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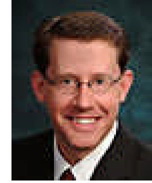
Bailout or Fallout? Will President Obama's Foreclosure Moratorium Slow the Onslaught of Mortgage Litigation?

by Kerry P. McInerney



Credit Default Swaps. Collateralized Debt Obligations. Mortgage-Backed Securities. No television, radio, or Internet newscast is complete today without multiple mentions of these buzz words. And with good reason—these words reflect some of the key ingredients of the current economic crisis. The part played by credit default swaps, mortgage-backed securities, and the like played in the economic downturn is well-documented. So, too is the governmental bailout of our nation's leading financial institutions (although the implementation of that bailout changes on a daily basis).

In the context of these uncertain economic times, two things are certain. First, the tide of mortgage-related litigation has not fully crested. Recently, an FDIC official likened current mortgage litigation volume to the second inning of a nine inning baseball game. The second certainty is that the Presidential and Congressional election results signify the coming of *change*. One such change, if campaign promises are to be believed, will take the form of Barack Obama's proposed foreclosure moratorium. For the skeptics who doubt the viability of such a moratorium, there is historical precedent from another dark economic time in our nation's history. As further proof, a headline ripped from this very morning's headline finds Freddie Mac and Fannie Mae voluntarily halting foreclosures through early January 2009. But will President-Elect Obama's plans for solving our mortgage banking crisis impact on the volume of mortgage litigation? Read on.

A foreclosure moratorium. Really? Yes, Really.

With the unprecedented rise in numbers of foreclosures, some state legislatures are considering the possibility of enacting statutes that would halt foreclosures. Minnesota's plan is making headlines this week, and Fannie and Freddie announced voluntary, short-term moratoriums today. So far, however, none of the mandated "foreclosure moratoriums" have made it very far in the legislative process. It is important to remember, however, legal precedent for the enactment of such moratoriums exists.

During the height of the Great Depression, three-and-a-half years after the stock market crash of 1929, homeowners across the country were losing their residences because they could not stay current on their mortgage payments. In response, the Minnesota Legislature declared an "emergency" and enacted the Minnesota Mortgage Moratorium Law. The statute, enacted in 1933, allowed homeowners to petition state court judges to temporarily halt the foreclosures of their mortgages. The statute also extended the right of redemption for up to two years, provided that the homeowners made "reasonable" monthly payments that were to be applied to their mortgage payments, property taxes and insurance during the extended period of redemption.

While many hailed the moratorium as the type of essential measures needed to protect citizens from the economic crisis, lenders argued that the moratorium violated the contract clause of the U.S. Constitution: The statute retroactively altered the lenders' rights under the mortgage contract voluntarily entered into by the homeowners because the extension diluted the lenders' rights and increased the borrowers rights, contrary to the express terms of the mortgage. The constitutionality of the statute was challenged when one couple, the Blaisdells, sought protection under the law after their home was foreclosed upon because they were delinquent on their mortgage payments. The trial judge ruled in favor of the Blaisdells, extending their right of redemption for two years, and the Minnesota Supreme Court affirmed the ruling. On appeal to the United States Supreme Court, the statute was upheld by 5-4 vote. *Home Building & Loan Ass'n v. Blaisdell*, 290 U.S. 398 (1934).

The majority opinion, written by Chief Justice Charles Evans Hughes, found that the law did not violate the contract clause and was thus constitutionally valid. The Supreme Court upheld the law on five grounds. First, the Court found that an emergency existed in Minnesota, one which gave rise to a "proper occasion" for the state to protect the vital interests of the community. Second, the Court found that the legislation had a legitimate purpose and was not enacted to protect certain individuals but for the protection of society as a whole. Third, the Court found that the relief provided to homeowners by the statute was only permitted in certain, limited conditions. Fourth, the Court found that contractual rights were reasonably protected:

Homeowners were required to maintain payments during the postponement of the foreclosure, and the obligation under the mortgage was not extinguished. Fifth, the Court relied upon the fact that the legislation was temporary and set to expire in 1935 (although it was later extended until 1942).

