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Chinese Mortgage Law: An American Perspective

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Recommended Citation

Dale A. Whitman, Chinese Mortgage Law: An American Perspective, 15 Colum. J. Asian L. 35 (2001)

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CHINESE MORTGAGE LAW: AN AMERICAN PERSPECTIVE

DALE A. WHITMAN*

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The task of creating a system of law for real estate security interests is a daunting one – and all the more so if it must be done very quickly. The law of mortgages that prevails in the United States, the United Kingdom, and the other nations whose legal systems were derived from England has had the luxury of some 600 years of development.¹ By contrast, the People’s Republic of China had little privately-owned real property, and hence little need for a law of real estate security, until 1988. From that time to the present, the Chinese government has been aggressively building a system of real estate finance that can support private ownership of property.

In general, this effort has been remarkably successful and stands as a great compliment to its drafters. Loans on the security of houses, apartments, and commercial land and buildings are made every day, and without doubt have contributed vastly to the economic development of China during the past decade. At the same time, however, Chinese mortgage law has a number of serious problems – features which are either uncertain in operation, or which are unnecessary stumbling blocks to the smooth and efficient functioning of the market in real estate financing.

This statement should not be taken as unduly critical of the system’s designers. To a great extent, the same could be said of real estate finance law in the United States: that despite more than two centuries of development here and four more in England, it continues to exhibit some uncertainty and to impose some unnecessary barriers to the flow of capital. The fact that the designers of the Chinese system could achieve what they have in little more than a decade is impressive indeed.

My objective in this paper is to compare and to evaluate some of the features of the American and Chinese systems. I do so without any preconception that the American system provides better answers, but with the recognition that it is far more mature and provides more answers. Hence it provides a reference point from which the Chinese system can be considered. Perhaps each system has something to teach the other.²

1. The origins of English mortgage law date to the 14th and 15th centuries. See Grant S. Nelson & Dale A. Whitman, *REAL ESTATE FINANCE LAW* § 1.2 (3d ed. 1994) (hereafter cited “Nelson & Whitman”); George S. Osborne, *MORTGAGES* § 6 (2d ed. 1970).

2. Because I do not read Chinese, I have necessarily relied on translations and secondary sources for information about the laws of the People’s Republic. Fortunately, an excellent book on the subject, authored by Professor Patrick A. Randolph of the University of Missouri-Kansas City and Professor Lou Jianbo of Beijing University, has recently been published: Patrick A. Randolph & Lou Jianbo, *CHINESE REAL ESTATE LAW* (2000) [hereafter referred to as “Randolph & Lou”]. Much of the understanding of Chinese law reflected in this paper is traceable to the work Randolph and Lou. An earlier version of the authors’ work in this area is Patrick A. Randolph & Lou Jianbo, *Chinese Real Estate Mortgage Law*, 8 PAC. RIM L. & POL’Y. J. 515 (1999). I have also relied on

I. INTRODUCTION TO CHINESE REAL ESTATE LAW

Before turning to mortgage law issues, a brief summary of land ownership rights in China may be helpful. After the People's Republic of China was established in 1949, the government imposed several waves of confiscation of land, including that of "counter-revolutionaries," land formerly owned by the Kuo Minh Tang government, property of large landlords, foreign capitalists, and subsequently most urban residential property and rural agricultural land.³ Despite the Marxist theory that was used to justify these confiscations, and that holds that all land is ultimately owned by the state, individuals and families, especially in rural areas, were acquiring land rights as early as the mid-1950s.⁴

State policy toward individual ownership of land use rights has fluctuated widely during the half century since the revolution, sometimes favoring individual ownership and sometimes moving in the direction of ownership by agricultural and housing collectives controlled by the state.⁵ Prior to 1987, the land rights "allocated" (a technical term) to private individuals involved rather meager legal benefits. Commencing in 1987, and confirmed by constitutional amendment in 1988⁶ and by statutory amendment in 1990,⁷ the Chinese government began "granting" land use rights to private owners, although "allocations" continue to occur as well, primarily with respect to property intended for state, collective, or public use. The clear trend since 1987 has been toward private ownership to use rights in land.

Thus at present both allocated and granted land use rights exist widely in China. The differences between the two categories are extremely significant.⁸ Allocated rights are typically issued at no cost, or only at nominal cost, to the recipient. They have no definite term, and hence are subject to revocation without compensation. The holder of an allocated right is required to use the land only for stated narrow, specific

Andrew J. Godwin, *THE THEORY UNDERPINNING THE DEVELOPMENT OF MORTGAGE LAW IN CHINA* (2000) (Unpublished Master of Laws Thesis, University of Melbourne) [hereafter referred to as "Godwin"].

