

# A look at mortgage foreclosure abuse and the future of the mortgage servicing industry

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In April, 14 of the nation's largest banks and servicers signed consent orders with one or more federal regulators in an attempt to settle allegations of abusive foreclosure proceedings and other deficiencies in the mortgage servicing industry. As part of the settlement, the banks and servicers are required to put forth a plan to improve foreclosure and mortgage servicing procedures. The settlement agreement also provides for sanctions in an undetermined amount.

In late May a group of state attorneys general told five of the nation's largest banks that they could face civil lawsuits seeking at least \$17 million if a settlement is not reached to address mortgage servicing and foreclosure abuse.

This commentary focuses on the fraudulent procedures utilized by the banks and servicers in foreclosure actions. It also explores procedures that have been suggested by servicers and various governmental agencies to ensure that foreclosures and other aspects of the mortgage servicing business are carried out in compliance with federal and state laws.

## HOW DID WE GET HERE?

By now we are all too familiar with the subprime mortgage debacle. The short version of the story goes something like this: Under the guise of lowering the barriers to home ownership, mortgage companies began to offer mortgage loans to people with bad credit and/or insufficient income. As the volume of loans to unqualified borrowers increased, the demand for housing increased, and home values were falsely inflated.

In order to document the loans to unqualified borrowers, false credit reports and income statements were generated so the loans could be sold off to large U.S. banks and packaged into mortgage-backed securities or collateralized debt obligations. These bundled securities could then be sold off to investors who believed they had purchased an investment-grade security.

In a traditional mortgage transaction, the borrower delivers a note, and a mortgage to the lender. If the loan is assigned to a new lender, an assignment of the mortgage together with the original note is delivered to the new lender. The assignment of the mortgage is then recorded in the applicable land records.

During the mortgage securitization process, loans were sold and assigned multiple times. In an effort to avoid the need to record a mortgage assignment each time a loan was sold, a group of lenders formed a company known as Mortgage Electronic Registration Inc. Any lender who is a member of MERS can register the transfer of a note or servicing rights on an electronic registration system maintained by MERS. Although MERS serves as nominee for the lender, MERS does not hold legal title to the note.

In states where a lender is required to commence a foreclosure action in a court of law, the lender, as plaintiff, is required to submit a sworn affidavit as to the lender's ownership of the note, the nature of borrower's default, and the outstanding principal balance and accrued interest on the loan.<sup>2</sup>

Faced with an overwhelming number of bad loans, banks and servicing companies used untrained personnel to sign foreclosure affidavits in bulk without checking the accuracy of the facts set forth in the complaint. In addition, parties like MERS commenced foreclosure actions without having the legal standing to do so.

As borrowers started to challenge the validity of the foreclosure actions, the courts were forced to dismiss actions where they found

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As subprime borrowers began to default in record numbers, banks and servicers found themselves unwinding pools of mortgages in order to locate the paperwork necessary to initiate foreclosure proceedings. In many cases, where the loans were registered with MERS, the holder and location of the underlying note and assignment documents were unknown.

## COMMENCING A FORECLOSURE ACTION

Pursuant to the Uniform Commercial Code, in order to foreclose on a mortgage, the party entitled to payment on the debt must be in possession of the original note or prove to the court that the note was lost.<sup>1</sup> This is because under the UCC, the borrower runs the risk that another party may produce the note and claim the right to payment even if a foreclosure action has been finalized.

the plaintiff lacked standing to bring the action because it lacked the legal right to enforce the note or mortgage at the time the action was commenced, or that the plaintiff was unable to produce the note.<sup>3</sup>

## CLEANING UP THE MESS

Pursuant to the federal consent orders, the plan put forth by the banks and servicers must include the following components:

- The designation of a primary point of contact for the borrower at the servicing company.
- A prohibition against proceeding with a foreclosure action after a loan is approved for a modification (unless there is a subsequent default).
- Checks and balances for overseeing third-party vendors hired by the servicers.

- Compensation to any borrower who suffers a financial injury as a result of a wrongful foreclosure.

A number of other proposals have been put forth by various legislators, banks and servicers to address past wrongs, including:

- Requiring a servicer to provide a sworn statement to a borrower in a nonjudicial foreclosure, setting forth the basis for the servicer's right to foreclose, an account statement and a certification of ownership.

principal reductions will encourage defaults by borrowers who do not need a principal reduction.

## CONCLUSION

A significant number of foreclosure actions arising from the subprime mortgage era are likely to be defective in one manner or another. It would behoove borrowers as defendants in these actions to challenge the lender's ability to foreclose, particularly when the lender or servicer is unable to prove it is

- The loss of the note did not result from a transfer of the note by the person or a lawful seizure.
- The person seeking to enforce the note cannot reasonably obtain possession of the note.

In addition, a court cannot enter judgment in favor of the person seeking enforcement of the note unless it finds that the defendant in the action is adequately protected against loss that may occur by another party seeking to enforce the note.

<sup>2</sup> In states where a lender is not required to commence a legal proceeding in order to foreclose, the borrower is served with a notice of the lender's intent to foreclose. In these so-called "non-judicial" states, the borrower must initiate its own legal proceeding in order to challenge a lender's right to foreclose.

<sup>3</sup> See *In re Foreclosure Cases*, 521 F. Supp. 2d 650 (N.D. Ohio 2007). The court dismissed more than 20 foreclosure actions in which the plaintiff lenders were unable to provide copies of the assignment of note and mortgage to prove they were the lawful owners of the note and mortgage at the time the actions were commenced.

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## Banks found themselves unwinding pools of mortgages to locate the paperwork necessary to initiate foreclosure proceedings.

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- Requiring the affiant in any sworn statement to set forth the basis of its personal knowledge of the information contained therein.
- The performance of regular audits by servicers of a sufficient sample of documents prepared by staff in foreclosure actions to confirm compliance with prevailing law and the applicable loan documents.
- Requiring the servicer to identify the holder of a note and any assignments of the mortgage and any custodian or recording system associated therewith.

There are many who believe that mandatory principal reductions should be included as part of any settlement plan. Critics of principal reductions argue that the write-downs result in a permanent loss to the investor or lender without any opportunity to share in the upside if the property value increases or if the financial condition of the borrower improves. Others argue that

the lawful holder or owner of the note and mortgage it seeks to foreclose.

The inability to ascertain the legal holder of a note or mortgage can also adversely affect the non-defaulting borrower who seeks to sell or refinance his or her home. If the borrower is unable to locate the legal holder of its mortgage, it will be very difficult to obtain a proper mortgage satisfaction at the time the loan is repaid.

The mortgage servicing industry is in need of a major overhaul. The proposed changes to the system should result in greater transparency for borrowers; however, without a requirement for immediate, mandatory principal reductions and the impositions of significant sanctions against the responsible parties, the American consumer will not be satisfied. [WJ](#)

## NOTES

<sup>1</sup> Under Section 3-309 of the UCC, a person can enforce a note if not in possession of the same only if the following are proven:

- The person was entitled to enforce the note at the time it was lost.



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