

FORECLOSURE-GATE AND THE \$25 BILLION NATIONAL MORTGAGE SETTLEMENT: IMPLICATIONS FOR FUTURE LITIGATION EXPOSURE AND TAXPAYER LIABILITY

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SUMMARY

Controversy surrounding alleged illegal foreclosure practices led to a February 2012 settlement of \$25 billion with the nation's five largest mortgage servicers, brought forth by the U.S. Department of Housing and Urban Development, the Justice Department, and Attorneys General from 49 states. In this policy brief, we describe the legal and policy issues that led to the 2010 Foreclosure-Gate controversy, outline the resulting National Mortgage Settlement, and consider implications for future litigation exposure among mortgage industry participants and taxpayers, who remain liable for losses on mortgages owned or guaranteed by the federal government.

WHAT IS AN ASSIGNMENT OF MORTGAGE?

Traditionally, banks funded mortgage loans through bank deposits or debt, and held the mortgages until maturity or payoff. Modern mortgage lending practices are characterized by a series of more complex transactions in which banks or other mortgage lending institutions decide whether to hold loans in portfolio as an investment, or whether to sell or securitize loans in the secondary mortgage

market. The secondary mortgage market is comprised of private-label investors including banks, institutional investors, and hedge funds, as well as government-sponsored agencies including the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae) (FHFA, 2012b). Known together as the Enterprises, Freddie Mac and Fannie Mae own or guarantee 60 percent of all outstanding mortgages. The right to service these mortgages—that is, to accept and record payments of mortgage principal, interest, taxes, and insurance; to collect past due payments from delinquent borrowers; to modify mortgages in default; and to administer the foreclosure process—may be retained by the originating mortgage lender, passed through to secondary market investors, or sold to mortgage servicing companies. Mortgage loans and their associated servicing rights may be bought, sold, and transferred multiple times, as long as the mortgage borrower receives notice of any transfer of the servicing rights (U.S. Department of Housing and Urban Development, 2004). An assignment of mortgage is a written document that serves as proof of transfer of the mortgage from

the recorded mortgagee to a third party and complies with the applicable state requirements for the conveyance of an interest in real estate. In the event of loan default, the assignee cannot foreclose without evidence of a recorded mortgage assignment.

MORTGAGE ELECTRONIC REGISTRATION SYSTEMS (MERS) AND MORTGAGE ASSIGNMENTS

In 1995, a consortium of 28 mortgage industry firms—including the Enterprises—founded an organization that was subsequently incorporated as Mortgage Electronic Registration Systems, Inc. (MERS). MERS, Inc. established a paperless loan registration system that currently tracks more than 65 million mortgages, approximately 95 percent of all mortgages originated since 2000. MERS, Inc. allows participating banks, lenders, and investors to transfer mortgages without recording assignments in local public registries, thereby accelerating the securitization and mortgage transfer process and eliminating recording and transfer fees incurred at local recorders' offices (Mitchell J. Stein & Associates, 2011). MERS participants designated MERS, Inc. as the mortgagee in public records, and this designation was maintained through all subsequent assignments of mortgage. Importantly, listing MERS, Inc. as the mortgagee throughout a series of ownership transfers allowed MERS participants to bypass the traditional process of preparing, recording, and maintaining documentation accompanying an assignment of mortgage in jurisdictions requiring such documentation (Hunt et al., 2011). In the event of mortgage default that leads to foreclosure or other acquisition of title, MERS, Inc. records an assignment of mortgage back to the assignee or to a servicer, which may subsequently initiate foreclosure proceedings.