3. Randolph & Lou, *supra* note 2, at 14-16.

4. See Kate Xiao Zhou, *HOW THE FARMERS CHANGED CHINA: POWER OF THE PEOPLE* (1996) at 46, describing the advent of *baochan daohu*, the turning of agricultural production over to individual households, which began in the mid-1950s and has proceeded at a steady pace since the late 1970s.

5. Godwin, *supra* note 2, at 17-22.

6. P.R.C. Constitution (1982) (Amend. to Art. 10, 1988)

7. 1990 Interim Provisions for the Granting and Transfer of Land Use Rights on State Owned Urban Land in Cities and Towns (1990). See Randolph & Lou, *supra* note 2, at 19.

8. See Randolph & Lou, *supra* note 2, at 85-99.

purposes. The right cannot be transferred except at the discretion of the state, and cannot be leased to a tenant (although buildings constructed by the holder of the right are considered to belong to the right-holder and can be leased). Allocated rights can be mortgaged (somewhat illogically, since they cannot be transferred as of right), but there is a risk that the government will refuse to approve the transfer that results from a foreclosure of the mortgage. The mortgagee might apply for conversion of the allocated right to a granted right at the time of foreclosure, but the state may demand a substantial payment for the conversion. Thus, lending on the security of an allocated land use right is a perilous business.

By comparison, granted land use rights have specific, limited terms – commonly from 30 to a maximum of 70 years. The grantee pays a negotiated price that is ordinarily quite substantial. The granted rights are limited in terms of use, but typically only in broad terms, similar to those of a zoning ordinance in the United States. The granted right can be transferred, leased, and mortgaged without state approval. If the right is revoked, the holder is entitled to compensation. Hence in many respects, a granted land use right is analogous to a long term ground lease in English and American practice. However, it is technically not a lease, and landlord-tenant law is not applicable.

There is a general expectation that granted land use rights will be renewed upon their expiration. Existing law guarantees renewal except when it would be contrary to the “public interest.”⁹ However, there is no certainty as to the interpretation of that phrase. Moreover, a renewal of a granted right will require the holder to enter into a new contract with the land administration and pay a new fee – which presumably will be based on the then-current value of the land (although not the buildings constructed by the right-holder, which are considered to be separate property and to be owned by the right-holder). Thus renewal may be costly, and may not be economically attractive in some cases.¹⁰

Within a few years after the 1988 legal changes mentioned above were made, a thriving private real estate development industry developed in China, but much of the early development occurred without mortgage financing. Instead, many projects were financed by equity investment, both by Chinese and offshore (mainly Asian) investors. Chinese lenders were (and to some extent remain) distrustful of mortgage security, in large part because of legal uncertainties and a lack of confidence that the theoretical remedies against mortgaged land would be made available in

9. Urban Real Estate Administration Law, Section 21.

10. Randolph & Lou, *supra* note 2, at 128-128.

practice. For this reason, mortgage finance and mortgage law have expanded more slowly than private ownership and land development in China.¹¹

While granted land use rights plainly fall short of “fee simple absolute” ownership as is common in the United States,¹² they nonetheless have very substantial value, and thus far have been regarded by mortgage lenders as tantamount to outright ownership. Allocated rights are understandably far less attractive as security, and are generally employed today only for property intended for public or state use. But even granted land use rights have limitations as security for credit. Obviously no astute mortgage lender would be willing to make a loan secured by a granted land use right for a term exceeding the duration of the right itself. Moreover, as granted rights begin to approach the end of their terms, it may be that their market value will begin to decline, perhaps precipitously, much in the same way that the value of ground-leased property declines in England and America as its termination date approaches.¹³ But since this will not occur with respect to any granted rights in China for a number of years, and will obviously depend on the policies followed by the Chinese government at that time, predictions about it are necessarily speculative. In the meantime, granted land use rights have characteristics sufficiently similar to outright ownership in the West that a comparison of mortgage law in the Chinese and American systems is a sensible and useful exercise.

To compare all aspects of American and Chinese real estate finance law would require a book, not merely an article. To keep this paper of manageable size, I have limited it to three areas of mortgage law, all of them extremely important. I discuss (1) transfers of mortgaged real

11. Randolph & Lou, *supra* note 2, at 19-23.

12. While residents of the United States or England might feel uncomfortable with ownership that is less than absolute, there is ample precedent and cultural acceptance of it in China. See Jonathan D. Spence, *THE SEARCH FOR MODERN CHINA* (1990) at 14, describing the development of a variety of forms of limited ownership of land during the Ming Dynasty, ca. 1600, as a response to taxes imposed on the transfer of absolute ownership.

