6-1-2010

Protecting Absent Stakeholders in Foreclosure Litigation: The Foreclosure Crisis, Mortgage Modification, and State Court Responses

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Recommended Citation
Andrew J. Kazakes, Protecting Absent Stakeholders in Foreclosure Litigation: The Foreclosure Crisis, Mortgage Modification, and State Court Responses, 43 Loy. L.A. L. Rev. 1383 (2010), Available at: http://digitalcommons.lmu.edu/lr/vol43/iss4/6
PROTECTING ABSENT STAKEHOLDERS IN FORECLOSURE LITIGATION:
THE FORECLOSURE CRISIS, MORTGAGE MODIFICATION, AND STATE COURT RESPONSES

Andrew J. Kazakes*

The role of the judiciary has been noticeably absent from discussions about solutions to the foreclosure crisis. This Article argues that state courts have an opportunity to meaningfully intervene in the foreclosure process by addressing the competing financial interests of mortgage servicers and the absent securities investors whom servicers represent in foreclosure proceedings. Under the depressed housing market conditions following the economic collapse of 2006–07, foreclosure resulted in more than a ten-fold average loss in loan value compared with modification, according to some estimates. This Article proposes that state courts utilize pre-foreclosure mediation programs to ensure that foreclosure is in the best interests of absent investors before permitting foreclosure to proceed. Unlike foreclosure defense and other palliative measures, widespread mortgage modification has the potential to immediately reduce the foreclosure rate and resolve borrower default, prerequisites to stabilizing mortgage markets and the broader economy.

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I. INTRODUCTION

As the country struggles to recover from the recent collapse of the housing market, there is general agreement that the number of foreclosures needs to be reduced in the short term and that the mortgage lending system must be recalibrated to cure its dysfunction and facilitate sustainable homeownership over the long term. Nevertheless, neither the executive nor the legislative branch of the federal government has implemented effective national policy solutions.

Hope for Homeowners, a 2008 Bush administration plan, promised to prevent 400,000 foreclosures but delivered only twenty-five loan refinances. President Barack Obama’s $75 billion Homeowner Stability initiative, launched in early 2009, has failed to meet its goal to generate three to four million mortgage modifications. As of January 31, 2010, the program had produced only 116,000 permanent modifications. Moreover, proposed legislation to empower bankruptcy judges to modify mortgages on primary residences has stalled multiple times in Congress.

The role of the judiciary has been noticeably absent from discussions about solutions to the mortgage crisis. Policymakers have overlooked the critical role state courts play in the foreclosure process. Given the structural opportunity for them to meaningfully intervene in the foreclosure process, it is imperative to question why the state courts have not taken more decisive action to mitigate the


foreclosure crisis and to consider what state courts should be doing to that end.

This Article argues that state courts failed, or were unable, to limit the magnitude of the foreclosure crisis for two principal reasons. First, foreclosure defense does not effectively reduce foreclosures because it involves numerous practical barriers and generally does not resolve borrower default, thus delaying, rather than preventing, foreclosures. Second, state courts have not done enough to encourage mortgage modification, which has the potential to substantially mitigate the foreclosure crisis. In particular, state courts have failed to apply objective standards and vigorous judicial oversight to mandatory pre-foreclosure mediation programs designed to encourage mortgage modification. In their current form, these programs fail to regulate the behavior of mortgage servicers, who generally prefer foreclosure to modification even though such behavior, under current market conditions, entails significant financial losses for securities investors.

This Article proposes that to reduce foreclosures, state courts should recognize a duty to protect securities investors—primary stakeholders in foreclosure litigation, though absent from proceedings—from the competing interests of mortgage servicers. To implement this duty, state courts should require mortgage servicers to utilize a readily available economic formula—the net present value calculation—to prove that foreclosure is in the best interests of investors prior to permitting the foreclosure action to proceed through the court system.

Part II provides background on traditional foreclosure law and how it has been reconfigured by modern mortgage securitization. Part III discusses why state courts have not been effective in limiting the magnitude of the foreclosure crisis. Part IV proposes that state courts recognize a judicial duty to protect the financial interests of absent stakeholders. This part first examines other areas of the law in which courts have recognized a duty to protect absent stakeholders. It then argues that state courts should adopt a similar doctrinal approach in the foreclosure context by blocking mortgage servicers from foreclosing unless servicers show that foreclosure is in the best interests of absent investors. Part V concludes.
II. THE ROAD TO CRISIS: FORECLOSURE LAW AND THE RISE OF THE MORTGAGE SERVICER

State foreclosure laws aim to minimize the cost of credit by providing mortgage holders with an economically efficient route to recover collateral on nonperforming debt while also protecting borrowers against erroneous, fraudulent, or premature deprivation of property. While this balancing has undergone periodic recalibration by state lawmakers over the years, most state foreclosure laws have not been substantially updated since the advent of mortgage securitization. After it developed in the 1980s, mortgage securitization expanded aggressively in the 1990s, and culminated in the collapse of the housing market in 2007. The resulting high rate of foreclosure has undermined national and global economies and adversely affected neighborhoods and cities by reducing surrounding property values, increasing crime, and eroding municipal tax bases.

State courts are positioned at the juncture between antiquated foreclosure laws and modern securitization practices. The interaction between these two institutional forces frames the problems state courts face in responding to the foreclosure crisis. Securitization injects new actors into the mortgage process who were not


9. See infra notes 45-48 and accompanying text.

10. See Dan Immergluck & Geoff Smith, The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values, 17 HOUSING POL'Y DEBATE 57, 57–60 (2005) (finding "that each conventional foreclosure within [one] eighth of a mile of a single-family home results in a 0.9 percent decline in the value of that home" and noting study that found city costs of $27,000 per foreclosure); Dan Immergluck & Geoff Smith, The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime, 21 HOUSING STUD. 851, 862 (2006) (calculating that a 1 percent increase in the foreclosure rate in a census tract yields a corresponding 2.33 percent increase in violent crime rate).
contemplated by traditional foreclosure law, significantly influencing the way legal foreclosure procedures affect borrowers, investors, and the mortgage market generally.

A. The Basic Borrower-Lender Relationship: Mortgage and Promissory Note

A home mortgage loan is a debt obligation secured by residential real estate. The borrower agrees that failure to meet payment obligations will empower the lender to force sale of (or take title to) the property through foreclosure. Loan origination produces two related documents: the promissory note and the mortgage. The promissory note is a contract defining the mutual rights and obligations of the borrower and lender, including the borrower’s duty to pay, total debt owed, interest rate calculation, payment schedule, and monthly payment amount.

The mortgage is a security interest that is activated when a borrower fails to tender timely payments—thereby defaulting on the mortgage—and enables the mortgage holder to foreclose to satisfy the debt defined in the promissory note. Almost every promissory note contains an acceleration clause that renders the full mortgage debt due upon borrower default. Aside from some mitigating doctrines, once a lender properly invokes the right to acceleration, a borrower must either arrange payment of the remaining loan balance in full or lose the real estate to foreclosure.

11. ROBERT KRATOVIL, MODERN MORTGAGE LAW AND PRACTICE § 1, at 23 (1972).
12. See BLACK’S LAW DICTIONARY 719 (9th ed. 2009); see also GRANT S. NELSON & DALE A. WHITMAN, 1 REAL ESTATE FINANCE LAW § 1.1, at 1–2 (4th ed. 2002).
13. See JOHN RAO ET AL., NAT’L CONSUMER LAW CTR., FORECLOSURES § 4.3.4.1, at 81 (2d ed. 2007). Some states use deeds of trust instead of mortgages as the controlling security instrument. Because there is little practical difference between the two, this Article uses the term “mortgage” exclusively even if a particular state employs deeds of trust. Id. § 4.5, at 90 (noting that deeds of trust, unlike mortgages, give rise to a fiduciary duty between trustee and borrower). The term “mortgage” is also often used as a general descriptor of the entire mortgage lending relationship, including both the promissory note and the security instrument. See, e.g., CAL. CIV. CODE § 2920 (West 2009). This Article will use the term “mortgage” in its general sense unless referring to “mortgage” in the specific sense of a security instrument.
14. RAO ET AL., supra note 13, § 10.2.3, at 260.
15. NELSON & WHITMAN, supra note 12, § 7.6, at 615.
16. See infra note 57 and accompanying text (discussing reinstatement).
B. Securitization Fragments Mortgage Players and Interests

The past two decades have seen two significant transformations in the mortgage market—the fragmentation of loan ownership through mortgage securitization and a corresponding increase in the riskiness of mortgage lending. Instead of making only safe loans to low-risk borrowers, as had generally been done in the past, lenders increasingly made loans to high-risk borrowers at correspondingly higher rates.\(^\text{17}\)

In a typical securitization process, investment banks purchase individual mortgages from originating lenders and aggregate them into a mortgage pool.\(^\text{19}\) The mortgage pool is transferred to a trust created to hold the mortgages and to enable the investment bank to issue mortgage-backed securities to investors on the open market.\(^\text{20}\) The securitization trust is established contractually by the pooling and servicing agreement (PSA), a document that defines the rights and duties of the participants in the securitization process.\(^\text{21}\)

Investors who purchase securities can acquire interests in different segments, or tranches, of the mortgage pool that correspond to various “slices” of mortgage payments.\(^\text{22}\) One tranche might represent principal repayments during the first few years of the mortgages in the trust, while another might represent interest payments over the lifespan of the mortgages.\(^\text{23}\) Tranches are also tiered by payment priority with subordinate tranches first in line to

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\(^{17}\) Under the traditional mortgage-lending model, banks would typically extend standard 30-year fixed-rate mortgages and retain them over their full terms, creating a lasting relationship with borrowers. See Willis, supra note 8, at 1206–07. Access to mortgage credit was limited to low-risk borrowers because the originating lender bore the risk of borrower default. See id. at 1206–08.

\(^{18}\) See id. at 1213; Eggert, supra note 8, at 1272. Prior to the 2007 mortgage-market collapse, subprime lending was touted as expanding access to homeownership to lower-income borrowers and minorities. See Willis, supra note 8, at 1195.

\(^{19}\) Christopher L. Peterson, Predatory Structured Finance, 28 CARDOZO L. REV. 2185, 2208–09 (2007); see also Eggert, supra note 8, at 1266.

\(^{20}\) See Peterson, supra note 19, at 2208–09. The business entity used to securitize mortgages, called a special purpose vehicle, can be a corporation, partnership, or limited liability company, but usually is a trust. Id. at 2209.

\(^{21}\) See RAO ET AL., supra note 13, § 1.2.2.3, at 7.

