

How to Stop Foreclosure Reversal from Triggering the Next Financial Collapse –

A Title and Economic Perspective

By David Hostyk

For the second time in two years, the United States stands at the edge of a financial abyss. In 2008, the economic recession combined with the escalating decline in real estate values to trigger a national financial freefall and a tsunami of foreclosures. The financial collapse was stopped in time, but the foreclosure crisis continues. Today we stand at an equally precarious point in time, not because of the so-called foreclosure freeze, but because of the threat of foreclosure reversals. In the wake of the admittedly wholesale violation of legal procedures in the foreclosure process, courts are beginning to reverse foreclosures and are threatening to evict buyers of foreclosure property. The possibility even exists that prior owners will regain their property mortgage free!

Scott and Susan Christensen of Poway California have not been evicted from their house — which was foreclosed last July — because of improperly notarized documents among other deficiencies.¹ In Fall River, Massachusetts, Mark and Tammy LaRace were allowed to move back into the house from which they were evicted two years earlier. The case is under appeal.² Foreclosure expert Neil Garfield is quoted as saying: “Millions of people who THINK they have lost their homes still own them.”³

¹ Curt Anderson, *Despite Foreclosure Halt, Mortgage Crisis Not Over*, ASSOCIATED PRESS (Oct. 12, 2010 3:40 PM EDT), http://hosted.ap.org/dynamic/stories/U/US_FORECLOSURE_FREEZE_BUSINESS_AS_USUAL?SITE=TXDAM&SECTION=HOME&TEMPLATE=BUSINESS.html

² Kathleen M. Howley, *Foreclosure Errors May Cloud Ownership of U.S. Homes*, BUSINESSWEEK (Oct. 1, 2010, 6:37 PM EDT), <http://www.businessweek.com/news/2010-10-01/foreclosure-errors-may-cloud-ownership-of-u-s-homes.html>

³ Ellen Brown, *Shock Therapy For Wall Street: JPMorgan Suspends 56,000 Foreclosures, GMAC And BoA Many More*, RENSE.COM (Oct. 2, 2010), <http://www.rense.com/general92/shock.htm>

If the courts follow through with their threats, then all foreclosed property will become unmarketable. Who would buy a foreclosed property knowing that they can be evicted? As Ron Lieber writes in the New York Times: “Are you out of your mind to even consider buying a foreclosed property right now?”⁴ And if foreclosed property becomes unmarketable, then hundreds of billions of dollars of real estate will be wiped off the books of the nation’s financial institutions, thereby restarting the financial freefall by wiping out the equity of even the largest banks. One of the casualties will be the title insurance industry, which will not be able to handle the avalanche of claims made against foreclosed property. A much greater danger is a capital markets freeze-up as the pool of marketable assets is decimated.

All of this can be avoided by taking an equitable and balanced approach to the problem of procedural fraud in foreclosure, cutting off this chain reaction before it becomes unstoppable. The three goals of the solution proposed here are 1) protecting the innocent; 2) formulating remedies that are proportionate to the damage suffered; and 3) evaluating the risk to the various players.

1) The key to stopping foreclosure fraud from triggering another financial collapse is to protect the bona-fide-purchaser-for-value from the consequences of a foreclosure reversal. Since the bona-fide-purchaser-for-value did no harm, he should not be vulnerable to eviction. On the contrary, the bona-fide-purchaser-for-value needs to be encouraged to buy foreclosed properties, invest in them and raise their value. Whatever damages the court wishes to award the previous owner must be paid by the perpetrator of the damage, namely the foreclosure plaintiff and its agents, and not by the new owner. State legislatures must grant statutory protection to the bona-fide-purchaser-for-value; otherwise we will witness a total collapse of the foreclosure market.

⁴ Ron Lieber, *Your Money: Avoid Foreclosure Market Until the Dust Settles*, NEW YORK TIMES (Oct. 15, 2010), <http://www.nytimes.com/2010/10/16/your-money/mortgages/16money.html? r=2>

This is not to say that the bona-fide-purchaser-for-value will be protected from any of the other dangers present in the foreclosure process, such as superior claims, unnamed junior claims, unnamed parties of interest, or any of the other myriad pitfalls currently found in buying foreclosed property. The statutory protection suggested here is aimed solely at protecting the bona-fide-purchaser-for-value from a foreclosure reversal due to foreclosure fraud. The foreclosure plaintiff and its agents must be held liable, not third parties who are actually acting in a beneficial manner. The remedy must not hurt the innocent, and must not cause even greater damage than the original violations.