Though MERS, Inc. certainly streamlined the mortgage securitization process, its practices raise a number of legal issues. All states have statutes specifying how ownership interests in real property should be recorded, and failure to follow these recording procedures can render the assignee vulnerable to competing claims of an ownership interest in the property. Hunt et al. (2011) found that recording statutes for real property specifically apply to assignments of mortgage in nine out of

10 states with the highest volume of private-label mortgage securitizations. It is unclear whether listing MERS, Inc. as the nominee in public records complies with state statutes requiring that assignments of mortgage list the name of the party with an ownership interest in the real property. On one hand, it can be argued that designating MERS, Inc. in public records fulfills state statutes requiring the recording of mortgage assignments because MERS, Inc. uses internal databases to track transfers of ownership. On the other hand, Hunt et al. (2011) argue that using nonpublic databases to track mortgage assignments does not fulfill state statutory requirements. Further, MERS records are often inaccurate; an independent audit recently revealed that fewer than 30 percent of MERS database records matched those in the public domain (Powell & Morgenson, 2011). Finally, MERS, Inc. itself maintains that it does not record assignments of mortgage, which is why it requires an assignment of mortgage back to the assignee or to a servicer before the initiation of foreclosure proceedings (Hunt et al., 2011).

Mortgage servicing practices associated with MERS, Inc. further complicate the legal landscape. Throughout the housing crisis, mortgagees routinely subcontracted cases of mortgage default and foreclosure to attorneys, mortgage servicers, or to specialty default sub-servicers including First American National Default Outsourcing, LLC (FANDO), Lender Processing Services, Inc. (LPS), and LPS subsidiary DocX. These contractors often requested an assignment of mortgage and initiated foreclosure proceedings by executing authority from MERS, Inc., sometimes without obtaining required affidavits or appropriate documentation including the promissory note (the borrower's IOU), the mortgage, evidence of title insurance, and securitization agreements (Smith, 2010; N. Wooten, personal communication, March 30, 2012). These practices raise the question of whether agencies foreclosing in the name of MERS, Inc. had the authority to do so. Currently, lawsuits in several states implicate banks and servicers for their use of MERS, and lawsuits naming MERS, Inc. as defendant were filed or are pending in several states including Arizona, Delaware, Florida, Georgia, Massachusetts, Minnesota, Nevada, New York, Utah, Virginia, and Washington (Mortgage Daily, 2012).¹ Moreover, Hunt et al. (2011) warn that

these lawsuits may bankrupt MERS, Inc. and lead to financial “chaos” because it is unclear who owns the mortgage cash flows registered under MERS, Inc. This uncertainty has the potential to render investors in mortgage-backed securities insolvent.

FORECLOSURE-GATE AND THE ROBO-SIGNING CONTROVERSY

In addition to legal issues arising from assignments of mortgage by MERS, Inc., a series of recent court cases exposed that several mortgage lenders, purchasers, investors, and servicers mishandled foreclosures through “robo-signing.” Robo-signing is an umbrella term used to describe a variety of mortgage servicing practices that involve signing documents and affirming their accuracy without proper verification. Robo-signing practices include notary fraud on assignments of mortgage, mortgage affidavits, title documents, and other foreclosure documents (The Associated Press, 2011). As one example, assignments of mortgage were often left blank in perpetuity throughout multiple transfers of the ownership interest, a practice that violates the statute of frauds in most states;² when a mortgage became delinquent, the servicer often requested an assignment of mortgage and simply backdated the transfer of collateral in electronic records (N. Wooten, personal communication, March 30, 2012).

Robo-signing raises two major legal issues. First, robo-signers do not have the authority to sign on behalf of entities transferring an ownership interest in the mortgage, or to execute documents related to foreclosure. Second, robo-signers often did not maintain the formality required for mortgage assignments or foreclosure proceedings—for example, by failing to notarize documents—resulting in their improper and potentially invalid execution. Though instances of robo-signing were reported as early as the late 1990s (Brown, 2012), robo-signing did not attract attention from the public policy community, consumer advocacy groups, the mortgage industry, or the popular press until the mass production of robo-signed foreclosure documents was exposed in late 2009 amid the ongoing foreclosure crisis. The resulting scandal is now known as the “robo-signing controversy” or “Foreclosure-Gate” (Allen, 2012). In October 2010, several banks including Bank of America, Citigroup, Goldman Sachs, GMAC, JPMorgan Chase, PNC,

and Wells Fargo temporarily suspended foreclosure proceedings in light of the scandal (The Associated Press, 2011; White, 2010).