\(^{22}\) See Kurt Eggert, Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine, 35 CREIGHTON L. REV. 503, 539–40 (2002).

absorb losses from reduced mortgage payments. \textsuperscript{24} Tranches are often resecuritized, creating securities backed by other securities rather than mortgages. \textsuperscript{25}

Mortgage securitization splits the unitary mortgage owner into a dispersed cloud of investors who are collectively unable to make decisions about particular loans and a passive loan pool trustee. \textsuperscript{26} In need of a mortgage management mechanism, investors must rely on mortgage servicers. \textsuperscript{27} The servicer’s duties and compensation are defined by the PSA \textsuperscript{28} and include collecting and distributing mortgage payments to investors, paying property taxes from escrow accounts, verifying insurance coverage, and executing foreclosure or workout agreements \textsuperscript{29} on borrower default. \textsuperscript{30} The servicer plays a critical intermediary role in the mortgage process. It is likely the only party with which the borrower has any direct contact and is responsible for making decisions about the mortgage on behalf of investors. \textsuperscript{31} As explained \textit{infra}, the structural characteristics of mortgage securitization and foreclosure create incentives for mortgage servicers to prefer foreclosure over modification even when it is financially detrimental to investors. \textsuperscript{32}

\begin{itemize}
\item \textsuperscript{25} \textit{Id.} at 1100 (discussing recursively structured collateralized mortgage obligations (CMOs) and collateralized debt obligations (CDOs)).
\item \textsuperscript{26} A pool trustee is little more than a passive legal placeholder, a “passive synthetic creature whose only purpose is to funnel highly specified cashflows to investors.” \textit{Id.} at 1092; see also Kurt Eggert, \textit{Limiting Abuse and Opportunism by Mortgage Servicers}, 15 HOUSING POL’Y DEBATE 753, 754 (2004). Mortgage-pool trusts are structured as automatic revenue “pass-throughs” to avoid adverse tax and regulatory consequences. See Gelpern & Levitin, \textit{supra} note 24, at 1096–98 & n.85.
\item \textsuperscript{27} See Gelpern & Levitin, \textit{supra} note 24, at 1088; Christopher Foote et al., \textit{Reducing Foreclosures: No Easy Answers} 21 (Fed. Reserve Bank of Atlanta, Working Paper No. 2009-15, 2009).
\item \textsuperscript{28} RAO ET AL., \textit{supra} note 13, § 1.2.2.3, at 7; Alan M. White, \textit{Deleveraging the American Homeowner: The Failure of 2008 Voluntary Mortgage Contract Modifications}, 41 CONN. L. REV. 1107, 1127 (2009).
\item \textsuperscript{29} See \textit{infra} Part II.E.
\item \textsuperscript{30} Eggert, \textit{supra} note 26, at 755; Gelpern & Levitin, \textit{supra} note 24, at 1088.
\item \textsuperscript{31} See RAO ET AL., \textit{supra} note 13, § 2.2.4.3, at 26. A borrower has almost no control over which entity services her mortgage. See Eggert, \textit{supra} note 26, at 767.
\item \textsuperscript{32} See \textit{infra} Part III.B.1.
\end{itemize}
C. Foreclosure Crisis: The Chain of Plausible Deniability

Securitization also changed which party bears the cost of bad lending practices. Under the holder in due course doctrine, the securitization process creates a “chain of plausible deniability” that shields mortgage holders and investors from liability for any fraudulent and predatory practices of the original lender.\(^\text{33}\) Untethered from the risk of borrower default, brokers and lenders aggressively deployed an array of non-traditional loan products\(^\text{34}\) to induce high volumes of high-risk subprime borrowers to obtain mortgages that were then sold down the securitization stream for a profit.\(^\text{35}\) Almost three million subprime loans were originated in 2006 alone.\(^\text{36}\)

The profitability of these practices and a seemingly perpetual period of housing price increases led to an overextension of risky credit.\(^\text{37}\) Credit markets collapsed in 2007 after funds heavily invested in subprime mortgage products imploded from high rates of default and foreclosure.\(^\text{38}\) Housing prices plummeted,\(^\text{39}\) eroding home equity that many subprime borrowers needed to refinance out of resetting adjustable-rate mortgages,\(^\text{40}\) thereby fueling increases in the


\(^{34}\) See RAO ET AL., supra note 13, § 1.2.5, at 11–13.

\(^{35}\) See Gelpem & Levitin, supra note 24, at 1084. Lending institutions that securitize mortgages make money from up-front fees rather than interest-payment streams. Id. Borrowers have limited recourse for predatory lending practices because the holder in due course doctrine insulates investors from any defects not apparent on the face of the documents. Although lenders must make representations and warranties to investors that, if violated, obligate the lender to buy back loans, such recourse is little comfort if the originating lender has gone bankrupt. Eggert, supra note 22, at 548–49. Many lenders have gone bankrupt in recent years. Oren Bar-Gill, The Law, Economics and Psychology of Subprime Mortgage Contracts, 94 CORNELL L. REV. 1073, 1129 & n.196 (2009).

\(^{36}\) Bar-Gill, supra note 35, at 1074.

\(^{37}\) See Eggert, supra note 8, at 1259–61.


\(^{40}\) Eggert, supra note 8, at 1260 (citing estimate of $3.3 trillion loss in homeowner equity in 2008).
foreclosure rate.\footnote{See RAO ET AL., supra note 13, § 1.2.5, at 13; White, supra note 38, at 522–25.} As the national economy dipped into recession, unemployment rose to its highest level since 1983.\footnote{Neil Irwin & Michael A. Fletcher, Nation’s Jobless Rate Tops 10 Percent; Surge to 26-Year High Puts Damper on Signs That Recession Is Over, WASH. POST, Nov. 7, 2009, at A1.} With unemployment also at its longest average duration on record,\footnote{Mortimer Zuckerman, The Economy Is Even Worse Than You Think, WALL ST. J., July 14, 2009, at A13 (reporting that the average length of official unemployment had reached 24.5 weeks, the longest duration since the government began tracking this data in 1948).} the scope of the crisis extended to all classes of borrowers, even those with low-risk prime mortgages.\footnote{See Peter S. Goodman & Jack Healy, Work Losses Hit Mortgages Seen as Safe, N.Y. TIMES, May 25, 2009, at A1; see also HOPE NOW, APPENDIX - MORTGAGE LOSS MITIGATION STATISTICS INDUSTRY EXTRAPOLATIONS (AS OF Q3-2009) (2009), https://www.hopenow.com/industry-data/HOPE%20NOW%20National%20Data%20July07%20to%20Oct09%20v6%20All.pdf.}

In the second quarter of 2009, the national rate of residential mortgages either delinquent or in foreclosure rose to a record-high 13.16 percent, or more than one in eight households with a mortgage.\footnote{Press Release, Mortgage Bankers Ass’n, Delinquencies Continue to Climb, Foreclosures Flat in Latest MBA National Delinquency Survey (Aug. 20, 2009), http://www.mbaa.org/NewsandMedia/PressCenter/70050.htm.} In total, out of the approximately 51 million mortgaged residential units in the United States,\footnote{CONGRESSIONAL OVERSIGHT PANEL, FORECLOSURE CRISIS: WORKING TOWARD A SOLUTION 7 (2009).} approximately 2.15 million foreclosures were completed from July 2007 to October 2009.\footnote{HOPE NOW, supra note 44.}

Looking to the horizon, foreclosure starts are projected to reach eight to thirteen million by 2013.\footnote{CONGRESSIONAL OVERSIGHT PANEL, TAKING STOCK: WHAT HAS THE TROUBLED ASSET RELIEF PROGRAM ACHIEVED? 63 & n.240 (2009).}

D. Foreclosure: An Equitable Remedy Shaped by State Law

Foreclosure is an equitable remedy,\footnote{See FLA. STAT. § 702.01 (2010); KRATOVLIL, supra note 11, §§ 525–42, at 331–36; RAO ET AL., supra note 13, § 6.4.5.4 (Supp. 2009); Steven Seidenberg, Homing in on Foreclosure, A.B.A. J., July 2008, at 54, 57; Debra Pogrund Stark, Foreclosing on the American Dream: An Evaluation of State and Federal Foreclosure Laws, 51 OKLA. L. REV. 229, 231–32 (1998).} although foreclosure procedures are defined by state law.\footnote{See RAO ET AL., supra note 13, § 4.2.1, at 75.} The foreclosure process begins when a borrower fails to make several monthly mortgage payments
and the mortgage holder\textsuperscript{51} determines that the borrower defaulted.\textsuperscript{52} While each state maintains its own unique set of foreclosure rules, most state schemes fall into one of two categories: judicial and nonjudicial.\textsuperscript{53}

1. Judicial and Nonjudicial Foreclosure

The judicial foreclosure process is similar to other civil adjudications. The foreclosing party must file a complaint\textsuperscript{54} and serve the borrower and other related parties with notice to initiate foreclosure proceedings.\textsuperscript{55} The borrower must then file an answer to avoid default judgment.\textsuperscript{56} After payment default but before foreclosure proceedings, many states provide a reinstatement period during which the borrower has a right to cure the default by bringing

\textsuperscript{51} Note on terminology: when referring to the entity pursuing foreclosure, this Article will use the term "foreclosing party." This entity could be a lender, servicer, nominee, trustee, or other authorized agent for the mortgage holder, although it is most often the servicer. It is also important to distinguish between the "mortgage originator," which is the original lending institution, and the present mortgage holder. The identity of the mortgage holder is often unclear to borrowers, courts, and even the foreclosing party itself. This Article will refer to the specific type of entity or agent when known or appropriate. Because this Article focuses on residential foreclosure, this Article will use the terms "borrower" and "homeowner" interchangeably.

\textsuperscript{52} See RAO ET AL., supra note 13, § 6.4.2, at 160–61. While payment delinquency is the principal reason for borrower default, failure to perform other obligations under the mortgage contract, such as maintaining insurance and paying property taxes, can also lead to default. See RESTATEMENT (THIRD) OF PROP.: MORTGAGES §§ 4.6(b)(1), (c), 8.1 cmt. a (1997).

\textsuperscript{53} All states have a procedure for judicial foreclosure. RAO ET AL., supra note 13, § 4.2.1, at 75. Nonjudicial foreclosure by power-of-sale is only permitted in twenty-six states and the District of Columbia. Id. § 4.2.3, at 76. There are other infrequently used forms of foreclosure allowed in a few states, including strict foreclosure and foreclosure by entry and possession. See id. § 4.2.4, at 77. The remaining states require judicial foreclosure. See id. § 4.2.1, at 76.

\textsuperscript{54} See id. § 4.2.2, at 76. The complaint in foreclosure proceedings usually must be filed in a court in the county in which the property sits. See PATRICK MEARS ET AL., STRATEGIES FOR SECURED CREDITORS IN WORKOUTS AND FORECLOSURES § 4.01, at 157 (2004); RAO ET AL., supra note 13, § 4.2.2, at 76.

\textsuperscript{55} In addition, the foreclosing party must file a \textit{lis pendens}—a notice of impending foreclosure—with the county recorder. See BLACK'S LAW DICTIONARY, supra note 12, at 1015; see also Debra Pogrud Stark, Facing the Facts: An Empirical Study of the Fairness and Efficiency of Foreclosures and a Proposal for Reform, 30 U. MICH. J.L. REFORM 639, 644 (1997). While states vary regarding the number and timing of notice requirements, most states mandate that the foreclosing party follow them strictly. See RAO ET AL., supra note 13, § 4.2.3, at 76 n.9, § 4.3.2, at 79 n.35. For more information on the complexities of state notice requirements, see generally SIDNEY A. KEYLES, ABA SECTION ON REAL PROPERTY, PROBATE AND TRUST LAW, FORECLOSURE LAW & RELATED REMEDIES: A STATE BY STATE DIGEST (1995).

payments current and covering the foreclosing party’s fees and costs.\textsuperscript{57}

If the borrower is unable to cure the default, the case proceeds through the court system with the judge sitting as fact-finder.\textsuperscript{58} The foreclosing party usually files a motion for summary judgment claiming it has met the state’s foreclosure requirements.\textsuperscript{59} In most states, the foreclosing party’s prima facie case is composed of three elements: (1) proof of a valid mortgage between the parties; (2) proof that the foreclosing party owns the unpaid promissory note;\textsuperscript{60} and (3) evidence that the borrower is in default.\textsuperscript{61} In response to the motion for summary judgment, the borrower has an opportunity to present defenses and counterclaims to defeat the motion. These can include failure to adhere to procedural prerequisites, mistakes and improprieties in charging and collecting fees, mishandling payments, and other errors or misconduct.\textsuperscript{62} The judge will then issue a decree authorizing a foreclosure sale or dismiss the foreclosure action.\textsuperscript{63}

Nonjudicial foreclosure, as the term itself implies, requires little or no court involvement.\textsuperscript{64} In states permitting nonjudicial foreclosure, most mortgages contain a power-of-sale clause authorizing the mortgage holder to initiate and execute foreclosure upon borrower default without any prior judicial order.\textsuperscript{65} The borrower in a nonjudicial foreclosure state can redirect the foreclosure process into the state court system. Yet the borrower

\begin{flushright}
\textsuperscript{57} RAO ET AL., \textit{supra} note 13, § 4.2.5, at 77–78 (noting that at least nineteen states and the District of Columbia provide a right to cure default through reinstatement).

\textsuperscript{58} See, e.g., \textit{FLA. STAT.} § 702.01 (2010).

\textsuperscript{59} See RAO ET AL., \textit{supra} note 13, § 4.2.2, at 76 & n.5.

\textsuperscript{60} However, many state courts have adopted a relaxed attitude towards proving ownership of the note. \textit{See infra} notes 107–08 and accompanying text.