13. See, e.g., Schulem B. Association, *In re Appeal from a Decision of the Leasehold Valuation Tribunal for the London Rent Assessment Panel* (2000) <http://www.courtservice.gov.uk/tribunals/lands/decisions/dec_lra_47_00.htm>. The Leasehold Valuation Tribunal hears disputes concerning the value that tenants must pay a landlord when acquiring the reversion, a transaction in which London tenants are entitled to engage as a matter of right under certain conditions. See *Should I Buy My Lease?* <<http://www.thisismoney.com/undated/mh120.htm>>; Department of the Environment, *Transport and the Regions, Leasehold Flats* <<http://www.housing.dtlr.gov.uk/order/flats>> (last visited Nov.20, 2001). With respect to Hawaiian ground leases, see Del Osman Realty, *Hawaii Real Estate Issues: Leasehold Ownership in Hawaii* <<http://www.osman1.com/leashold.html>> (last visited Nov.20, 2001). Both English and Hawaiian practice (as well as Japan, Hong Kong, and China) are discussed in *The Second Annual International Land Policy Forum, LAND: POSSESSION TO UTILIZATION, FIXED TERM GROUND LEASE AND LAND USAGE*, NATIONAL LAND AGENCY OF JAPAN (1995).

estate, (2) transfers of mortgages and associated debt instruments (typically promissory notes in the United States); and (3) foreclosure of mortgages.

II. TRANSFERS OF MORTGAGED REAL ESTATE

When real estate that is subject to a mortgage is sold or otherwise transferred, what is the mortgage's effect on the transfer? Under American law, there are three possibilities.¹⁴ The first (and doubtless most frequent in practice) is that the mortgage debt will be paid in full. The source of the funds for payment is usually the sale price, and the payment itself is usually made directly by the escrow company, attorney, or other "closing agent" who handles the mechanics of the sale transaction. The closing agent is thus able to obtain from the mortgage lender a document (usually termed a "release," a "satisfaction," or a "reconveyance" of the mortgage) that will be recorded in the public records, evidencing that the mortgage no longer affects title to the land. This, in turn, permits the closing agent to authorize the issuance of a title insurance policy, an attorney's opinion of title, or other title evidence showing that the land is passing to the purchaser free of encumbrance by the mortgage.

From the mortgage lender's viewpoint, this form of transfer brings the mortgage relationship to an end. The lender's consent to the transfer is usually unnecessary and will not be sought. The person who is acquiring the real estate may pay cash for it. If that person needs financing to complete the purchase, she or he may obtain a new mortgage loan from the same or a different lender. In all events, the old lender has no interest in the identity or qualifications of the transferee as such. The capital that was originally lent is now returned to the lender, which may use the funds for other loans.

Since the mortgage loan is likely to be for a long term, and the sale of the property is likely to precede the end of that term, the transfer of the real estate usually results in a prepayment of the mortgage debt – that is, a payment prior to the debt's scheduled maturity. Depending on the terms of the original mortgage, this may or may not actuate the obligation by the borrower to pay a "prepayment fee" to the lender.¹⁵ In one circumstance it may be impossible to complete the sale of the real

14. See Nelson & Whitman, *supra* note 1, at § 5.2. Other classic discussions are Storke and Sears, *Transfer of Mortgaged Property*, 38 CORN. L. Q. 185, 187 (1953); Cunningham and Tischler, *Transfer of the Real Estate Mortgagor's Interest*, 27 RUTGERS L. REV. 24 (1973).

15. If the loan documents contain a provision requiring a prepayment fee, such a fee is generally enforceable. See generally Dale A. Whitman, *Mortgage Prepayment Clauses: An Economic and Legal Analysis*, 40 U.C.L.A. L. REV. 851 (1993).

estate as outlined above. That is the situation in which the existing mortgage loan's documents provide that it cannot be prepaid. Such a loan is sometimes referred to as being "locked in." American courts routinely enforce this sort of "lock-in" clause if the lender refuses to accept the payoff.¹⁶

A second mode by which mortgaged real estate may be transferred involves an agreement by the buyer and seller that the mortgage loan will not be paid off, but will be left in place and will continue to encumber the real estate. The buyer will take over payment of the (usually monthly) installments owing on the debt, and will eventually pay it off in full in the normal course of events or prepay it at some future date.

In this form of transaction, a number of important questions arise. First, is the mortgage lender's consent necessary in order to complete the sale? In modern American law, the answer is nearly always yes, although it depends on the provisions of the mortgage and the promissory note or other obligation that the mortgage secures. Almost without exception modern mortgages in the United States contain "due on sale" clauses. Such a clause authorizes the lender to demand that the loan be paid in full when the real estate is sold.¹⁷ By virtue of a federal statute enacted in 1982, due-on-sale clauses are enforceable by lenders despite the existence of any contrary state law.¹⁸ Hence, if such a clause is present, the lender has the choice of whether to permit the sale to go forward, or to insist that the loan be paid off instead.