Ultimately, the mishandling of mortgage assignments and other foreclosure documents resulted in foreclosures on homeowners by entities that did not have the legal authority to do so. These practices were so prevalent that in May 2011, Federal Deposit Insurance Corporation (FDIC) Chair Sheila Bair testified to the Senate Banking Committee that “flawed mortgage-banking processes have potentially infected millions of foreclosures, and the damages to be assessed against these operations could be significant and take years to materialize” (Zibel, 2011).

“SHOW ME THE PAPER” LITIGATION

Alleged servicing abuses—including improper assignments of mortgage, robo-signing, and illegal foreclosure practices—have resulted in a series of both individual and class action lawsuits brought forth by homeowners. These lawsuits are commonly referred to as “show me the paper” or “show me the note” cases, in which borrowers challenge foreclosure proceedings because the foreclosing party—either a bank or servicer—cannot produce the mortgage note, cannot produce an accurate mortgage note, and/or cannot prove “chain of title” by demonstrating a series of proper endorsements and assignments of mortgage back to the originating lender (Timiraos, 2011). “Show me the paper” cases often include claims that the foreclosing party does not have the legal right to foreclose, including cases raising the following issues:

1. The foreclosing party did not hold an assignment of mortgage and initiated foreclosure proceedings, even when the note was lost or was endorsed to a different party.
2. The foreclosing party initiated foreclosure proceedings in the name of MERS, Inc.
3. Foreclosure documents were invalidated due to robo-signing.

There are substantial cross-state differences in rulings on these issues, and several cases are now in the appeals process. Some courts have ruled that sloppy record-keeping practices do not excuse homeowners from repaying debt that is

rightfully owed to assignees (Timiraos, 2011); courts also have ruled that borrowers cannot appeal a foreclosure case if they did not raise “show me the note” issues during initial foreclosure proceedings (Hopkins, 2012). However, other courts have ruled that foreclosures cannot be enforced if banks and servicers violated state statutes and cannot demonstrate a legal right to the mortgage note (Timiraos, 2011).

\$25 BILLION NATIONAL MORTGAGE SETTLEMENT

In February 2012, the U.S. Department of Housing and Urban Development, the Justice Department, and Attorneys General from 49 states reached a \$25 billion settlement with the nation’s five largest mortgage servicers—Ally Financial/GMAC, Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo—for engaging in illegal foreclosure procedures. The settlement is the second-largest in U.S. history and specifies a number of relief measures to assist borrowers at risk of foreclosure, as well as damages paid to homeowners who were foreclosed illegally (AGBeat, 2012).³ Of the \$25 billion settlement, the first \$20 billion were allocated to programs addressing the needs of distressed mortgage borrowers: \$3 billion of these dollars were allocated to programs designed to refinance loans for borrowers of underwater mortgages, and \$17 billion were allocated to borrower assistance programs including loan modification programs, short sales, and borrower transition programs (AGBeat, 2012).⁴ Of the remaining \$5 billion, \$1.5 billion were allocated to pay damages to homeowners who were wrongfully foreclosed between 2008 and 2011, \$750 million were allocated to fund payments to resolve federal claims, and \$2.75 billion were allocated to state-level foreclosure prevention programs.

Only \$1.5 billion out of \$25 billion—6 percent of the total settlement funds—will be used to compensate borrowers who were foreclosed illegally; the funds are anticipated to pay average damages of \$2,000 each to 750,000 borrowers (AGBeat, 2012). Notably, the settlement does not apply to mortgages owned or guaranteed by the Enterprises, so borrowers of Fannie Mae- or Freddie Mac-backed mortgages seeking loan modifications, relief, or damages due to wrongful foreclosure are not eligible for settlement funds. Further, the settlement

indemnifies the servicers from any future civil claims made by state and federal governments related to servicing activities—including loss mitigation, loan modification, and foreclosure activities—though it does not indemnify them from future actions related to securitization, claims by individual homeowners, or from state or federal criminal claims (Rieker, 2012).

