to protect investors and other consumers of mortgage-backed securities.²⁵⁸ The current system puts the rating agencies in the pocket of the securitizing banks and gives them incentives to mislead investors. It would be better if incentives could be changed to put the rating agencies on the side of the investors rather than the sellers of securities. And if that is not possible, then they should be replaced by a professional, expert public agency.

While securitization should be promoted, it must be better regulated to protect all of us from the systemic risks associated with subprime mortgages. Even if investors are willing to take great risks, they are not entitled to impose those risks on the rest of us. And the biggest risk they are not entitled to impose on society is the risk of undermining the foundations of the property system itself. Regulations designed to clarify ownership are preconditions to markets. They are the way we ensure that we have both freedom and prosperity. Fair treatment of consumers and adequate formalization and publicity of titles are the bedrock on which housing exchange and finance sit. These foundational protections make property markets possible and securitization exists *on top* of that foundation, not despite it.

Finally, there are many ways to promote homeownership for low and

²⁵⁷ See Katy Burne, *Lawmakers Tell Raters to "Get It Right,"* WALL ST. J., June 22, 2013, at B2 ("We don't want history to repeat itself, and the history is that the rating agencies aided and abetted the big banks in giving sweetheart ratings to structured-finance deals." (internal quotation marks omitted)).

²⁵⁸ The Dodd-Frank law requires the SEC to examine conflicts of interest in the bond rating agency and either create a board that would assign a rating agency to rate structured-finance deals or create an alternative mechanism to avoid the conflict of interest that arises when issuers pay for the ratings. See Pub. L. No. 111-203, § 919a, 124 Stat. 1837, 1837-38 (2010) (requiring the SEC to consider conflicts of interests so to protect investors). As of May 2013, no reforms have been put into place. Jeannette Neumann, *Rating Firms Steer Clear of an Overhaul,* WALL ST. J., May 13, 2013, at C1.

moderate income families that work.²⁵⁹ The subprime market was not one of them. To the extent that the idea of spreading homeownership was a justification for subprime mortgages, we should learn from experience and move back to other strategies to achieve this purpose. Many nonprofit organizations provide affordable housing ownership in a manner that led to few defaults.²⁶⁰ Low income housing ownership was not the problem; subprime mortgages were. And we should realize that many people are better off renting than owning.²⁶¹ That, in turn, requires better enforcement of landlord-tenant law, especially promoting housing code enforcement and preventing invidious discrimination.

IV. PROPERTY AND THE RULE OF LAW

The subprime crisis happened because banks sold mortgages to people who should not have bought them. Some of those people took honest risks but others had to be convinced that the deals were in their best interest. Some banks convinced them through unfair and deceptive consumer practices. Then they sold these risky mortgages to investors on the pretense that they were as safe as U.S. Treasury bonds. In addition, the banks tried to evade regulatory requirements they considered costly and archaic while assuming that the courts would trust them to manage housing finance as they saw fit. But nothing turned out as the banks imagined it would. Borrowers defaulted, the housing bubble burst, borrowers could neither refinance nor sell, and banks had trouble foreclosing when they could not prove they had a right to do so, making titles unmarketable. Not only did banks treat many homeowners unfairly and deceptively, but they similarly misled investors in mortgage-backed securities and created a market designed to fail, causing a worldwide recession. Worse still—and almost hard to believe—they broke a well-functioning recording system that had, for more than three hundred years, provided a basis for clear public property titles in the United States.

The banks' failures cannot be corrected by a simple admonition to

²⁵⁹ See DAVID ABROMOWITZ & JANNEKE RATCLIFFE, CTR. FOR AM. PROGRESS, HOMEOWNERSHIP DONE RIGHT: WHAT EXPERIENCE AND RESEARCH TEACHES US 3–4 (Apr. 2010), available at http://www.americanprogress.org/wp-content/uploads/issues/2010/04/pdf/homeownership_done_right.pdf (discussing other programs, besides subprime mortgages, that have been successful).

²⁶⁰ See *id.* at 4 (discussing how the Massachusetts Affordable Housing Alliance had only a 2.2% delinquency rate).

²⁶¹ See Salsich, *supra* note 3, at 67 (“One of the clear lessons of the foreclosure crisis is that not all households have the emotional and financial resources to discharge the responsibilities associated with homeownership.”). On government policies needed to increase the availability of affordable rental housing, see DAVID ABROMOWITZ, CTR. FOR AM. PROGRESS, THE HOUSING MARKET IS NOT ONLY FOR HOMEOWNERS: POLICYMAKERS NEED TO FOCUS ON RENTERS TO FACILITATE A TRUE “HOUSING RECOVERY” 4–6 (2012), available at <http://www.americanprogress.org/wp-content/uploads/2012/12/AbromowitzRentalBrief.pdf>.

adhere to the traditional rules. Keep records of your transaction and use available public recording and registration procedures to document those transactions publicly. *We had clear rules but the banks did not follow them.* What we need is a greater appreciation of the benefits of having a secure legal infrastructure for property as well as a moral compass that bends away from unfair and deceptive practices. New rules that clarify bankers' obligations can help, but they will not suffice. To prevent unfair and deceptive practices that harm consumers and investors, we should define safe harbors through regulations that create presumptively valid loans. Federal law now does this, but we should *also* retain the statutes that supplement safe harbors with prohibitions of "unfair and deceptive" practices. No set of clear rules could be complete enough to catch all the ways businesses can trick consumers and investors into products they should not be buying.

Federal and state law has long prohibited unfair and deceptive practices in consumer transactions. These laws represent a modern version of the Biblical injunction not to "put a stumbling block before the blind."²⁶² Both ancient and modern law prohibit market transactions whose purpose or effect is to lead someone to disaster. Deceptive practices fueled the subprime market and consumers were induced to take out loans they could not afford. Banks should not sell mortgages to those who cannot pay them back. These loans not only impose undue externalities on others but harm the consumers they are intended to benefit. It is surprising that we appear to need the new federal law that prohibits selling a mortgage to someone who cannot afford to pay it back. But such a law was necessary because banks made risky loans and then fooled investors into thinking they were AAA safe.

We also need to recreate clear, public property titles either by replacing MERS with a national mortgage registration system or by requiring MERS to open its records to the public and forcing banks to register all mortgage assignments with MERS so we have clear chain-of-title records of who has the right to enforce the loan secured by the mortgage. To address hard foreclosure cases still in the pipeline, courts cannot strictly enforce the statute of frauds in the face of such massive resistance to it without harming both homeowners and the general public. We must acknowledge that even bankers make mistakes. Property law has always been sufficiently flexible to settle conflicting claims when we have excusable errors. I have proposed ways to clear property title that require banks to prove their right to foreclose by clear evidence while protecting homeowners by promoting negotiation to mutually beneficial outcomes.

The bottom line is that we are entitled to expect bankers to act

²⁶² *Leviticus* (Vayikra) 19:14.

responsibly. You cannot build a house without a foundation and you cannot operate a market without a legal infrastructure. Of course bankers are in business to make money but we expect them to do so without undermining the framework that makes our housing market function. There are many ways to make money honorably, but deceiving consumers and investors is not one of them. There are many ways to improve the efficiency of our property title system, but privatizing title records and carelessly recording them is not one of them. There are many ways to improve our housing markets, but undermining their legal infrastructure is not one of them. Property law must be interpreted or changed to vindicate these norms, and business ethics must evolve to internalize them.