On what basis does the lender make this choice? First, the lender will invariably examine the proposed transferee's credit-worthiness and ability to pay the required installments. Credit ratings, based on the individual debtor's prior history of payment of her or his obligations, are supplied by a number of national and regional credit reporting agencies in the United States. The lender will obtain and review a report from one or more of them, and may reject the proposed transferee if her or his

16. *Id. See Prudential Insurance Co. v. Rand & Reed Powers Partnership*, 141 F.3d 834 (8th Cir. 1998); *Trident Center v. Connecticut Gen. Life Ins. Co.*, 847 F.2d 564 (9th Cir. 1988); *Rivertidge Associates v. Metropolitan Life Ins. Co.*, 774 F. Supp. 892 (D.N.J. 1991); *Clover Square Assoc. v. Northwestern Mut. Life Ins. Co.*, 674 F. Supp. 1137 (D.N.J. 1987); *Gutzi Associates v. Switzer*, 215 Cal. App. 3d 1636, 264 Cal. Rptr. 538 (1989); Nelson & Whitman, *supra* note 1, at § 6.2.

17. A typical clause reads as follows: "If all or any part of the Property or any Interest in the Property is sold or transferred * * * without Lender's prior written consent, Lender may require immediate payment in full of all sums secured by this Security Instrument."

18. Garn-St. Germain Depository Institutions Act of 1982 at § 341, 12 U.S.C.A. § 1701j-3; 12 C.F.R. § 591.2 (regulations of Office of Thrift Supervision). See generally Grant S. Nelson and Dale A. Whitman, *Congressional Preemption of Mortgage Due-on-Sale Law: An Analysis of the Garn-St. Germain Act*, 35 HASTINGS. L. J. 241 (1983); Nelson & Whitman, *supra* note 1, at §§ 5.22-5.26.

payment history is judged inadequate. Second, the lender will require submission of “underwriting” data – for example, information about the proposed transferee’s income and the type and duration of her or his present employment. This will allow the lender to make a judgment about whether the transferee represents an acceptable risk as a borrower.

Even if this credit, income, and employment information is deemed satisfactory, the lender may have another reason for refusing to permit the transferee to take over payment of the mortgage loan. If current market interest rates are significantly higher than the rate on the mortgage loan, the lender may demand that the loan’s rate be increased to a level approximating market rates, and may refuse to consent to the transfer if the transferee is unwilling to agree to the increase. The rate increase may be reflected in higher monthly payments or in the form of a lump sum “assumption fee” to be paid to the lender at the time of the transfer; the economic effect is substantially the same.

This latter objective of the due-on-sale clause – to ensure that the loan’s interest rate can be adjusted at the time the property is transferred, in order to approximate the higher rates prevailing in the current mortgage market at that time – is of far less importance to the lender if the original mortgage loan was based on an adjustable interest rate. In the United States, the proportion of single-family residential loans that have adjustable rates has varied over time, ranging from as little as 12 percent to more than 60 percent of all such loans.¹⁹ Mortgage loans on commercial property are much more likely to have adjustable rates. If the loan’s rate is adjustable, it will presumably be adjusted in fact in a manner that will keep it close to market rates. Of course, the approximation will be imperfect, since the loan’s rate will adjust only at specific intervals (e.g., perhaps once each year), and perhaps only subject to a stated ceiling or limitation (e.g., not more than 2 percent increase in any one year), while market rates will fluctuate constantly. Nonetheless, the approximation may be close enough that the lender considers the further “fine tuning” that is possible under the due-on-sale clause when the property is sold to be unnecessary.²⁰ The effect is to limit the lender to

19. During the period 1980 to 1999, the lowest ARM market share of home mortgages was 12% in 1998; the highest was 62% in 1984. See Mortgage Bankers Ass’n, *1-4-family Loan Originations* (2001) <<http://www.mbaa.org/marketdata>> (last visited Nov.20, 2001).

20. This is, in effect, the position of the two largest federally-sponsored secondary mortgage market purchasing entities, Fannie Mae and the Federal Home Loan Mortgage Corporation. Their standard adjustable-rate promissory note form for one-to-four-family residential loans contains the usual due-on-sale language, but adds to it the following provision:

“Lender also shall not exercise this option [to demand payment upon sale of the property] if:
(a) Borrower causes to be submitted to Lender information required by Lender to evaluate the intended transferee as if a new loan were being made to the transferee; and (b) Lender reasonably

demanding payment only if the proposed purchaser's credit or income is unacceptable, and not to permit the lender to demand payment because market interest rates have risen since the loan was made.

There is a third mode in which sales of mortgaged property can occur in the United States, but it is relatively unimportant and need detain us only briefly.²¹ In this mode, the borrower pays the full agreed price for the property in cash, but the seller does not pay off and discharge the existing mortgage. Instead, the seller agrees (at least implicitly) to continue making the required payments on the mortgage debt in the ordinary course, and thus to retire it only when it reaches its scheduled maturity. The risks of this approach to the buyer are obvious. If the seller fails to make the payments and becomes insolvent, the buyer, who has already paid for the property in full, may now be required to pay the remaining balance owing on the mortgage loan in order to clear the property's title of the mortgage encumbrance. Sophisticated real estate purchasers almost never agree to buy under these conditions.²² This approach is sometimes used by less-reputable sellers of land, especially subdivisions in remote locations that are marketed with "high pressure" sales tactics. But it is not very important in the overall scheme of real estate sale financing in the United States.