\textsuperscript{62} See Eggert, \textit{supra} note 26, at 756–61; see also RAO ET AL., \textit{supra} note 13, § 4.2.2, at 76.

\textsuperscript{63} See RAO ET AL., \textit{supra} note 13, § 4.2.2, at 76.

\textsuperscript{64} See RAO ET AL., \textit{supra} note 13, § 4.2.3, at 76; Cox, \textit{supra} note 8, at 700.

\textsuperscript{65} See RAO ET AL., \textit{supra} note 13, § 4.2.2, at 76; Cox, \textit{supra} note 8, at 700.
\end{flushright}
bears the burden of filing for and securing a preliminary injunction to stop the foreclosure sale from continuing. 66

Mortgage holders typically prefer nonjudicial foreclosure because it avoids the delay (and expense) associated with instituting court action, which can be considerable. 67 Although numbers vary depending on the jurisdiction and the caseloads in the courts, one source estimates that on average nonjudicial foreclosure takes less than two months, whereas judicial foreclosure takes about eight months. 68 However, mortgage holders sometimes prefer judicial foreclosure when state law requires this method of foreclosure to obtain a post-sale deficiency judgment. 69

2. Borrower’s Response: Right of Redemption, Bankruptcy, and Post-Sale Challenge

Both judicial and nonjudicial foreclosures conclude with the foreclosure sale. 70 Prior to the foreclosure sale, all states give the borrower the opportunity to avoid foreclosure by exercising the equitable right of redemption. 71 The equitable right of redemption involves paying the mortgage holder the total outstanding balance on

66. See RAO ET AL., supra note 13, § 4.2.3, at 77. This typically includes posting a security bond. Id. § 4.2.3, at 77, § 10.5, at 268–69.
67. See KAREN PENCE, BD. OF GOVERNORS OF THE FED. RESERVE SYS., FORECLOSING ON OPPORTUNITY: STATE LAWS AND MORTGAGE CREDIT 5 (2003) (discussing 1996 study suggesting that delaying foreclosure for sixteen months on $100,000 loan increased costs by more than $13,500); see also Stark, supra note 55, at 646.
68. According to a study in the mid-1990s, the median time to complete a power-of-sale foreclosure was fifty-six days compared to eight months for judicial foreclosure. Stark, supra note 49, at 232 n.10, 257–67 tbl.1; see also PENCE, supra note 67, at 5 (discussing 1997 study finding that judicial foreclosure takes 148 days longer than nonjudicial foreclosure on average and that the difference in average duration between the slowest judicial foreclosure state (Maine) and the fastest nonjudicial foreclosure state (Texas) was 300 days).
69. See Grant S. Nelson & Dale A. Whitman, Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act, 53 DUKE L.J. 1399, 1404–06 (2004). When a defaulting borrower has assets in addition to the property in foreclosure, a deficiency judgment enables the mortgage holder to recover the difference between the borrower’s outstanding debt and the price paid for the property at the foreclosure sale. Id. Some states prohibit deficiency judgments after nonjudicial foreclosure. Id. Deficiency judgments are more often pursued against commercial borrowers because most residential borrowers have too few resources to make deficiency judgment profitable. See PENCE, supra note 67, at 6. In general, any surplus from the foreclosure sale is returned to the borrower, assuming there are no other valid liens wiped out by the foreclosure which must first be satisfied. See NELSON & WHITMAN, supra note 12, § 7.31, at 726–28.
70. See RAO ET AL., supra note 13, §§ 4.2.2–.3, at 76–77.
71. See NELSON & WHITMAN, supra note 12, § 3.1, at 34–35.
the loan plus any expenses the mortgage holder incurred in administering the default.\textsuperscript{72}

A common strategy for borrowers facing imminent foreclosure is to file for bankruptcy, which invokes an automatic stay and halts the foreclosure process.\textsuperscript{73} However, bankruptcy court is only a detour in most foreclosure cases because mortgages on primary residences are not eligible for bankruptcy restructuring.\textsuperscript{74} Unless the borrower proves a defense to foreclosure or finds a way to settle the mortgage debt during the automatic stay, the foreclosure action will ultimately be returned to, and executed in, state court.\textsuperscript{75}

After a foreclosure sale occurs, a borrower faces extreme difficulty in convincing the court to set the sale aside.\textsuperscript{76} Courts disfavor post-sale challenges to foreclosure because such a challenge prejudices a subsequent purchaser who has paid for the property and is unaware of any defects in the foreclosure process.\textsuperscript{77}

\textbf{E. Mortgage Modification and Other Negotiated Pre-Foreclosure Alternatives}

Borrower default does not inevitably lead to foreclosure. In addition to reinstatement or redemption, there are a variety of pre-foreclosure alternatives, sometimes called "workout agreements" or "loss mitigation."\textsuperscript{78} The mortgage holder may agree to a short sale, which enables the borrower to resolve the default by selling the

\textsuperscript{72} See id. In addition to the equitable right of redemption, some states allow a statutory right of redemption. This right extends the redemption period for a time after the foreclosure sale and gives the borrower the right to buy back property sold at a foreclosure from the purchaser for the foreclosure sale price plus interest and costs. See RAO ET AL., supra note 13, § 14.2, at 359.

\textsuperscript{73} See Linda Northrup & Karen Luong, Locked Out: In Fighting a Potential Foreclosure, the Time to Act Is Before the Sale Takes Place, L.A. LAW., Feb. 2008, at 34, 36.

\textsuperscript{74} 11 U.S.C. § 1322(b)(2) (2006) (permitting modification of secured claims "other than a claim secured only by a security interest in real property that is the debtor's principal residence"); see also supra note 5 and accompanying text.

\textsuperscript{75} See RAO ET AL., supra note 13, § 9.2.3.1, at 220; supra note 5 and accompanying text.

\textsuperscript{76} Northrup & Luong, supra note 73, at 34. The only notable exception here is the statutory right of redemption applicable in a few states. See supra note 72.

\textsuperscript{77} In other words, the winning bidder is a bona fide purchaser for value. Northrup & Luong, supra note 73, at 34–35. For example, courts generally will not set aside a sale based on evidence of defective notice, even if such evidence would have been sufficient to stay foreclosure presale. Id. A borrower is more likely to be successful in a post-sale challenge if: (1) the underlying security instrument is invalid; (2) fraud or collusion occur in the bidding process; or (3) the winning bidder is not a bona fide purchaser, for example if she regularly participates in foreclosure auctions. Id. at 37–38.

\textsuperscript{78} See generally RAO ET AL., supra note 13, §§ 2.3.4–4.5, at 31–35.
property for less than the outstanding debt. Similarly, in a deed in lieu of foreclosure the mortgage holder agrees to discharge mortgage debt if the borrower voluntarily returns the property. Deed-in-lieu and short sale avoid a foreclosure notation on the borrower’s credit history. A repayment or forbearance plan enables a borrower who has missed payments to avoid foreclosure and retain the mortgaged property by repaying arrears concurrently with regular monthly payments. The discretion to authorize any of these alternatives rests with the mortgage holder but is usually delegated to the mortgage servicer.

In addition, there is growing interest in another alternative: mortgage modification. Mortgage modification is a written agreement to permanently alter one or more loan terms. While modifications can take a variety of forms, they typically involve some combination of a reduction in interest rate, elongation of the loan payment term, or reduction in the principal balance. Regardless of its form, a mortgage modification seeks to make a loan affordable to a borrower who, while capable of making substantial contributions, can no longer afford the mortgage loan terms.

By revising mortgage terms so that monthly payments correspond to what particular borrowers can afford, modification directly addresses the underlying problem that led to the foreclosure crisis—the overextension of risky and unaffordable credit through subprime and predatory lending. The foreclosure crisis has been

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79. See RAO ET AL., supra note 13, § 2.4.3, at 34–35; see also Cox, supra note 8, at 707–08.
80. See RAO ET AL., supra note 13, § 2.4.5, at 35; see also Cox, supra note 8, at 707–08.
81. See RAO ET AL., supra note 13, § 2.4.3, at 34; Willis, supra note 8, at 1118 n.34. But see Cox, supra note 8, at 715 n.201 (stating that the difference between foreclosure versus short sale or deed-in-lieu on a borrower’s credit may not be as significant as many borrowers believe). A short sale or deed-in-lieu may also enable a borrower to avoid a deficiency judgment. See RAO ET AL., supra note 13, § 2.3.4.3, at 32.
82. See RAO ET AL., supra note 13, §§ 2.3.4.3–2.3.4.4, at 32; see also Cox, supra note 8, at 707–08.
83. See RAO ET AL., supra note 13, § 2.2.4.3, at 26.
84. Id. § 2.3.4.6, at 33; see also Cox, supra note 8, at 707–08.
85. See RAO ET AL., supra note 13, § 2.3.4.6, at 33.
86. Id. To bring a loan current, a lender might also capitalize arrears and reamortize the loan. Capitalizing arrears involves adding past due payments to the total remaining loan balance and reamortization means recalculating monthly payments based on the new loan balance. This type of modification will make the loan less affordable because monthly payments will increase. Id.; see also White, supra note 28, at 1114.
87. See supra note 38 and accompanying text.
intractable in part because borrowers have had little recourse for predatory lending, defined in the mortgage context as overpriced or overly risky loans.\textsuperscript{88} By making mortgage debt more closely reflect current home values and borrower payment capacities, modification can reduce the foreclosure rate, thereby stabilizing mortgage markets and the broader economy.\textsuperscript{89}

Finally, and most significantly, modification is economically advantageous for mortgage holders and investors under depressed market conditions because, on average, modification results in a smaller loss than foreclosure.\textsuperscript{90} Recent data indicate that, under current mortgage market conditions, the average foreclosure entails more than 50 percent loss in value to investors in securitized mortgages as opposed to around 5 percent loss for modification.\textsuperscript{91} Despite the stark contrast between these numbers, state courts have done little to encourage modification prior to foreclosure proceedings. The next section explains why.

III. \textbf{STATE COURTS HAVE BEEN INEFFECTIVE IN MITIGATING THE FORECLOSURE CRISIS BECAUSE THEY HAVE NOT ADEQUATELY ENCOURAGED MORTGAGE MODIFICATION}

Despite their central role in administering and policing the foreclosure process, state courts have been ineffective in mitigating the foreclosure crisis. Part of the problem stems from the courts' passive facilitation of mechanical foreclosure proceedings. However, even model foreclosure proceedings can generally only delay, not avoid, foreclosure. Instead, the central weakness in the state courts'
response has been inadequate encouragement of mortgage modification. Mortgage modification resolves default and shifts mortgage debt to make it affordable for borrowers. Mandatory pre-foreclosure mediation programs, recently established in many states, have the potential to significantly increase the rate of mortgage modification. However, state courts have failed to exploit this potential because they have not taken steps to ensure that mortgage servicers, who exhibit a foreclosure bias related to their compensation scheme, behave in accordance with the best interests of investors who are absent from proceedings.

A. Foreclosure Defense Is Not a Viable Solution to the Foreclosure Crisis

It is difficult for borrowers in default to defend against foreclosure. Informational barriers prevent borrowers from identifying errors that would justify halting the foreclosure process. Foreclosing parties—generally servicers—routinely file incomplete or unreviewed legal documents with courts, while borrowers and their advocates often struggle with those same servicers to obtain loan documents crucial to foreclosure defense. Understaffed to minimize overhead, servicers keep borrowers in call-center limbo for long periods and are generally uncooperative with borrower requests, whether informal or formal. As the court in one case commented, "[I]t takes four to six months for [the servicer] to produce a simple accounting of a loan’s history and over four court hearings."

92. A 2006 study by Katherine Porter found that of 1,733 chapter 13 bankruptcy filings by mortgage creditors across more than twenty states, 52.8 percent lacked required documentation (missing note, missing itemization, or missing security interest), yet 96 percent of these claims passed through the bankruptcy process undisturbed. Katherine M. Porter, Misbehavior and Mistake in Bankruptcy Mortgage Claims, 87 Tex. L. Rev. 121, 141, 144–46 (2008). This data raises the inference that state court foreclosure filings suffer similar rates of documentary error. See id. at 125. As this Article went to press, it was being reported that Bank of America, GMAC Mortgage, and JPMorgan Chase decided to freeze pending foreclosures in twenty-three states to correct errors in foreclosure filings that resulted from the practice of "robo-signing," in which a bank executive would sign thousands of affidavits each month without knowledge of the information contained in those documents. David Streitfeld, Bank of America to Freeze Foreclosure Cases, N.Y. Times, Oct. 2, 2010, at B1.