FUTURE LITIGATION EXPOSURE: PRIVATE SECTOR

The \$25 billion National Mortgage Settlement resolves only a portion of the outstanding claims against mortgage banks, servicers, and investors for mortgage servicing abuses including illegal foreclosures, improper assignments of mortgage, robo-signing, and fraud. The settlement does not provide full indemnification for the named servicers, and does not resolve ongoing litigation with other banks, servicers, MERS, Inc., or the Enterprises. In fact, a motion by three parties to the settlement—Bank of America, JPMorgan Chase, and Wells Fargo—was unsuccessful in dissolving a lawsuit filed against them by New York State Attorney General (AG) Eric Schneiderman for their use of MERS (Dayen, 2012; Smith, 2012). Additional lawsuits filed through class action or by state Attorneys General are currently pending in several states, including Massachusetts, where the AG filed a lawsuit against these same institutions, as well as Citi and GMAC (Massachusetts State Office of the Attorney General, 2011); West Virginia, which has a class action servicing lawsuit pending against Nationstar Mortgage, LLC; Ohio, which has a lawsuit pending against American Home Mortgage Servicing, Inc. and a class action lawsuit pending against Bank of America; Missouri, which has a lawsuit pending against LPS, Inc.; Nevada, which has class action lawsuits pending against LPS, Inc., Bank of America, Recon Trust Co., IndyMac Mortgage Services, and Regional Service Corp.; and Arizona, which has lawsuits pending against Bank of America for mortgage lending abuses related to its subsidiary Countrywide Financial Corp., a subprime mortgage lender (Dayen, 2012; Mortgage Daily, 2012). Mortgage litigation reached an all-time high in the fourth quarter of 2011 with 244 pending cases, 99 of which are foreclosure-related, and 70 of which are related to mortgage servicing (Cho, 2012; Dayen, 2012; Mortgage Daily, 2012).

In April 2012, a consortium of 30 Louisiana parishes sued 17 banks for their use of MERS, alleging that their practices defrauded the government from recording fees and improperly assigned mortgages. The lawsuit is unique because the parishes are suing under the Racketeer Influenced and Corrupt Organizations (RICO) Act, a law used for prosecuting crime syndicates that provides for treble criminal damages and will allow the parishes a jury trial (Steele, 2012). The National Mortgage Settlement does not provide indemnification from criminal allegations brought forth under RICO, so Louisiana's lawsuit may set a precedent for other states to pursue similar criminal claims against banks or servicers – even if they already have settled civil claims. A recent Bankruptcy Law Network article claimed that eventually RICO “will become synonymous with the names of some well-known banks, servicing companies and foreclosure mills” (Parker, 2012).

In short, the National Mortgage Settlement is not a panacea that resolves claims arising from Foreclosure-Gate. Banks, servicers, and MERS, Inc. will continue to face substantial litigation exposure for the following reasons:

1. The settlement does not apply to mortgages owned or guaranteed by the Enterprises.
2. The settlement applies to the named servicers only and does not resolve claims against other banks, servicers, or MERS, Inc.
3. Banks, servicers, and MERS, Inc. remain liable for claims brought forth by individual homeowners – including class action lawsuits.
4. The settlement does not provide indemnification from criminal claims that may be pursued under RICO.
5. In spite of the settlement, ongoing civil litigation against the named servicers – including a major lawsuit filed by the New York State AG – has not been dismissed.
6. The settlement does not resolve claims against banks arising from non-servicing mortgage industry activities.