Let us return to the second mode of sale discussed above, in which the buyer takes over the payment of the installments owing on the existing mortgage. Two questions arise: does the purchaser become personally liable on the mortgage debt? And does the seller remain liable? These questions have meaning because in most American states,²³

determines that Lender's security will not be impaired by the loan assumption and that the risk of a breach of any covenant or agreement in this Security Instrument is acceptable to Lender."

The effect is to limit the lender to demanding payment only if the proposed purchaser's credit or income is unacceptable, and not to permit the lender to demand payment because market interest rates have risen since the loan was made.

21. See Nelson & Whitman, *supra* note 1, at § 5.2.

22. A variation of the scheme described in the text is the "wrap-around sale," in which the buyer does not pay all cash for the property, but instead enters into a note or contract agreeing to pay the purchase price over time. In this setting the seller will typically receive a payment each month from the buyer, and will also make a payment each month on the underlying loan. This method of sale is also risky to the buyer for the reason mentioned in the text, but at least has the advantage that the buyer has not invested the entire value of the property at the outset. In "wrap-around" transactions, wise buyers take precautions to ensure that, when they make their payments to the seller, the seller's corresponding payments on the underlying mortgage loan will be made. One way to do this has the buyer make her or his payment into an escrow account held by an independent third party, who will then disburse the payment on the underlying loan and forward the remainder of the funds to the seller each month. See generally Nelson & Whitman, *supra* note 1, at § 9.8; St. Claire, *Wraparound Mortgage Problems in Nonjudicial Foreclosures*, 20 REAL EST. L. J. 221 (1992); Notes, 47 WASH. & LEE L. REV. 1059 (1990); 21 TEX. TECH. L. REV. 873 (1990); 51 TEX. B. J. L. 1051 (1988).

23. The notable exception is California, where debtors on purchase money mortgages are exempt from deficiency liability. See Nelson & Whitman, *supra* note 1, at § 8.3. In addition,

most mortgage debtors are personally liable on their debts, and may be subjected either for a judgment for the entire amount (if the lender does not foreclose the mortgage first) or for the deficiency or remaining indebtedness (if the lender forecloses first but does not receive a sufficient sum from the foreclosure to pay the debt in full). It is possible for the lender and borrower to agree, at the time the loan is made, that the borrower will have no (or only limited) personal liability. Such loans are termed “non-recourse” loans.²⁴ It is fairly common for mortgage loans on commercial real estate in the United States to contain “non-recourse” clauses. However, residential loans, secured by one-to-four-family homes, almost never contain such clauses, and hence give rise to personal liability on the part of the borrower. In the absence of a non-recourse clause, the two questions raised at the beginning of this paragraph are both relevant: when the real estate is sold and the mortgage continues in effect, does the purchaser become personally liable and does the seller remain liable?

Under American law, the answer to the first question (the personal liability of the purchaser of the real estate) depends on the agreement of the parties – the purchaser and seller – although the mortgage lender may play a major role in the decision. If the buyer “assumes” the mortgage debt by promising the seller to make the payments as they fall due,²⁵ then the buyer becomes personally liable to the mortgage lender as well. The usual theory is that the mortgagee is the third party beneficiary of the buyer’s assumption agreement, even if the mortgagee was not directly a party to that agreement.²⁶ On the other hand, if the buyer gives no “assumption” promise, he or she undertakes no personal liability. Such a buyer is said to have taken “subject to” the mortgage but not to have “assumed” it. A “subject to” buyer, like one

California and a few other states have “one-action” or “security first” rules that prevent a mortgage lender from seeking a personal judgment on the debt prior to foreclosure of the mortgage. *Id.* at § 8.2.

24. See Gregory M. Stein, *The Scope of the Borrower's Liability in a Nonrecourse Real Estate Loan*, 55 WASH. & LEE L. REV. 1207 (1998). Even if there is a non-recourse clause, it will typically be subject to a lengthy list of “carve-outs” – situations in which personal recourse against the borrower (and perhaps one or more guarantors) will exist. The carve-outs usually include liability for fraud, waste, failure to insure, failure to apply rental revenue to operating expenses and debt service, and the like. A lender who approves the sale of real estate subject to a loan of this sort will almost certainly insist that the grantee assume the “carve-out” liabilities.