93. See RAO ET AL., supra note 13, § 10.2.2.1, at 259, § 10.2.5, at 261–62, § 10.2.7.1, at 263; see also Eggert, supra note 26, at 769.

94. See Nelson & Whitman, supra note 69, at 1451.

95. In re Jones, 418 B.R. 687, 699 (Bankr. E.D. La. 2009). In this case, Wells Fargo was enjoined to completely revise its accounting procedures not only with respect to the plaintiff but for all borrowers it serviced in the court’s district because Wells Fargo’s preexisting accounting
In addition to—or perhaps because of—these informational barriers, between 80 and 90 percent of defaulting borrowers fail to appear at their hearing dates. 96 By failing to appear at the judicial hearing, the borrower enables the judge to enter default judgment in favor of the foreclosing party. 97 Of the small portion of borrowers who appear in court to challenge foreclosure, most proceed without counsel. 98 Few self-represented borrowers know how to navigate the legal system and many simply “tell the judge their tales of woe . . . . Some of those tales are very sad, but there’s nothing the judge can do.” 99

Despite the magnitude of the current foreclosure crisis, evidence of incomplete foreclosure filings, and lack of effective legislative, regulatory, or market responses, state courts in residential foreclosure proceedings have mostly adhered to a passive conception of the trial judge’s role. Indeed, “the overwhelming majority of foreclosure cases before U.S. courts are in essence rubberstamped by the judges in favor of the mortgage companies.” 100 In some jurisdictions, the judicial foreclosure process is so abbreviated that borrowers do not even have the opportunity to relate their tales of woe. For example, in Florida’s “rocket docket,” judicial foreclosure proceedings often last only fifteen seconds. 101 At these hearings, the judge asks the

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96. See Mark Fass, Court Taps Community Resources and Creates Foreclosure Program, N.Y. L.J., June 19, 2008 (quoting Judge Pfau regarding 90-percent default rate in New York); Seidenberg, supra note 49, at 56 (quoting lender attorney Robert C. Hill Jr. that, “Only about 5 to 10 percent of borrowers show up”); Azam Ahmed, The View From Foreclosure Court, CHI. TRIB., Oct. 20, 2008, at C1 (reporting estimates that 80 percent of Cook County’s foreclosure cases go uncontested).

97. See supra note 56 and accompanying text.

98. MELANCA CLARK, BRENNAN CTR. FOR JUSTICE, FORECLOSURES: A CRISIS IN LEGAL REPRESENTATION 12 (2009). For example, in Stark County, Ohio, 86 percent of borrowers who appear in foreclosure proceedings do so without any legal representation. Id.


101. Michael Corkery, A Florida Court’s ‘Rocket Docket’ Blasts Through Foreclosure Cases, WALL ST. J., Feb. 18, 2009, at Al. The “rocket docket” approach stands in stark contrast to the approach adopted by judges in other jurisdictions emphasizing careful, sua sponte review of foreclosure filings. See infra notes 202–204 and accompanying text. This variation demonstrates the broad discretion state courts exercise in determining the manner in which foreclosure cases are adjudicated.
borrower whether she is behind on her mortgage and whether she is currently living on the property; if the borrower answers "yes" to both questions, the judge immediately authorizes a foreclosure sale date.\footnote{102} According to one county clerk of courts, administrative efficiency is the primary purpose behind these rapid-fire proceedings: "We have to move these cases out of here."\footnote{103} In addition, Florida judges who display leniency to borrowers by delaying foreclosure sales so borrowers have time to find foreclosure alternatives can expect scolding by higher courts.\footnote{104}

More searching judicial review and increased access to legal representation and loan documentation would assist borrowers in identifying foreclosure defenses and ease their stress in the foreclosure process. Nevertheless, such improvements would likely not significantly reduce the foreclosure rate.\footnote{105} With few exceptions, successful foreclosure defense does not resolve underlying borrower default.\footnote{106} In a recent opinion issuing from an Ohio federal court, the judge dismissed a set of foreclosure actions due to the foreclosing parties' failure to prove ownership of the underlying mortgages and promissory notes at the time the foreclosure complaints were filed.\footnote{107} This case was heralded as a harbinger of tougher judicial review that would help to reduce the foreclosure rate.\footnote{108} However, as with most cases where the judge determines a foreclosure claim is flawed or incomplete, the foreclosure actions were dismissed without

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\footnote{102}{Corkery, supra note 101.}
\footnote{103}{Id. (quoting Charlie Green, Lee County's clerk of the circuit courts).}
\footnote{104}{See Amir Efrati, Foreclosure Challenges Raise Questions About Judicial Role, WALL ST. J., Dec. 24, 2009, at A15. In September 2009, a Florida state appeals court admonished Judge Valerie Manno Schurr for routinely delaying foreclosure sales for several months for no reason other than to enable borrowers to find alternatives to foreclosure. See id.}
\footnote{105}{See RAO ET AL., supra note 13, § 4.1, at 75.}
\footnote{106}{See id.; see also KRATOVIL, supra note 11, § 474, at 307 (noting how a defect in foreclosure proceedings "makes a judgment or decree erroneous, but not void").}
\footnote{107}{In re Foreclosure Cases, Nos. 1:07CV2282, 07CV2532, 07CV2560, 07CV2602, 07CV2631, 07CV2638, 07CV2681, 07CV2695, 07CV2920, 07CV2930, 07CV2949, 07CV2950, 07CV3000, 07CV3029, 2007 WL 3232430, at *1 (N.D. Ohio Oct. 31, 2007). This defense has not gained significant traction in other courts. See Goodyke v. BNC Mortgage, Inc., No. CV 09-0074-PHX-MHM, 2009 WL 2971086, at *2 (D. Ariz. Sept. 11, 2009); Spencer v. DHI Mortgage Co., 642 F. Supp. 2d 1153, 1166 (E.D. Cal. 2009); see also Robert P. Barnett & Robert S. Swaine, Re-creating and Correcting Instruments and Agreements, in FLORIDA REAL PROPERTY LITIGATION § 6.3 (5th ed. 2009) (noting how Florida law is "clear that a person not in possession of a negotiable instrument may nonetheless enforce it").}
\footnote{108}{See Gretchen Morgenson, Foreclosures Hit a Snag for Lenders, N.Y. TIMES, Nov. 15, 2007, at C1.}
prejudice, meaning the foreclosing parties were free to amend and refile their claims.109

B. Mortgage Modification Is a Viable Solution to the Foreclosure Crisis

Unlike foreclosure defense, widespread mortgage modification has the potential to immediately and directly resolve underlying borrower default and render mortgage debt affordable over the long term. Ideally, mass modification would reset unaffordable mortgage debt originating in subprime and predatory lending. However, state courts have not sufficiently enforced existing pre-foreclosure mediation procedures designed to encourage modification and have thus failed to overcome the foreclosure bias of mortgage servicers.

1. Mortgage Servicers Exhibit a Foreclosure Bias Even When Modification Is in the Best Interests of Investors

Even when securities investors and borrowers in default would prefer modification, mortgage servicers gain more financially from foreclosure. This is one of the primary reasons, if not the central reason, why voluntary modification has not been more widespread.110 Most PSAs explicitly instruct the mortgage servicer to make decisions as though the servicer owned the mortgage, functionally positioning the servicer as a proxy for investors, taken as a whole.111 Despite this directive, mortgage servicers are motivated by different financial interests than investors. Investors receive income from

109. In re Foreclosure Cases, 2007 WL 3232430, at *3. Absent blatant misconduct, foreclosure defense is unlikely to result in cancellation of mortgage debt. See, e.g., IndyMac Bank F.S.B v. Yano-Horoski, 890 N.Y.S.2d 313, 315–17, 319 (Sup. Ct. 2009) (canceling alleged $525,000 mortgage debt because the foreclosing party misled the court about the mortgage debt owed and engaged in “harsh, repugnant, shocking and repulsive” conduct towards the borrowers). Foreclosure defense will obviously resolve default if the borrower proves that the default itself is erroneous. See, e.g., Schlosser v. Fairbanks Capital Corp., 323 F.3d 534, 535–36 (7th Cir. 2003). In this case, Fairbanks erroneously instituted foreclosure proceedings against a couple who had brought their delinquent account current. See id.

110. See White, supra note 28, at 1127–29.

111. See DIANE E. THOMPSON, NAT’L CONSUMER LAW CTR., WHY SERVICERS FORECLOSE WHEN THEY SHOULD MODIFY AND OTHER PUZZLES OF SERVICER BEHAVIOR 7 (2009); Gelpen & Levitin, supra note 24, at 1088–89.
borrower mortgage payments and are thus interested in a borrower’s ability to make those payments without interruption.

In contrast, a servicer’s compensation comes from three primary sources, defined in the PSA. As a base fee for servicing the loan, the servicer typically receives twenty-five basis points corresponding to the loan principal. In most cases, servicers are compensated at twice this rate to service loans in default. Servicers also collect “float income,” which is interest earned on payments prior to disbursement to investors. Finally, servicers keep any fees collected, including late payment fees and fees associated with default. Servicers have been caught posting timely made payments late, or “losing” payments altogether, in order to charge unnecessary late fees. Default triggers an additional set of fees, such as property inspection fees and legal fees, creating additional incentive for servicers to push borrowers into default and keep them there as long as possible before foreclosure. These ancillary fees are a major source of income for servicers. One report indicates that mortgage servicer Ocwen derives up to 18 percent of its income from ancillary

112. See THOMPSON, supra note 111, at 4; Gelpern & Levitin, supra note 24, at 1092 (noting that trusts are mere pass-throughs funnelling mortgage payment cashflows to investors).


114. See White, supra note 28, at 1127.

115. One basis point is equal to 0.01 percent of a total quantity. MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY 102 (11th ed. 2003).


117. THOMPSON, supra note 111, at 19 (noting that mortgage servicer fees are calculated on an annual basis); Seidenberg, supra note 49, at 58. Thus, while the fee for servicing a performing loan with a $250,000 balance would be $625, the fee increases to $1,250 upon borrower default. See id. Servicing fees for subprime loans are also generally higher than for Alt-A and fixed-rate prime loans. See id.

118. THOMPSON, supra note 111, at 19; see also White, supra note 28, at 1127.

119. THOMPSON, supra note 111, at 17.

120. See Eggert, supra note 26, at 758–59.

121. THOMPSON, supra note 111, at 17.

122. Eggert, supra note 26, at 757.

123. THOMPSON, supra note 111, at 17; Kurt Eggert, Comment on Michael A. Stegman et al.’s “Preventive Servicing Is Good for Business and Affordable Homeownership Policy”: What Prevents Loan Modifications?, 18 HOUSING POL’Y DEBATE 279, 287 (2007); see also Eggert, supra note 26, at 772–73 (discussing how servicer-fee abuse may be the cause of foreclosure in many cases); Porter, supra note 92, at 132.
fees, while another study found that ancillary fees covered a servicer’s entire operating expenses, leaving the basic servicing fee as almost pure profit.

Foreclosure also generates immediate income for servicers. When a borrower enters default, the servicer must front legal fees and borrower payments to investors. With a foreclosure sale, the servicer recoups these cash outlays immediately. In contrast, if the servicer modifies a loan, investors receive the benefit of continued monthly payments while the servicer may receive no extra fees in the short term.

Another reason that servicers may be resistant to modification is fear of investor lawsuits. Because investors own tranches that represent different revenue streams, there is concern that modification will be detrimental to some investors even while benefiting others. For example, a modification that reduces the interest rate but does not reduce the principal will benefit investors who own principal payment tranches and harm investors who own interest payment tranches. Some have argued that these internal investor frictions have deterred servicers from modifying for fear that adversely affected investors would consequently sue the servicers.