Writing for the dissent, Justice George Sutherland viewed the moratorium as the precise type of government action that the contract clause meant to prevent, especially in view of the pre-constitutional practice of legislatures enacting measures to mitigate the sometimes harsh consequences that debtors suffered as a result of financial or economic troubles.

Today, with the number of foreclosures on the rise, some states are considering enacting similar measures, modeled after the moratorium upheld in the *Blaisdell* case. A similar bill is under consideration by the Michigan Legislature (S.B. 1306), and Minnesota is again considering a foreclosure moratorium (H.F. 3612). The Minnesota legislation, which would apply only to owner-occupied properties, would block foreclosures for a year, and is designed to force lenders to modify the terms of the loans rather than foreclosing. Mortgages eligible for the moratorium must be either sub-prime or negative-amortization loans for which the minimum monthly payments have increased. The borrowers would be required to maintain a reduced payment — the lower of 65 percent of the payment at the time of default or a payment calculated with the initial interest rate. If the borrowers failed to maintain the payments, the lender is permitted to proceed with the foreclosure process. During the deferment period, however, the lender cannot charge the borrower for any amount other than the reduced payment.

With the government takeover of Fannie Mae and Freddie Mac, there have been increasing calls for a federal foreclosure moratorium. Already, a bill has been introduced in the House of Representatives, H.R. 6076, that proposes to amend TILA to permit certain homeowners to take deferrals on their foreclosures. And, earlier this year, in response to a City Council measure that called for a foreclosure moratorium, the Philadelphia sheriff refused to hold court-ordered foreclosure auctions. However serious the current situation, it does not compare to the Great Depression, where the national unemployment rate reached more than 25 percent at its highest. While the Depression may have provided precedent for this type of legislation, these bills present several problems. To obtain a deferment on foreclosure, borrowers may be required to file a court action. Regardless of the court's ultimate ruling, the foreclosure process will have been delayed, the borrowers likely will have fallen further behind on their mortgage payments, and the lender or servicer will have incurred court costs and legal fees. These bills also raise several questions: What happens when the deferment period expires? Can the lender recover unpaid principal, interest and necessary advances that accrue during the deferment period? What happens to the unpaid amounts that pre-date the deferment period? Will the lenders be able to recover the costs that they incur as a result of borrowers filing court actions?

Since 1934, the *Blaisdell* decision has been widely criticized, and many view it as an unfaithful interpretation of the contract clause. Nevertheless, *Blaisdell* has never been explicitly overruled, and the decision has set the stage for future mortgage moratoriums.

President-Elect Obama's Proposals.

When presidential hopefuls John McCain and Barack Obama hit the campaign trail almost two years ago, the economic plans proposed by both candidates took a backseat to the conflict in Iraq. Now that President-Elect Barack Obama prepares to take office, the focus has shifted to economic relief and reform. As homeowners across the nation face a steep and worsening decline in home values, many either cannot afford their mortgage payments, or stop making mortgage payments altogether, after losing hope that their home values will eventually recover.

When President-Elect Obama enters the White House on January 20, 2009, he has proposed a number of plans in hopes to revive the economy and address the mortgage situation. Passage of another economic stimulus package is high on President-Elect Obama's priority list, and likely will be his first major act as President. Additionally, he is expected to ask Congress for an additional economic stimulus. Part of this quick economic plan could include a cut in tax rates so that refund checks would be sent to individuals before tax returns are filed in April 2009.

Included among President-Elect Obama's proposed stimulus package are several items targeting the mortgage industry, such as the Stop Fraud Act, aimed at fighting mortgage fraud and protecting consumers against abusive lending practices. This Act, first introduced in 2007, would ensure accountability in the sub-prime

mortgage industry by increasing funding for federal and state law enforcement programs, creating new criminal penalties for mortgage professionals found guilty of mortgage fraud, and imposing industry standards for insiders to report suspicious activity.

The President-Elect also suggests creating a Homeowner Obligation Made Explicit score, a measure designed to give individuals the ability to better compare mortgage products and further their understanding of what home loans entail. Specifically, the score would provide potential borrowers with simplified, standardized borrower metric for home mortgages.