25. By the great majority of American cases, the Statute of Frauds is inapplicable to assumption agreements and the promise need not be in writing, *See Nelson & Whitman, supra* note 1, at § 5.6; *Cassidy v. Bonitatibus*, 39 Conn. Supp. 188, 473 A.2d 350 (1984), *aff'd* 5 Conn. App. 240, 497 A.2d 1018 (1985); *Daugharthy v. Monrith Associates*, 293 Md. 399, 444 A.2d 1030 (1982); *Stevenson v. Stevenson*, 618 S.W.2d 715 (Mo. Court. App. 1981).

26. *See Nelson & Whitman, supra* note 1, at § 5.22; *In re Cunningham*, 48 B.R. 509 (Bkrcty.Tenn.1985); *City Mortg. Investment Club v. Beh*, 334 A.2d 183 (D.C.App.1975); *Papamechail v. Holyoke Mutual Life Ins. Co.*, 8 Mass. App. Ct. 849, 397 N.E.2d 1153 (1979).

who “assumes,” has a strong incentive to make the payments due on the mortgage debt, since failure to do so raises the risk that the mortgage lender will foreclose, thereby taking the real estate away from the buyer and risking the loss or part or all of the buyer’s cash investment in the property. But while the economic incentive to make the payments is the same whether buyer assumes or not,²⁷ the buyer who does not assume and who fails to make the payments has a much smaller legal risk. The worst that can happen to the non-assuming buyer is the loss of the property; by comparison, the assuming buyer who defaults on the mortgage debt payments risks both losing the property and being held personally liable for the debt or a deficiency.

Obviously it is in the buyer’s interest to avoid entering into an assumption agreement, but in the seller’s interest to persuade the buyer to do so.²⁸ In theory the buyer and seller can agree that the buyer will or will not assume, as suits them. However, the mortgage lender also has a strong interest in getting the buyer to assume, since under the third-party beneficiary theory mentioned earlier the buyer who assumes can be held directly liable to the lender for the debt or a deficiency after foreclosure. Hence, the lender may (and if properly advised, almost surely will) insist that the buyer enter into an assumption agreement. Why is the lender’s demand persuasive to the buyer? Simply because the due-on-sale clause in the original mortgage gives the lender the power to prevent the transaction from occurring if the buyer and seller fail to meet its demands. Thus the lender can condition its consent, required by the due-on-sale clause, on the buyer’s execution of the assumption agreement.²⁹ Since due-on-sale clauses are now nearly universally found in American mortgages, this means that an alert lender can, and as a matter of self-

27. There are a number of additional technical differences between the roles of assuming and nonassuming buyers. They arise from the fact that a principal-surety relationship arises between the parties if the buyer assumes, and are well beyond the scope of the present discussion. See RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES §§ 5.1-5.3 (1997).

28. This is true because if the buyer assumes but defaults in payment, and the seller (who remains liable on the debt) is forced to pay it, the seller can seek personal subrogation, reimbursement or exoneration of this payment from the buyer. See Nelson & Whitman, *supra* note 1, at § 5.10. By comparison, if the buyer does not assume, the seller can seek only subrogation against the real estate, and no personal remedy at all against the buyer. See *Tighe v. Walton*, 233 Miss. 781, 103 So.2d 8 (1958) (subrogation); *Thompson v. Miller*, 195 Va. 513, 79 S.E.2d 643 (1954) (subrogation); *First Interstate Bank v. Nelco Enterprises, Inc.*, 64 Wash. App. 158, 822 P.2d 1260 (1992) (reimbursement); *Jones v. Bates*, 241 S.C. 189, 127 S.E.2d 618 (1962) (exoneration).

29. The lender may go further, insisting that it be a party to the assumption agreement or that the agreement expressly recognize its rights as a third-party beneficiary. These steps are probably unnecessary legally, but have the virtue of clearly informing the buyer that she or he may in the future be held directly and personally liable by the lender for the full mortgage debt.

interest should,³⁰ require an assumption agreement imposing personal liability on the buyer of the property in virtually all sales except, perhaps, where there was a broad original non-recourse clause and hence no personal liability on the part of the original borrower.

Now let us turn to the other question raised above: does the original borrower continue to be personally liable after selling the real estate to a buyer who assumes or takes subject to the mortgage? Under traditional common-law principles, the answer to this question is affirmative; if one undertakes personal liability – for example, on a promissory note – one does not escape that liability by transferring the real estate that secures the note to someone else, unless the lender is willing at that point to give a voluntary release of liability.³¹ However, the borrower is now considered a surety, with primary liability residing in the new owner (if that person enters into an assumption agreement) or the land (if there is no assumption agreement).³² This continued liability of the original borrower is arguably sensible if the lender relied on that party's income and creditworthiness in making the original loan. On the other hand, since the lender almost invariably has the authority under its due-on-sale clause to block a transfer in which the mortgage remains on the property, one might argue that the lender should satisfy itself as to the credit-worthiness of the *new* owner, and should be willing to forego any claim of liability against the original borrower after it approves the sale of the property.³³ Whether this language has the effect of compelling the

30. Of course this matter is open to negotiation, and it is conceivable that a buyer could offer to pay a higher interest rate in return for the lender's willingness to forego its demand for an assumption agreement.