Servicers’ anxiety over exposure to investor litigation has been undercut by several developments. First, servicers are effectively protected by recently enacted federal safe harbor provisions, which immunize servicers against investor litigation so long as modifications are performed in conformity with standard industry practices. In 2007, the American Securitization Forum established

124. THOMPSON, supra note 111, at 17.
125. Eggert, supra note 26, at 758.
126. See THOMPSON, supra note 111, at 19; Eggert, supra note 26, at 755; White, supra note 28, at 1127–28.
128. See id. Modification typically incorporates servicer advances into the loan balance, often deferred in a balloon payment due at the end of the loan term many years later. See id. at 1114; Piskorski et al., supra note 113, at 1 n.5.
standard industry practice for modification when the Forum issued general guidelines directing servicers to act in the best interests of investors in the aggregate, regardless of adverse consequences to particular classes of investors.\textsuperscript{131} Furthermore, as a practical matter, there simply has not been any litigation between investors and servicers\textsuperscript{132} and most PSAs impose only minor limits on modification.\textsuperscript{133}

In light of recent data demonstrating tenfold-higher losses from foreclosure compared to modification,\textsuperscript{134} servicer bias in favor of foreclosure is economically wasteful.\textsuperscript{135} Even when “investor losses may be very large, . . . the servicer will almost always benefit by completing a foreclosure sale.”\textsuperscript{136}

2. Mortgage Mediation Programs Provide Necessary But Insufficient Infrastructure to Overcome Servicer Foreclosure Bias

To address the conflict between foreclosure interests and modification interests, courts and legislatures in at least fourteen states have implemented mandatory pre-foreclosure mediation programs (“mediation programs”) to encourage voluntary modification or other workout agreements.\textsuperscript{137} Under some of these


\textsuperscript{132} See Adelino et al., supra note 129, at 4 (noting that “of the more than 800 lawsuits filed by investors in subprime mortgages through the end of 2008, not one involved the right of a servicer to modify a loan”).


\textsuperscript{134} See supra notes 90–91 and accompanying text (reporting study results showing that modification results in 5 percent loss for investors but foreclosure entails a 50 percent loss, on average).

\textsuperscript{135} See id.; Piskorski et al., supra note 113, at 31.

\textsuperscript{136} White, supra note 28, at 1128.

\textsuperscript{137} Geoffrey Walsh, Nat'l Consumer Law Ctr., State and Local Foreclosure Mediation Programs: Can They Save Homes? 1, 4–5 (2009). Maryland recently implemented a foreclosure mediation program that requires the foreclosing party to submit a loss-mitigation report with thirty days prior to a foreclosure sale. See Ovetta Wiggins, Maryland Bill Provides Foreclosure Mediation for Homeowners, WASH. POST, Apr. 15, 2010,
programs, a mortgage servicer cannot foreclose without good-faith participation in mediation.138 Most mediation programs require a servicer to designate a representative who has the power to authorize modification or other pre-foreclosure alternatives in negotiations with the borrower.139 Mediation helps achieve mortgage modification by bringing relevant parties to the bargaining table and creating the opportunity for amicable resolution to borrower default.140 But without a rigorous enforcement scheme to ensure that servicers participate in good faith, these programs are fatally pro forma and thus insufficient to fulfill their potential.

Because mediation programs have only recently been implemented, there is currently little data available to empirically evaluate their efficacy.141 Early reports contain mixed results and are difficult to interpret due to their lack of specific information about case outcomes. In Connecticut, about 4,000 cases were mediated between July 2008 and August 2009, with 62 percent of participants keeping their homes and 13 percent arranging “graceful exits”142 through short sales or deeds in lieu of foreclosure.143 It is not clear what percentage of participating borrowers who kept their homes received modifications.144 Philadelphia’s Mortgage Foreclosure Diversion Pilot Program, considered one of the best mediation programs, has resulted in 2,776 out of 4,690 participants avoiding

http://www.washingtonpost.com/wp-dyn/content/article/2010/04/14/AR2010041404602.html. As of this writing, it is too early to evaluate the efficacy of this program, although it has received criticism for its timetable. See ANDREW JAKABOVICS & ALON COHEN, CTR. FOR AM. PROGRESS, NOW WE’RE TALKING 13–14 (2010), http://www.americanprogress.org/issues/2010/06/pdf/foreclosure_mediation.pdf.

138. See WALSH, supra note 137, at 17 (noting that, as of September 2009, Maine and Nevada were the only states with mediation programs that include a good-faith requirement). Foreclosure mediation programs take several forms. Some programs refer parties to the court’s pre-existing alternative dispute resolution system. Some involve court-supervised settlement conferences between the parties. Others simply direct mortgage servicers to communicate with defaulting borrowers to discuss pre-foreclosure settlement alternatives. See id. at 4–5. For the sake of brevity, this Article uses the term “mediation program” to refer to all of these program formats.

139. Id. at 12.
140. See id.
141. See id. at 1.
144. See id.
foreclosure between June 2008 and May 2009.\textsuperscript{145} It is unclear how many of these borrowers received modifications or what form those modifications took.\textsuperscript{146}

In most states or cities, if the state or city has a program at all, the outcomes probably look more like those in New Jersey. There, about 2,600 troubled borrowers have requested mediation\textsuperscript{147} since the program went into effect in January 2009.\textsuperscript{148} Of these borrowers, only 750 have received modifications, many of them temporary.\textsuperscript{149} In contrast, 63,208 New Jersey properties received foreclosure filings during roughly the same period.\textsuperscript{150} So far, there is little evidence that these programs are producing substantial and affordable long-term modifications.\textsuperscript{151}

Anecdotal evidence suggests that mediation programs have been ineffective because servicers have been allowed to satisfy court requirements through minimal participation and continue to move cases to foreclosure.\textsuperscript{152} In many cases, servicers provide take-it-or-leave-it offers without the documentation that would allow borrowers or courts to objectively evaluate the reasonableness of offers.\textsuperscript{153} While some courts apply “ stricter standards for appearances, production of documents, and good faith participation,” many “freely tolerate[] token participation.”\textsuperscript{154} As a consequence, “[s]ervicers effectively control the terms of discussion in most programs.”\textsuperscript{155}


\textsuperscript{146} See id.


\textsuperscript{149} Editorial, supra note 147. This report does not indicate how many modifications are temporary. See id.; see also Henry Gottlieb, \textit{N.J. Foreclosure Mediation Program Found Hampered by Low Participation}, 197 N.J. L.J. 1029 (2009) (presenting earlier figures and noting that the program has been hampered by a low rate of borrower participation, as only 5 percent of borrowers seek help).


\textsuperscript{151} See WALSH, supra note 137, at v.

\textsuperscript{152} See id. at 12.

\textsuperscript{153} Id.

\textsuperscript{154} Id. at 13.

\textsuperscript{155} Id.
Without external oversight, servicers will continue to act to maximize their financial gain, skimping on mediation and pushing for foreclosure.

IV. STATE COURTS SHOULD PREVENT MORTGAGE SERVICERS FROM PURSUING FORECLOSURE WHEN MODIFICATION IS IN THE BEST INTERESTS OF INVESTORS ABSENT FROM LITIGATION

The economic and social consequences of litigation are rarely limited to the litigants. The costs or benefits of a particular judgment may flow to the litigant’s family, community, or business relations. In most cases, the connection between litigation and collateral consequences is too attenuated to merit legal consideration. When, however, court proceedings are poised to directly affect absent parties whose interests are not aligned with those of active litigants, courts have repeatedly and consistently assumed an equitable duty to protect the absent parties’ interests. This duty is amplified when important public policy considerations are at stake—when, in essence, the public at large is an absent stakeholder to the litigation: “[t]he interests of absentees ... become more pressing as social and economic activity is increasingly organized through large aggregates of people.” In such cases, courts justifiably employ discretionary power to craft or withhold relief that would otherwise be left to individual litigants. In doing so, courts exercise what may be termed their parens absentis power—their reserved authority to guard the interests of absent stakeholders.

Judicial protection of absent stakeholders is a recurring theme in the law, though its sporadic appearance in different contexts has inhibited development of a coherent doctrinal approach. This section reviews a selection of these scattered areas in an effort to trace a principled approach to the absent stakeholder problem. The subsequent section explains that the current foreclosure crisis presents a novel but needed application of the absent stakeholder doctrine.

157. See infra Part IV.A.
A. Identifying the Judicial Duty to Protect Absent Stakeholders

Before crafting a principled approach on the absent stakeholder problem, it is important to recognize that judicial intervention on behalf of absent stakeholders presents a valid concern about eroding the appearance of judicial impartiality. For this reason, courts and legislatures have developed applications of the absent stakeholder doctrine that are only as broad as necessary to protect absent stakeholder interests.

1. The Servicemembers Civil Relief Act

One of the simplest and narrowest applications of this doctrine is codified by the Servicemembers Civil Relief Act (SCRA). Under 50 U.S.C. app. § 521(b)(2), when it appears that a defendant named in a civil action is an active member of the military, the court has a duty to appoint an attorney to represent the absent defendant’s interests. Notably, the SCRA protects servicemembers on active duty from foreclosure. The policy behind this rule is clear: volunteering to defend the national interest through military service should not render a citizen defenseless to adverse default judgment in civil court.

2. Ex Parte Judicial Proceedings

Another example of the judicial duty to protect absent stakeholders appears in the context of ex parte judicial proceedings. Commenting on the duty of candor, the Model Rules of Professional Conduct (MRPC) explain, in pertinent part, that “[t]he object of an ex parte proceeding is . . . to yield a substantially just result. The judge has an affirmative responsibility to accord the absent party just consideration.” Commonly arising in the context of requests for temporary restraining orders, the duty of candor in ex parte proceedings obligates an attorney appearing before the court to

160. This statute provides, in relevant part, that “[i]f in an action covered by this section it appears that the defendant is in military service, the court may not enter a judgment until after the court appoints an attorney to represent the defendant.” Id. § 521(b)(2).
disclose material facts favorable to the absent party.\textsuperscript{164} However, as the text of the MRPC commentary clearly provides, the duty of candor includes a corollary judicial duty to weigh the interests of absent stakeholders in deciding whether to extend injunctive relief.\textsuperscript{165} This duty is both mandatory and narrow: the judge in ex parte proceedings does not assume an advocacy position in favor of the absent party, but only counterpoises a representational imbalance prior to authorizing a remedy.


The absent stakeholder doctrine takes on a more paternalistic form in the \textit{parens patriae} power the court assumes in relation to child welfare and mental incapacitation. \textit{Parens patriae} translates to "parent of his or her country" and is a doctrine under which the state must protect those unable to care for themselves.\textsuperscript{166} Despite the fundamental constitutional right of parents to choose how to rear children,\textsuperscript{167} courts may exercise their inherent \textit{parens patriae} authority to intervene in the "private realm of family life" to protect children from harm.\textsuperscript{168} For example, courts have ordered medically necessary blood transfusions against parents' wishes.\textsuperscript{169} In a child custody dispute, the court's overriding duty is to protect the best interests of the child even though the nominal litigants are parents or guardians seeking custody.\textsuperscript{170}

Courts also recognize a duty to protect the interests of infants and unborn beneficiaries in settlement agreements involving trust funds.\textsuperscript{171} Thus, courts have the power "not to approve [a settlement]
where it is made to appear to the court that the rights and interests of minor or unborn beneficiaries are not protected." Courts have thus shown a willingness to apply the absent stakeholder doctrine to protect the purely economic interests of absent minor or unborn trust beneficiaries in addition to the physical and developmental interests of nonparty children.

4. Class Action Settlement

Courts most frequently exercise the absent stakeholder doctrine in the context of class action settlement. Class actions are proper where the aggregated claims are legally or factually similar, the claims are sufficiently numerous that individual adjudication or adjudication through joinder would impose excessive administrative burdens on the court, and the class has adequate legal representation. A class representative is chosen to participate in court proceedings on behalf of the class alongside class counsel. Courts perform an oversight role to address a major problem in class action cases: in settling class action claims, there may be an internal class conflict or a conflict between the class and its attorney.