In addition, Mr. Obama has proposed tightening the standards for mortgage companies seeking to file for bankruptcy protection. He plans to achieve this by permitting bankruptcy courts to modify both an individual's monthly mortgage payments and principal mortgage loan balance. This proposed change allowing mortgage "cram-downs" is controversial with many on Wall Street, who claim that the law would cause the mortgage market to seize up, as investors would stop buying mortgage-backed securities out of fear a judge could unilaterally change the terms of the loan. As a consequence, future borrowers might be required to pay higher rates or fees to offset the risk that a court could rework the loan and lower the value of the mortgage-backed security.

While tightening the standards for mortgage companies to file bankruptcy, President-Elect Obama has proposed other changes designed to make it easier for individuals to file bankruptcy under certain circumstances, increase the homestead exemption for seniors, streamline the bankruptcy process for families who are recovering from a natural disaster, and create a fast track process for military families. President-Elect Obama is also expected to create a universal mortgage credit of ten percent to homeowners who do not itemize their tax deductions. Obama's plan claims this credit will provide an average credit of $500 to 10 million homeowners, many of whom earn an annual income of less than $50,000.

At the center of the mortgage banking component of President-Elect Obama's economic plan, however, is his proposed foreclosure moratorium. Under this plan, foreclosures of delinquent mortgages will freeze for 90 days for borrowers making "good faith" efforts to pay their mortgage. This moratorium seeks to keep thousands of homeowners in their homes, presumably pursuant to modified loan terms. However, many in the mortgage servicing industry have warned that such a moratorium could have a reverse effect on the housing downturn by simply prolonging the situation. Mortgage servicing companies are generally required by contract to advance numerous payments and costs to their investors regardless of whether the debtor is paying the debt. The servicers are reimbursed, but generally after the property goes into foreclosure. Thus, repayment to the servicer for advanced sums already takes many months on average; a moratorium could extend that investment by the servicers for an additional three months. In the current economic climate, many in the mortgage banking industry may be hard-pressed to withstand such additional strain. On the other hand, advocates for the moratorium argue that a blanket moratorium is exactly what is needed right now, as it would provide immediate relief to American homeowners.

Will a Moratorium Impact Litigation?

The short, truthful answer is time will tell. Mortgage litigation, notably sub-prime mortgage litigation, is clogging our courts and crippling our mortgage lenders and servicers. Moratoriums will do little to stem the tide of securities-related cases or class actions alleging predatory lending or servicing abuses. On the other hand, many of the cases involve the individual borrowers who hope to prevent a foreclosure. For those putative lawsuits, a moratorium may spell some interim relief for docketing clerks.

On the other hand, a moratorium will simultaneously save and cost money for mortgage servicers and investors. Foreclosure costs may decrease, but carry costs will increase. Moreover, the inability to foreclose on a non-performing loan necessarily means the corresponding inability to liquidate the asset securing the loan. Without this source of recovery, struggling financial institutions will face even more hardship. Certainly, if foreclosures occur after the effective date of a moratorium, you can bet that lawsuits will follow.

But ultimately, no President can halt foreclosures forever; they will resume. Most agree that our current economic crisis was caused in large part by perceived flaws in our mortgage banking system, and further that the crisis must run its course. Included along that course are foreclosures and lawsuits, and lots of both. Federal funds and laws designed to stimulate our economy, rebuild public trust, and shore up the foundation of the weakened credit markets may well reduce the volume of new lawsuits, at least temporarily. If, however, the

bailout fails, then the fallout will almost certainly be a significant increase in an already staggering volume of mortgage litigation.

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Kerry P. McInerney is a shareholder with Sirote & Permutt, P.C. where he practices in the firm's Birmingham, Alabama office. Co-Chair of his firm's dedicated Mortgage Banking Litigation Group, Mr. McInerney represents banks, mortgage lenders, and mortgage servicing companies in all types of state and federal litigation. Also an active member of DRI, Mr. McInerney is the Chair of the Marketing Subcommittee for the Commercial Litigation Committee. Mr. McInerney expresses his gratitude to Ms. Meaghan Ryan and Ms. Jennifer Miller for their invaluable assistance with this article.

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