31. This follows from the common law principle that a party may delegate his or her duties a contract, but doing so does not relieve one from liability for performance of those duties. *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 318(c) (1981): "Unless the obligee agrees otherwise, neither delegation of performance nor a contract to assume the duty made with the obligor by the person delegated discharges any duty or liability of the delegating obligor." In home loans insured by the Federal Housing Administration, the lender is required to release the borrower if the new owner qualifies under FHA's underwriting guidelines and enters into an assumption agreement; *see* 24 C.F.R. § 203.510. In loans guaranteed by the Department of Veterans Affairs, a similar rule is followed, but the release is only of the VA's claim and not necessarily the mortgagee's; *see* 38 C.F.R. § 36.4323(h). It is improbable, but not impossible, that the mortgagee would have a further claim against the original borrower after completing the VA claim process.

32. Because of the original borrower's liability being characterized as a suretyship duty, the borrower may be discharged as a matter of law if the lender and the new owner modify the terms of the loan. The raising of these "suretyship defenses" by the original borrower is complex and fraught with difficult issues; *see* RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 5.3 (1997).

33. Indeed, perhaps this is precisely the result under the regulation of the Office of Thrift Supervision, issued under the authority of the Garn-St. Germain Depository Institutions Act of 1982, *supra* note 18. *See* 12 C.F.R. § 591.5(b)(4):

A lender waives its option to exercise a due_on_sale clause as to a specific transfer if, before the transfer, the lender and the existing borrower's prospective successor in interest agree in writing that the successor in interest will be obligated under the terms of the loan and that interest on sums

lender to release the original borrower is uncertain. The General Counsel of the Federal Home Loan Bank Board (the predecessor agency of the OTS) and one court have held that it does not. This argument has great force in the case of residential mortgage loans, since it is often the case that the original borrower does not realize that she or he remains liable on the debt. Discovering, perhaps years after selling a house, that one is being sued for a deficiency following a foreclosure action brought against the subsequent owner can be a rude shock indeed.³⁴

Summary and Policy Evaluation. Let us now summarize and evaluate the way American law treats the transfers of mortgaged property. Here are the fundamental elements of the system, with a commentary about the equity and efficiency of each of them.

1. *No lender control if loan is paid off.* If the purchaser of the property is willing to obtain new financing, rather than taking over the existing loan, the lender has no control of the transfer whatever, and must allow it to proceed (unless the loan is “locked in,” prohibiting prepayment).³⁵ This feature of the American system seems unexceptionable. If the lender is being fully repaid, it simply has no interest in controlling the future course of ownership of the property. If such control could be exercised, it might be used in ways that would interfere with legitimate and efficient transfers.

2. *Lender rights if transferee takes over loan.* If the purchaser wishes to take over the payments on the existing loan, the lender has discretion as to whether or not to permit the sale to go forward, and is legally empowered to halt the transaction if it is not satisfied with it. This power of lenders stems from the existence in nearly all mortgages of a “due-on-sale” clause. In the absence of that clause, a lender would have

secured by the lender's security interest will be payable at a rate the lender shall request. Upon such agreement and resultant waiver, a lender shall release the existing borrower from all obligations under the loan instruments, and the lender is deemed to have made a new loan to the existing borrower's successor in interest.

Whether this language has the effect of compelling the lender to release the original borrower is uncertain. The General Counsel of the Federal Home Loan Bank Board (the predecessor agency of the OTS) and one court have held that it does not; *see Federal Home Loan Bank Board General Counsel Opinion Letter No. 1090*, Nov. 26, 1984; *Bank USA v. Sill*, 221 Ill. App. 3d 598, 164 Ill. Dec. 102, 582 N.E.2d 310 (1991). *Contra Gate City Fed. Sav. & Loan Ass'n v. Dalton*, 808 P.2d 1117 (Utah Ct. App.1991) (lender has duty to release original borrower).

34. *See, e.g., In re Knevel*, 100 B.R. 910 (Bankr. N.D. Ohio 1989), in which the owners of a house sold it in 1980 with the purchasers assuming the mortgage, and found themselves, about nine years later, threatened with a potential deficiency judgment by the Veteran's Administration, which had paid the mortgagee's debt. The court refused to enjoin the VA from proceeding to collect the deficiency, pointing out that the sellers had failed to qualify themselves under a VA procedure that could have given them a release of liability at the time of the sale. *See also Jensen v. Turnage*, 782 F. Supp. 1527 (M.D. Fla. 1990).