Internal class conflicts occur when subclasses within the pool of plaintiffs have different interests in the settlement terms. In *Amchem Products, Inc. v. Windsor*, a landmark asbestos class action, the U.S. Supreme Court rejected a settlement due to a conflict between plaintiffs already manifesting injuries, who preferred immediate payouts, and plaintiffs with latent or potential injuries, who preferred preserving funds for future payout. Attorney-class conflicts can also occur in class action settlements. For example, in *Ortiz v. Fibreboard Corp.*, another asbestos case, the full payment for previously settled claims was contingent on resolution of an insurance coverage dispute or a global settlement of claims, creating

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172. *Id.*

173. FED. R. CIV. P. 23(a). The four prerequisites to class certification are numerosity, typicality, commonality, and adequacy of representation. *Id.* In addition, a class action must fall into one of three enumerated categories. *Id.* R. 23(b).

174. See FED. R. CIV. P. 23.

175. See Amchem Prods., Inc. v. Windsor, 521 U.S. 591 (1997).

176. *Id.* at 625–29. The court stated that "for the currently injured, the critical goal is generous immediate payments. That goal tugs against the interest of exposure-only plaintiffs in ensuring an ample, inflation-protected fund for the future." *Id.* at 626.

an incentive for plaintiff’s counsel to reach a settlement for future claims at a discount in order to secure fees from the prior settlements.\(^{178}\)

To avoid conflicts of interest, the presiding judge must review any settlement for fairness and reasonableness before authorizing it to proceed.\(^{179}\) Courts have articulated this approval power in terms of a fiduciary duty—a duty to act in another’s best interests\(^{180}\)—owed to absent class members: “The court has a fiduciary responsibility as guardian of the rights of the absentee class members when deciding whether to approve a settlement agreement.”\(^{181}\) Further, the purpose of requiring court approval of class action settlement is “to protect the interests of non-party class members. In determining whether a settlement adversely affects such interests, the essential question is whether the proposed settlement is fair and reasonable and in the best interests of all those who will be [a]ffected by it.”\(^{182}\) Thus, in the class action context, the court assumes an explicit role in shaping the outcome of litigation by considering absent stakeholders.

5. Shareholder Derivative Lawsuits

A variation on the court’s duty to protect absent stakeholders appears in the context of settlement of stockholder derivative lawsuits.\(^{183}\) The plaintiff in a derivative lawsuit is a stockholder who sues on behalf of the corporation to prevent or remedy a wrong

\(^{178}\) *Id.* at 822–26, 852–53.

\(^{179}\) FED. R. CIV. P. 23(e)(2).

\(^{180}\) BLACK’S LAW DICTIONARY, *supra* note 12, at 581.

\(^{181}\) *In re* Cellphone Termination Fee Cases, 104 Cal. Rptr. 3d 275, 281 (Ct. App. 2009) (quoting Kullar v. Foot Locker Retail, Inc., 85 Cal. Rptr. 3d 20 (Ct. App. 2008)) (internal quotation marks omitted) (alteration omitted); see also *In re* N.M. Indirect Purchasers Microsoft Corp., 2007-NMCA-007, ¶ 12, 140 N.M. 879, 149 P.3d 976 (“T[he] judiciary has a duty . . . [to act] as a fiduciary for class members . . . .”), Platte v. First Colony Life Ins. Co., 2008-NMSC-058, ¶ 7, 145 N.M. 77, 194 P.3d 108 (“In a class action settlement, the district court is the protector of the unnamed class members’ rights and acts on the level of a fiduciary.”).


\(^{183}\) See FED. R. CIV. P. 23.1(c) (“A derivative action may be settled, voluntarily dismissed, or compromised only with the court’s approval.”). Such suits empower stockholders to vindicate the corporation’s rights when it appears likely that corporate executives will not act to redress a harm (for example if corporate executives are themselves responsible for the harm). *See* Seth Aronson et al., *Shareholder Derivative Actions: From Cradle to Grave*, in SECURITIES LITIGATION & ENFORCEMENT INSTITUTE 2009, at 167–68 (PLI Corporate Law and Practice Course Handbook Series No. 1762, 2009).
perpetrated against the corporation. In such cases, courts recognize a duty “to protect the best interests of the corporation and its absent shareholders all of whom will be barred from future litigation on these claims if the settlement is approved.”

Again, the purpose behind judicial oversight is to prevent named parties from reaching a self-interested settlement at the expense of the rights of absentees: “The reason for the [judicial approval] requirement is obvious. Because the rights of many persons are at stake who are parties to the action only through their representative, a settlement negotiated between the named parties may not give due regard to the interests of those unnamed.”

6. Crafting an Approach to the Absent Stakeholder

In reflecting upon legal applications of the absent stakeholder doctrine, several principal features become apparent. First, there must be an absent stakeholder—a party, beneficiary, or third person not directly represented in the proceedings whose interests or legal rights will be directly affected by the outcome of litigation. Second, courts find it appropriate to assume a protective role when there is reason to distrust an available party’s willingness or ability to adequately represent the interests of an absent stakeholder. Third, in discharging their protective duty, courts deploy remedial procedures narrowly tailored to protect absent stakeholders’ interests. In most cases, it is sufficient for courts to reserve the authority to reject proposed settlements or requested relief. With the exception of child custody cases, courts rarely go so far as to shape the form of relief itself. Given these considerations, conditions are ripe for extending the absent stakeholder doctrine to the foreclosure litigation context.

186. Norman v. McKee, 431 F.2d 769, 774 (9th Cir. 1970). The fact that unnamed or absent shareholders fail to directly intervene in the litigation tends to enhance rather than diminish the intensity of the court’s oversight function: “In compromises of class actions, such as minority stockholders’ suits, the District Court [acts as] . . . guardian of absent parties and of the corporation as a whole. The silence or the absence of shareholders does not relieve the judge of his duty. Indeed it may charge him with an added responsibility . . . .” Heddendorf v. Goldfine, 167 F. Supp. 915, 926 (D. Mass. 1958) (citations and emphasis omitted).
B. State Court Judges Should Recognize a Duty to Protect the Interests of Absent Stakeholders in Foreclosure Litigation

In the foreclosure litigation context, the first step is to identify the absent stakeholder. Given the structure of mortgage markets, foreclosure litigation creates a synecdoche of communities; each party stands in for the interests of a larger group. The defaulting borrower indirectly represents the residential neighborhood in which the borrower’s home is situated.\(^\text{187}\) The mortgage servicer more literally stands in for the trustee and investors in mortgage-backed securities.\(^\text{188}\) These represented “communities” are absent from foreclosure litigation and both groups are affected by foreclosure.

While the substantial secondary harms of foreclosure on residential communities and municipalities have been well-documented,\(^\text{189}\) there is a stronger basis for extending judicial protection to absent investors. First, unlike residential communities, investors have an immediate financial stake in the litigation itself.\(^\text{190}\) Second, unlike the relationship between borrowers and residential communities, there is a misalignment of incentives between mortgage servicers and investors regarding the outcome of foreclosure litigation. While borrowers and communities generally share a preference for avoiding foreclosure, mortgage servicers often favor foreclosure even when investors would financially benefit from loan modification.\(^\text{191}\) There is thus a concern that mortgage servicers are inadequately representing investor interests, a misalignment that calls for judicial oversight of the servicer’s behavior in litigation.\(^\text{192}\)

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187. Foreclosure lowers surrounding home values and decreases the municipal tax base, among other ills. See supra note 10 and accompanying text. Foreclosure also reduces the value of mortgage-backed investments when a foreclosure sale nets lower value than would accrue to investors from an affordable loan modification. See supra note 91 and accompanying text.
188. See supra notes 27 and 111 and accompanying text.
189. See, e.g., Immergluck & Smith, supra note 10; Willis, supra note 8.
190. See supra notes 90–91 and accompanying text.
191. See supra Part III.B.1.
1. State Courts Should Extend the Absent Stakeholder Doctrine to the Foreclosure Litigation Context

Despite owning a stake in the outcome of foreclosure litigation, investors are usually absent from the legal proceedings and exercise almost no control over the decision of whether to modify or foreclose upon a particular mortgage. Servicers are employed precisely because remote and dispersed groups of investors are not in a practical position to manage mortgages. Further, as set forth above, mortgage servicers’ financial incentives in relation to foreclosure are different than those of investors. Servicers do not own direct financial interests in the mortgages, only contracts to collect late fees and servicing charges. In most cases, servicers prefer foreclosure to collect immediate returns over modifications that would secure long-term gains for investors. As in other contexts in which courts have employed the absent stakeholder doctrine, foreclosure litigation involves a reason to distrust the representational adequacy of mortgage servicers on behalf of absent investors.

Foreclosure litigation involving securitized mortgages presents a functional scenario substantially similar to class action settlement negotiations. Both foreclosure mediation and class action settlement aim to dispose of cases in lieu of litigation. Both involve decision-making by parties purporting to represent the interests of numerous stakeholders absent from court proceedings. Most importantly, both involve perverse incentives for plaintiffs to choose sub-optimal outcomes for absent stakeholders in pursuit of narrow self-interest. Settling class action plaintiffs have an incentive to collude with defense counsel to secure larger fees at the expense of class interests. Similarly, mortgage servicers have an incentive to foreclose property in pursuit of immediate income irrespective of the financial benefits that would accrue to investors through modification. Without a procedural mechanism to police decision

193. See supra notes 19–27 and accompanying text.
194. See supra Part III.B.1.
195. Servicers sometimes own a residual interest in the trust as a whole, but this interest represents excess payments and is not a significant source of income. See THOMPSON, supra note 111, at 20–21.
196. See supra notes 137–140, 173–182 and accompanying text.
198. See supra notes 173–182 and accompanying text.
199. See Willis, supra note 8, at 1217–22; supra notes 126–128 and accompanying text.
making in foreclosure litigation, servicers will continue to exhibit a foreclosure bias to extract profits at the expense of absent investors’ interests.

2. Extending the Absent Stakeholder Doctrine to Foreclosure Litigation Presents Manageable Challenges

The comparison between class action settlement and foreclosure litigation reveals an important distinction. While the danger to absent class members is that attorneys have an interest in pushing inadequate settlements, the danger in foreclosure litigation is that mortgage servicers will improperly eschew settlement. This has an important consequence for the judge’s role in each case. In the class action context, the judge reserves the power to block the parties’ exit from litigation; in the foreclosure litigation context, the judge would need to block a mortgage servicer’s access to litigation.

However, this distinction is not critical. To the extent that courts take seriously the protection of absent stakeholder interests, it does not matter whether courts are closing procedural doors or refusing to open them. Courts cannot predict the “multifarious means which human ingenuity can devise . . . to gain an advantage over another” and should not excuse deleterious conduct simply because it takes a novel form or would require new procedures to curtail.

Further, judges already enjoy broad discretion in adjudicating foreclosure cases. As discussed above, some courts employ a passive, mechanical approach to foreclosure actions. However, it is important to note that state court judges are not legally bound to this mechanical style. For example, Judge Arthur M. Schack, a self-proclaimed “little guy in Brooklyn,” rejected nearly 50 percent of the foreclosure motions he reviewed over a recent two-year period. Performing his own research on property record databases in search of legal errors and improprieties, Judge Schack’s judicial approach is straightforward: “If you are going to take away someone’s house, everything should be legal and correct . . . . I’m a strange guy—I

201. See supra notes 100–103 and accompanying text.
don’t want to put a family on the street unless it’s legitimate." Judge Schack dismisses cases after searching for and identifying flaws in foreclosure actions sua sponte, even when the borrower fails to respond to foreclosure filings. The contrast between Florida’s “rocket docket” and Judge Schack’s conscientious approach demonstrates that there is no barrier in principle to judges applying the absent stakeholder doctrine to foreclosure litigation. Nor are there significant practical barriers, as mediation programs are already funded and in operation. The only remaining barrier is volitional.

In sum, foreclosure litigation involving securitized mortgages presents conditions ripe for judicial intervention under the aegis of the absent stakeholder doctrine because the primary stakeholders in foreclosure proceedings—investors—are neither present in the court nor adequately represented by mortgage servicers. Even if modification would plainly benefit investors, servicers are presently unrestrained from pursuing foreclosure. Given that the role of servicers within the securitization scheme is to manage mortgages on behalf of investors, this lack of regulation of servicer conduct despite evidence of abuse gives rise to a judicial duty to protect investors’ interests in their absence. Further, discharging this duty need not entail excessive burden on or complication for the courts. Instead, implementing this proposal would likely ease docket congestion, as a substantial number of foreclosure cases would be impeded from proceeding through the foreclosure process.