FUTURE LITIGATION EXPOSURE: TAXPAYER LIABILITY ON BEHALF OF THE ENTERPRISES

Another issue is the question of whether and how the Enterprises may be found liable for improper assignments of mortgage and other servicing issues related to Foreclosure-Gate. This question is particularly difficult to resolve due to the Enterprises' current regulatory structure. In July 2008, the Housing and Economic Recovery Act (HERA, P.L. 110-289) established the Federal Housing Finance Agency (FHFA) and granted the FHFA authority to place federally regulated entities into conservatorship or receivership. In September 2008, the FHFA exercised this right and placed the Enterprises into conservatorship, the goal of which is to “preserve and conserve each Enterprise's assets and property and restore the Enterprises to a sound financial condition so they can continue to fulfill their statutory mission of promoting liquidity and efficiency in the nation's housing finance market” (FHFA, 2012a). Currently, the FHFA maintains that HERA prohibits the investigation of and issuance of subpoenas to the Enterprises because they fall under federal conservatorship (Mortgage Daily, 2012; Timiraos & Simon, 2011). In 2011, California State AG Kamala Harris challenged this claim by filing lawsuits against the Enterprises for their role in California's mortgage crisis; both lawsuits are pending (Mortgage Daily, 2012; Timiraos & Simon, 2011).

In theory, the Enterprises also have the potential to be sued directly by homeowners – either individually or via class action – for contributing to improper mortgage assignments through MERS, Inc. However, the Enterprises are unlikely targets for such lawsuits because they do not service the loans they own or guarantee. Instead, the greatest potential liability faced by the Enterprises is that they may be unable to foreclose on seriously delinquent homeowners for mortgages they own or guarantee; this may occur in cases where the assignee is unable to prove chain of title, or where robo-signing or other servicing abuses may have occurred. This means that the Enterprises may need to repurchase with tax dollars seriously delinquent loans because the collateral in the real property cannot be recovered via foreclosure.

How might we estimate the Enterprises' repurchase exposure? According to First American CoreLogic

data from the third quarter of 2011, there are approximately 48.5 million outstanding U.S. mortgages worth \$8.8 trillion, and the Enterprises currently own or guarantee more than 60 percent of these mortgages – amounting to approximately 29.1 million mortgages with balances of \$5.3 trillion (CoreLogic, 2011). Roughly 10.7 million of these mortgages are underwater; Zillow.com estimates that 10.1 percent of underwater mortgages—about 1.1 million mortgages—are delinquent and have the potential to enter foreclosure (Humphries, 2012). Using First American CoreLogic state-level negative home equity data from the third quarter of 2011, we estimate that underwater, delinquent mortgages that are owned or guaranteed by the Enterprises account for approximately \$118 billion in unpaid loan balances.⁵ However, the Enterprises may not be able to initiate foreclosures for many of these loans, particularly in states with consumer-friendly “show me the paper” litigation. We use the Mortgage Daily Mortgage Litigation Index state categorizations to obtain the following estimated unpaid loan balances for delinquent, underwater loans that are guaranteed by the Enterprises:

- \$49.7 billion in consumer-friendly states
- \$56.8 billion in states with limited case history or conflicting rulings
- \$11.4 billion in bank-friendly states

While it is unlikely that the Enterprises will need to repurchase each of these seriously delinquent loans due to faulty documentation, the above figures provide initial estimates of potential taxpayer liability, which may be particularly large in consumer-friendly states.

FOOTNOTES

1. The case brought forth by the Delaware Attorney General against MERS, Inc. settled in July 2012, with MERS, Inc. agreeing to audit its records and to maintain a database that allows homeowners to access information on which organizations own and service their mortgages (McLaughlin, 2012).
2. The statute of frauds requires certain transactions to be contracted in writing.
3. The largest settlement in U.S. history is the 1998 Tobacco Master Settlement Agreement, which settled for \$206 billion.
4. The \$17 billion portion of the settlement may be expanded to up to \$32 billion in the next several years (AGBeat, 2012).

5. We obtained this figure by assuming the Enterprises own or guarantee 60 percent of the outstanding mortgage balances in each state, and applied CoreLogic’s state-level estimates of underwater mortgage shares to calculate the total estimated outstanding mortgage balances for underwater mortgages guaranteed by the Enterprises. Assuming that 10.1 percent of these underwater mortgages are delinquent, we obtained a figure of \$118 billion in underwater, delinquent mortgage balances that are owned or guaranteed by the Enterprises.

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