2) If fraud in the foreclosure process will no longer be remedied by foreclosure reversal, then what remedy is available and advisable? Foreclosure fraud should be classified as either procedural or substantive. Fraudulent acts in the foreclosure process such as falsely swearing to personal knowledge of the facts, or notarizing signatures without actual acknowledgment of the signer, are violations of the law. They are criminal, unethical and should be punished. But what are the actual consequences of this fraud? If the foreclosure plaintiff truly owns the note, then the procedural fraud simply bought several weeks of time for the plaintiff, and nothing more. The foreclosed owner lost several weeks, or months, of free rent, but nothing more substantial since the owner still had the right to save the property up until the day of sale, and ten days beyond. The remedy should not be foreclosure reversal but rather the several weeks or months in which the process was cut short. A limited and capped fine of between one and three thousand dollars seems fair and proportional to the damage incurred.

However, if the foreclosure plaintiff cannot prove ownership of the note, then the plaintiff committed substantive fraud - seizing property to which it had no right; claiming standing when none existed; evicting owners against whom it had no claim. Severe penalties

are in order. Reimbursing an evicted owner with the value of the lost property is not enough. Only double, or even triple damages, would make the foreclosed owners whole and serve as a deterrent against bringing suit to foreclose property belonging to others.

Unbelievably, there have been calls from various quarters to allow mortgage servicers the right to foreclose without documentation. This is unconscionable and flies in the face of centuries of legal doctrine. The whole point of title is that if one cannot prove title, then one doesn't have title. This is true with ownership and is equally true with liens and encumbrances. No justification exists for rewarding sloppy institutions that ignored basic procedures. Any institution that cannot produce the required documents, has no standing to foreclose. (This raises a different problem: What constitutes proper documentation: Ownership of the note or of just the mortgage? Now that MERS has bifurcated the note and the mortgage, many pundits, economists, and Congressmen are challenging the legitimacy of MERS, but that is a completely separate issue requiring analysis^{5,6}.)

3) The third component of this plan involves re-evaluating underwriting premiums of title insurance. Since the proposed statute would eliminate foreclosure reversal as a remedy for foreclosure fraud, title insurers would be exposed to less risk when insuring the purchase of foreclosed property. Title insurers should cede to the state that part of the premium which otherwise would cover the costs of foreclosure reversal. It could be argued that the cost of foreclosure reversal is greater than the entire premium. (Actually it might be greater than the entire equity of the all title underwriters since the courts could reverse one million foreclosures just in 2010). Nevertheless, some part of the premium should be ceded to the state to cover damages where the lender is bankrupt. It is only fair that if the state reduces the risk to the

⁵ Floyd Norris, *Some Sand in the Gears of Securitizing*, NEW YORK TIMES, Oct. 19, 2010, at B1.

⁶ Christopher Lewis Peterson, *Two Faces: Demystifying the Mortgage Electronic Registration System's Land Title Theory*, REAL PROP. PROB. & TR. J. (forthcoming), available at SSRN: <http://ssrn.com/abstract=1684729>.

underwriter, that the underwriters share some of the risk premium with the state. The state would use that premium to cover damages ordered against bankrupt lenders, to cover claims that cannot be covered by illiquid title underwriters, and for administering this program.

To summarize: National attention is myopically focused on the so-called foreclosure freeze, which is a temporary measure to take stock of the situation, while the real danger lies not in evaluating the extent of foreclosure fraud, but in using foreclosure reversal as a remedy for that foreclosure fraud. Should the courts make foreclosure reversal the common remedy for foreclosure, the market for foreclosed property will collapse, wiping out hundreds of billions of dollars of property now owned by the main financial institutions of the country. Such a collapse might bring down the housing market, the capital markets, and even the entire economy. To avoid such a chain reaction, it is recommended that the legislature provide statutory protection to the bona-fide-purchaser-for-value of foreclosed property, but only in terms of eliminating foreclosure reversal as a remedy for foreclosure fraud. Secondly, a limited and capped fine of several thousand dollars should be levied for procedural fraud in the foreclosure process, while substantive fraud should be punished by double, or triple damages. Finally, title insurers should forfeit that part of the premium equal to the risk of foreclosure reversal, since that risk would be eliminated by statute. The state would use that premium to cover damages ordered against bankrupt lenders, to cover claims that cannot be covered by illiquid title underwriters, and for administering this program. By protecting the bona-fide-purchaser-for-value, pegging punishments to actual damages, and correctly evaluating the risk premium, we can stop foreclosure reversal from acting as a catalyst of asset liquidation, bank failure and economic catastrophe.