The previous subsection sought to provide a basic theoretical justification for rigorously policing the foreclosure mediation process, a justification based on the neglected interests of absent stakeholders. This subsection proposes that state courts can narrowly and effectively discharge this duty to protect absent investors by

203. Id.
204. See id.
205. See supra Part III.B.2.
206. It is possible that implementing this doctrine in a consistent manner may require statutory intervention by state legislatures to mandate judicial oversight of the mediation process. However, passing such legislation would likely be much more feasible if particular courts first demonstrate that this approach produces successful results.
utilizing an existing analytical method: Net Present Value (NPV), the current value of a cash-generating investment. To give foreclosure mediation programs sufficient teeth, judges should require servicers to provide a written evaluation and offer sheet presenting an NPV calculation and reasonable workout alternatives for the borrower (or explaining why no such alternatives exist). This will require that the borrower reveal current income information and that the servicer disclose relevant loan documentation, including loan origination documents, complete loan payment history, PSA, and property appraisal. These disclosures will enable the court to determine whether the servicer’s and borrower’s claims in mediation are in good faith. Most importantly, judges should make advancement of cases to foreclosure contingent on the outcome of NPV analysis and satisfaction of disclosure requirements. If the NPV of a modification would exceed the NPV of foreclosure, the servicer should not be permitted to foreclose.

One method of calculating NPV, currently in use by the federal government’s Home Affordable Modification Program (HAMP), involves a two-step approach to determine whether it is in the best interests of investors for a mortgage servicer to modify or foreclose on a particular mortgage. The first step, dubbed the “standard waterfall,” involves arriving at modified loan terms that a

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207. See Investopedia, Net Present Value, http://www.investopedia.com/terms/n/npv.asp (last visited June 4, 2010) (defining NPV as “[t]he difference between the present value of cash inflows and the present value of cash outflows” and explaining that “NPV is used in capital budgeting to analyze the profitability of an investment or project”).


209. See MAKING HOME AFFORDABLE, HOME AFFORDABLE MODIFICATION PROGRAM BASE NET PRESENT VALUE (NPV) MODEL SPECIFICATIONS, https://www.hmpadmin.com/portal/docs/hamp_servicer/npvoverview.pdf (last visited June 4, 2010) [hereinafter HAMP SPECIFICATIONS]. The HAMP program claims that “[w]hen mortgage modifications have a positive NPV, it is in the best interests of lenders, servicers, investors, and borrowers to modify mortgages to reduce the risk of foreclosure.” Id. However, this Article questions the proposition that positive NPV necessarily implies that modification is in the best interests of servicers. See supra Part III.B.1. The securitization industry itself favors the use of NPV analysis to determine the best interests of investors. See WALSH, supra note 137, at 8 & 38 n.25.
defaulting borrower can afford given her current gross income. To arrive at this figure, the model calculates what a borrower can afford based on a 31 percent front-end debt-to-income ratio (DTI), which simply means the percentage of gross monthly income devoted to housing expenses. For example, a person with a $3,225 monthly income can afford to spend roughly $1,000 per month on housing at a 31 percent DTI. Next, the loan is recalibrated by incrementally lowering the interest rate, to as low as 2 percent, until monthly payments on the loan reach the 31 percent DTI figure. If at an interest rate of 2 percent the monthly payment still exceeds the 31 percent DTI, the length of the loan is incrementally increased up to forty years to further lower the monthly payment.

After the standard waterfall produces modified loan terms a borrower can afford, the next step involves calculating the NPV of the affordable modified loan (“modified value”) and comparing it to the likely net recovery from selling the mortgaged property through foreclosure (“foreclosure value”). It is a basic economic principle that cash in hand today is worth more than a promise of future payment. While foreclosure generates immediate income, NPV analysis discounts the value of a modified loan to present value, facilitating a simple comparison between modified value—which is


211. HAMP SPECIFICATIONS, supra note 209, at 2.

212. Front-end DTI is the percentage of income devoted to housing, while back-end DTI is the percentage of income devoted to all outstanding debt. Ronald Law, Note, Preventing Predatory Lending in the California Subprime Mortgage Market, 42 LOY. L.A. L. REV. 529, 542 n.101 (2009). This Article uses “DTI” to refer to front-end DTI.

213. See HAMP SPECIFICATIONS, supra note 209. The monthly payment calculation takes into account loan principal, interest, property taxes, and insurance. WALSH, supra note 137, at 8.


215. HAMP Overview, supra note 214; HAMP MODEL DOCUMENTATION, supra note 210, at 35. If the terms of the loan remain unaffordable even at 2 percent over a forty year term, HAMP guidelines then provide for forbearance of principal to further reduce monthly payments. HAMP Overview, supra note 214; HAMP MODEL DOCUMENTATION, supra note 210, at 35. This Article omits discussion of the forbearance component for the sake of simplicity.

216. See HAMP SPECIFICATIONS, supra note 209, at 2–3.

217. See id. at 4. For example, a $1,050 payment one year from now is worth $1,000 today assuming a 5 percent interest rate. Cash in hand today may also be more valuable than future payment to an entity facing immediate financial distress. See infra text accompanying note 246.
based on future payment—and foreclosure value. The NPV calculation also takes into account other factors, including the likelihood of redefault after modification, the likelihood of cure without modification, the likelihood of borrower prepayment, and financial incentives to modify provided by the government. Additionally, the foreclosure-value calculation takes into account expenses incurred in foreclosing and reselling property, including legal expenses, lost interest over the period between default and foreclosure, property maintenance costs, and resale costs. In sum, these calculations provide a nearly comprehensive cost-benefit analysis of affordable modification versus foreclosure. Moreover, these calculations condense the analysis into a coherent numerical output: modification value and foreclosure value.

Where modification value is equal to or greater than foreclosure value, courts should invoke the duty to protect absent investors by obligating servicers to demonstrate how foreclosure benefits investors, based on a rebuttable presumption that foreclosure is inequitable to investors. To overcome this presumption, servicers must (1) show that the borrower has refused a reasonable modification offer or (2) affirmatively demonstrate to the court that additional factors weigh sufficiently in favor of foreclosure. Absent sufficient rebuttal of pro-modification NPV analysis, courts should not allow servicers to push a case to foreclosure.

One issue that courts may have to address is conflict regarding the terms of modification. Even when NPV favors modification, the borrower and servicer may still disagree about the terms the modification will take. Servicers and borrowers may estimate the borrower’s earning capacity differently and therefore disagree as to what modified terms are required to render the loan affordable. Judges can sidestep this issue by leaving the negotiation to the parties. Judges need only require that the servicer demonstrate that there is no reasonable modification with an NPV greater than foreclosure before allowing the foreclosure to proceed. If the servicer cannot overcome this burden, then it will be forced to negotiate with

218. See HAMP SPECIFICATIONS, supra note 209, at 4.
219. Id. at 2–3; HAMP MODEL DOCUMENTATION, supra note 210, at 9–18.
220. HAMP SPECIFICATIONS, supra note 209, at 3.
the borrower. Likewise, a borrower will risk foreclosure by refusing to accept a reasonable modification offer.

State courts have generally failed to require mortgage servicers to demonstrate the objective basis for their litigation decisions. However, implementing such a requirement would involve little more than importing the traditional judicial function of protecting the interests of absent stakeholders into the context of foreclosure on securitized mortgages.221 Judges need not invent new doctrine, they need merely apply doctrine that is already widely recognized and established. Moreover, in the HAMP NPV calculation, judges have a widely used, preexisting method of objective analysis to implement this doctrine effectively, narrowly, and consistently.

C. Caveats and Responses to Counterarguments

This proposal’s focus on absent stakeholders limits its applicability to cases in which mortgages have been securitized and sold to investors. In cases where the mortgage servicer is a subsidiary of the same financial institution that owns the mortgage, there is no absent stakeholder in need of protection; the mortgage servicer is institutionally identical to the investor.222 Further, this proposal will likely be useful only in a housing market affected by a macroshock that has severely depressed housing prices.223 In a stable housing market, there are instances in which the disparity between modification value and foreclosure value weighs so heavily in favor of modification because the value of mortgage debt generally corresponds to the value the mortgage holder can recover through a foreclosure sale.

Beyond these qualifications, some analysts question the empirical accuracy of data indicating huge losses to investors from foreclosure and argue that additional economic factors bring investors’ interests into alignment with servicers’ foreclosure bias.

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221. In most (but not all) cases, the mortgage servicer does not represent its own interest in the mortgage. This Article focuses on securitized mortgages in which the mortgage holder is a trustee to a diverse set of investors absent from the litigation. Where a mortgage servicer is also the mortgage holder, then an absent-stakeholder analysis would not apply.

222. However, about 90 percent of mortgages originated in recent years have been securitized. Gelpenr & Levitin, supra note 24, at 1081.

223. See Piskorski et al., supra note 113, at 12, 31 (noting that macro shocks to the housing market create value for investors in modification and that the erosion of housing prices prevents borrowers from avoiding foreclosure through refinancing).
Since this Article’s proposal relies on empirical indications that servicers are neglecting investors’ best economic interests, it is necessary to consider and respond to these criticisms.

1. What If Foreclosure—Not Modification—is in the Best Interests of Investors?

In a pair of recent studies, Kristopher Gerardi, Paul Willen, Christopher Foote, and Lorenz Goette ("Gerardi and Willen")\(^\text{224}\) argue that servicers rarely modify mortgages because the costs of modification are higher, and the benefits smaller, than other analysts have assumed.\(^\text{225}\) Gerardi and Willen admit that mass modification may be in the best interests of society in general, but specifically questions whether it is in the best interests of investors.\(^\text{226}\) To this end, Gerardi and Willen compare modification rates between securitized mortgages, which are mostly managed by mortgage servicers, and mortgages held in portfolio,\(^\text{227}\) which are owned by investment banks rather than securitized and sold on the secondary market.\(^\text{228}\)

Gerardi and Willen’s hypothesis is that modification should occur at noticeably higher rates among mortgages held in portfolio if indeed modifications are in the best interests of investors.\(^\text{229}\) Instead, Gerardi and Willen find that modification occurs at a slightly but not substantially higher rate for mortgages held in portfolio compared to mortgages that have been securitized.\(^\text{230}\) Gerardi and Willen conclude that this casts serious doubt on the proposition that investors’ best interests are served by modification.\(^\text{231}\)

Gerardi and Willen suggest that hesitation to modify may simply be due to the fact that, in the aggregate, modification entails greater losses than foreclosure.\(^\text{232}\) According to Gerardi and Willen, two

\(^{224}\) Adelino et al., supra note 129; Foote et al., supra note 27. This nomenclature is adopted for ease of reference and because Kristopher Girardi and Paul Willen co-authored both studies.

\(^{225}\) Adelino et al., supra note 129, at 2–8; Foote et al., supra note 27, at 1–3.

\(^{226}\) See Foote et al., supra note 27, at 2–3.

\(^{227}\) Id. at 27–32.


\(^{229}\) See Foote et al., supra note 27, at 27.

\(^{230}\) Id. at 30, 48 tbl.8.

\(^{231}\) Id. at 34–35.

\(^{232}\) Id. at 24–25.
hidden costs may weigh against modification and in favor of foreclosure.\textsuperscript{233} First, modification may superfluously reduce loan value in a percentage of cases. Up to 30 percent of borrowers in default, according to Gerardi and Willen, bring their loans current prior to foreclosure without modification.\textsuperscript{234} Modification involves a "self-cure risk"\textsuperscript{235} by providing a discount to borrowers who might find ways to afford their original, non-discounted loans.

Second, Gerardi and Willen argue that risk of borrower redefault after modification makes modification more costly than many assume.\textsuperscript{236} If a borrower in default receives a modification but defaults again six months later, investors may recover less from the ultimate foreclosure. General housing prices may have fallen further and the borrower, anticipating redefault, may not have been motivated to maintain the property.\textsuperscript{237} To bolster this interpretation of the data, Gerardi and Willen calculate that investor losses on foreclosed mortgage-backed securities relative to affordable modification total as much as $180 billion.\textsuperscript{238} Gerardi and Willen are skeptical that rational investors would passively accept such massive losses and therefore conclude that other analysts must be overlooking additional factors that reduce the benefits of modification.\textsuperscript{239}

Gerardi and Willen’s theoretical observations merit consideration in the debate about the efficacy of mortgage modification in mitigating the foreclosure crisis. Because state courts would run a cost-benefit analysis on a case-by-case basis, however, it is irrelevant whether modification is more or less expensive to investors than foreclosure \textit{on average}. Courts should permit foreclosure litigation when the NPV calculation shows that it is in the best interests of investors. From the perspective of state courts, Gerardi and Willen’s hypotheses therefore amount to little more than a prediction about the number of foreclosures courts will identify as

\begin{itemize}
  \item \textsuperscript{233} See Adelino et al., supra note 129, at 7.
  \item \textsuperscript{234} Id.
  \item \textsuperscript{235} Id.
  \item \textsuperscript{236} See id. at 19. According to Gerardi and Willen, the redefault rate is between 20 and 50 percent. Id.
  \item \textsuperscript{237} Id. at 7.
  \item \textsuperscript{238} Foote et al., supra note 27, at 23. This estimation is based on an assumption that approximately 1.5 million foreclosures can be prevented through modification and that each preventable foreclosure produces a $120,000 loss to investors. Id.
  \item \textsuperscript{239} See id. at 2.
\end{itemize}
being against the best interests of investors. Further, there are reasons to question the extent to which self-cure risk and redefault risk influence the cost-benefit analysis of modification for investors.

First, as Gerardi and Willen acknowledge, most modifications do not reduce principal.\footnote{Id. at 28.} In fact, most modifications increase principal because arrears are recalculated into the mortgage debt.\footnote{Id.; see also White, supra note 28, at 1114.} If most modifications do not reduce loan principal, then the risk of self-cure is illusory—borrowers will pay no less for the loan than they would have otherwise.\footnote{See White, supra note 28, at 1114. Some modifications involve a minor reduction in interest rate to offset monthly payment increases caused by capitalization of arrears. See id. at 1116–17.} Further, Gerardi and Willen do not adequately address the possibility that borrowers who self-cure are themselves at risk of redefault. All else being equal, the probability of redefault for a borrower who receives a modification is a fortiori the same or greater for a borrower who self-cures without the benefit of modified loan terms. Gerardi and Willen’s methodology implicitly suggests this point. Gerardi and Willen define “cure” as a loan that is “either current, 30-days delinquent, or prepaid after 12 months following the first 60-day delinquency.”\footnote{Adelino et al., supra note 129, at 19.} Under Gerardi and Willen’s formulation, a loan is considered “cured” even if it is currently thirty days delinquent. Self-cure risk is nonexistent if a borrower “cures” only to redefault because the loan is unaffordable without modification. The alleged benefits to investors of avoiding self-cure risk are therefore partially canceled out. Also, Gerardi and Willen’s data is not based on modifications made according to the HAMP waterfall or similar formula.

Second, the risks of redefault and self-cure are already factored into NPV calculations as currently formulated under HAMP guidelines.\footnote{See HAMP MODEL DOCUMENTATION, supra note 210, at 5, 15. Gerardi and Willen acknowledge that many proponents of aggressive modification schemes already factor in redefault risk. Adelino et al., supra note 129, at 7 n.9.} Assuming that foreclosure value and modification value are otherwise equivalent in a particular borrower’s case, factoring in redefault risk and self-cure risk will tilt the NPV calculation to favor foreclosure, not modification. The NPV calculation therefore contains and minimizes the risks to investors of
self-cure and redefault, even if it does not eliminate these risks completely.

Third, to run Gerardi and Willen's theoretical assumptions in reverse, for foreclosure to be preferable to modification in the aggregate, the risk of self-cure and redefault must be so great as to exceed the roughly $180 billion in losses investors purportedly stand to lose from foreclosure relative to modification. Unfortunately, Gerardi and Willen do not provide direct empirical data on the costs of redefault and self-cure, so it is difficult to determine how heavily these factors weigh in a cost-benefit analysis.

Finally, Gerardi and Willen's conclusion is partly based on the finding that lenders who hold mortgages in portfolio do not modify at a substantially higher rate than servicers of securitized mortgages. Gerardi and Willen argue that this may be explained by the fact that investors crave liquidity: "[I]nvestors, especially in a time when liquidity is highly valued, may be less patient than society as a whole, and therefore foreclose when society would prefer renegotiation." In other words, if an investor faces financial difficulty or could put cash to immediate use in other opportunities, then it makes sense to prefer foreclosure despite losses relative to modification because foreclosure will free up cash immediately.

However, it is unclear that foreclosure provides the same short-term liquidity benefits to securities investors as it does to lending institutions holding mortgages in portfolio. For an institution holding a mortgage portfolio, liquidation requires foreclosure or assignment of the mortgage. For an individual investor, liquidation only requires selling her securities. It is therefore possible that the similarity in modification rates between servicers of securitized mortgages and lenders holding mortgages in portfolio is coincidental. Lenders with portfolios may prefer foreclosure to access liquidity, while investors in mortgage-backed securities may prefer modification yet be stymied by servicers.

Furthermore, the results of studies on the existence and magnitude of servicer foreclosure bias are equivocal. In a separate study using the same mortgage data set, Tomasz Piskorski, Amit

245. See Adelino et al., supra note 129, at 14; Foote et al., supra note 27, at 30, 48 tbl.8.
246. Adelino et al., supra note 129, at 8.
Seru, and Vikrant Vig ("Piskorski, Seru, and Vig") reach a different conclusion than Gerardi and Willen about servicer foreclosure bias.\(^{248}\) Critically, Piskorski, Seru, and Vig strate analysis of the data according to initial borrower creditworthiness.\(^{249}\) Thus, while Piskorski, Seru, and Vig find no consistent differences in foreclosure rates between portfolio loans and securitized loans for loans with the worst initial credit quality, portfolio loans of medium and highest credit quality suffered foreclosure rates 7.4 percent and 9.2 percent lower, respectively, than securitized loans.\(^{250}\)

In addition, Piskorski, Seru, and Vig find that bank-held loans were subject to much more aggressive forms of modification with lower rates of redefault.\(^{251}\) During the first quarter of 2009, the ratio of portfolio loan to securitized loan modifications with principal write-downs was more than one thousand to one,\(^{252}\) indicating that portfolio lenders perceive investment value in modification that servicers of securitized mortgages do not.\(^{253}\) Interpreting these findings, Piskorski, Seru, and Vig conclude that "securitization has imposed renegotiation frictions that have resulted in a higher foreclosure rate than would be desired by investors," and that "some investors could have benefited if their loans were serviced similarly to portfolio loans."\(^{254}\) These results are significant because the majority of recent foreclosure starts\(^{255}\) and completed sales involved medium-credit-quality Alt-A loans and high-quality prime loans, likely due to record rates of unemployment.\(^{256}\) The Piskorski, Seru, and Vig study thus lends empirical support to the existence of

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248. Id.
249. Id. at 3.
250. Id. at 16–17.
251. Id. at 28 & n.44.
252. See id. (noting that data on Q1 of 2009 indicates that portfolio lenders wrote down principal in more than 3,300 mortgages, while servicers of securitized loans wrote down principal for only three mortgages).
253. See id. at 30.
255. "Foreclosure start" refers to a loan entering the foreclosure process and typically includes loans that have been delinquent for more than ninety days. See Shane M. Sherlund, Bd. of Governors of the Fed. Reserve Sys., Mortgage Defaults 6 (2010), available at http://www.chicagofed.org/digital_assets/others/in_focus/foreclosure_resource_center/more_mortgage_defaults.pdf.
256. See supra notes 42–44 and accompanying text.
servicer foreclosure bias and indicates that overcoming servicer bias has the potential to avert substantial economic harm to investors.

Even assuming that risk of redefault and self-cure substantially reduce modification value to investors, as Gerardi and Willen claim, courts protecting absent investors should simply adjust NPV calculations accordingly. If Gerardi and Willen are right and the number of cases in which NPV calculations favor modification is small, then implementing a judicial duty to protect absent investors would impose some unnecessary administrative burdens on courts and litigants. However, if Gerardi and Willen’s predictions are incorrect and the number of cases in which modification would benefit investors is large, then this Article’s proposal has the potential to prevent massive economic waste, ease foreclosure dockets, and mitigate the foreclosure crisis. On balance, these potential benefits outweigh modestly higher administrative costs.

2. If Modification Is in the Best Interests of Investors, Why Have More Investors Not Filed Lawsuits Against Mortgage Servicers to Compel Modification?

As mentioned supra, the failure to prevent foreclosure through affordable modification threatens investors in mortgage-backed securities with a total economic loss of $180 billion.257 Given this massive loss figure, it seems natural to assume that investors would be flooding courts to compel servicers to modify more mortgages. Yet there has been almost no such litigation.258 Gerardi and Willen imply that the absence of investor-servicer litigation is circumstantial evidence that modification is not in the best interests of investors because rational investors faced with these massive losses would take action to avoid this sub-optimal outcome.259

While it is worth investigating, the lack of investor-servicer litigation is insufficient by itself to support the inference that

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257. See Foote et al., supra note 27, at 23. This estimation is based on an assumption that approximately 1.5 million foreclosures can be prevented through modification, and that each preventable foreclosure produces a $120,000 loss to investors. Id.

258. See Adelino et al., supra note 129, at 4 (noting that “of the more than 800 lawsuits filed by investors in subprime mortgages through the end of 2008, not one involved the right of a servicer to modify a loan”).

259. See Foote et al., supra note 27, at 23–24.
benefit not of Removing interests investors the difficult further securitization others has leading individual investors number litigation any against servicer. Moreover, the absence of investor-servicer litigation is ambiguous. Gerardi and Willen interpret the ambiguity to mean that investors prefer foreclosure and are silently but attentively allowing servicers to pursue foreclosure on investors' behalf. Alternatively, the absence of litigation could imply that servicers are successfully exploiting the fact that investors are not well positioned to evaluate and challenge servicer behavior.

Servicers are necessary in the mortgage securitization process precisely because disconnected investors are unable to collectively manage mortgages. Investor dispersion thus creates a collective action problem with respect to initiating litigation against a mortgage servicer. Assuming arguendo that investors in a mortgage pool would benefit in the aggregate from legal action, the cost of litigation against a servicer who pursued modification would likely outweigh any benefits for an individual investor. No single investor would find litigation worthwhile without collective action and funding by a large number of investors. Coordinating collective action among investors involves a prohibitive cost-allocation problem. No individual investor is likely to shoulder the costs of organizing and leading a cohort of investors in litigation. The fact that modification has the effect of benefiting some tranches of investors while costing others diminishes the pool of investors available for recruitment. Re-securitization adds an additional layer of investor diffusion and further complicates coordination. Rather than grapple with these difficult and costly obstacles in pursuit of uncertain gains in

260. Without more, this argument is circular. The argument asserts that modification is not in the best interests of investors because investors have not sued to compel modification, and that investors have not sued servicers to compel modification because modification is not in the best interests of investors.


262. See supra notes 26–27, 111 and accompanying text.

263. One exception to this might be when one investor owns a disproportionately large share of the securities in a mortgage pool. In such a case, it is plausible that the cost of litigating would not outweigh potential gains to the individual investor.

264. See supra note 25 and accompanying text.
litigation, investors dissatisfied with the performance of their securities are likely to consider a much simpler set of options: accept losses as part of the risk inherent in investing, or sell the securities to someone else.

V. CONCLUSION

State courts did not cause the foreclosure crisis, nor do they possess a cure for all the foreclosure problems currently afflicting the mortgage lending system. However, at critical points in the foreclosure process, state courts can channel foreclosure cases into modification. This Article has sought to demonstrate how existing state foreclosure laws facilitate servicers’ foreclosure bias, even when economically wasteful to investors and society generally. In response to these problems, this Article has articulated a normative basis for state court intervention that is procedurally feasible: courts should take advantage of existing mediation programs and NPV analyses to require servicers to prove that foreclosure is in the best interests of securities investors—absent stakeholders—before permitting foreclosure to proceed.