35. *See supra* text accompanying note 16.

no such power. Because the due-on-sale clause is so pervasive, there would be little practical change in American practice if lenders were granted by statute – state or federal – a direct power to accelerate the loan upon sale of the property.³⁶ The Garn Act defines a due-on-sale clause as one that permits the lender to accelerate the loan “if all or any part of the property, or an interest therein ... is sold or transferred. Hence, it does not literally cover transfers of ownership interests in the entity that owns the real estate, and state law governing clauses restricting such transfers is not preempted by federal law. However, it seems most unlikely that any state court would refuse to enforce such a clause. There is no judicial decision on the point.

The public policy supporting enforcement of due-on-sale clauses in the United States was highly controversial at one time. Some courts held that the clause, if enforced as a means for lenders to increase the yields on their loan portfolios, would be struck down as an invalid restraint on alienation. However, the passage of the Garn-St. Germain Depository Institutions Act³⁷ in 1982 represented a preemptive rejection of this argument by the federal government. In retrospect, it is clear that Congress followed the better policy. The state courts that held due-on-sale clauses unenforceable were in effect forcing lenders to finance not only their original borrowers, but also an indefinite succession of future owners of the land at a fixed interest rate, provided that such future owners were credit-worthy. There was and is simply no sound basis for forcing lenders to do this, and the results were financially catastrophic for lenders during a period of rapidly rising interest rates.

Adjustable rate mortgage loans were not very common during the late 1970s and early 1980s, when this controversy raged. Today they are quite routine. Viewed from today’s perspective, the notion of an enforceable due-on-sale clause seems innocuous. If a lender can validly enter into a contract that permits the lender to adjust the loan’s interest rate every year (or every six or three months), how can a borrower complain about a contract (the due-on-sale clause) that permits the lender to adjust the rate when, and only when, the property is transferred? In

36. In nonresidential mortgages, the due-on-sale clause is often very elaborate and may be aggressively negotiated by the parties. In such mortgages, there are usually extensive provisions dealing with the transfer of interests (e.g., shares of stock, partnership shares, etc.) in the borrower entity. These provisions recognize that, in practical terms, there is little difference between selling the real estate and selling a controlling interest in the entity that owns the real estate. Any statute embodying the due-on-sale concept would have to take this sort of sale into account. Since results of negotiations over due-on-sale clauses in commercial mortgages vary, and there is no “standard” clause in commercial mortgages, the present system, in which federal law (the Garn Act) simply validates the parties’ negotiated clause, is more flexible than a statute embodying the due-on-sale concept could be, and is therefore preferable. See note 18 *supra*.

37. See *supra* text accompanying note 18.

effect, a fixed-rate mortgage loan with an enforceable due-on-sale clause is really an adjustable-rate loan – but one whose rate adjusts only infrequently, when the real estate is sold.

In one sense, the due-on-sale clause arguably goes too far. It permits the lender to “call” or accelerate the loan even if the proposed transferee of the property is fully credit-worthy and is willing to adjust the loan’s interest rate to the current market level. Obviously most lenders would not accelerate the loan under these circumstances, simply because it is easier to leave the loan “on the books” at the higher rate than to relend the money to a different borrower at the same rate. Nonetheless, the clause literally allows a lender to act arbitrarily in this setting. A sensible alternative to the present form of the due-on-sale clause would be a clause (or a statute regulating such clauses) that permitted acceleration of the loan only if the proposed transferee (1) failed to meet the lender’s reasonable underwriting criteria, or (2) refused to agree to an adjustment of the loan’s interest rate to the level demanded by the lender. But this is a relatively minor issue, since it is doubtful that lenders often act arbitrarily.

Overall, the transition to enforceable due-on-sale clauses in the United States has been smooth and effective. The clause is extremely important to “portfolio lenders” – that is, those who hold large number of fixed-interest loans in their portfolios – as distinct from lenders such as mortgage bankers, who originate loans primarily for sale to other investors on the secondary market. It is equally critical to secondary market investors who hold fixed-interest mortgage loans for the long term. Portfolio lenders and investors, especially those whose lendable funds are derived from short-term deposits such as savings accounts, are placed in a position of extremely high risk if they use those funds to make long-term fixed-interest loans. The reason is obvious: if short-term market rates rise, the lender or investor will be compelled to pay a higher price for its money, while the yield on its long-term mortgage loan portfolio will move upward only gradually. Such a lender or investor can easily find itself in a deficit position in which its cost of funds exceeds its earnings on those funds. If that situation continues for long, it is a recipe for insolvency and failure. The due-on-sale clause provides at least some amelioration of this problem, since it gives long-term loans a shorter effective life as the mortgaged real estate is sold. To the extent of that amelioration, the clause is advantageous to the nation’s economy as a whole, while at the same time it imposes no unreasonable or unfair burden on borrowers. It thus appears that all portfolio lenders and investors, in all nations, who hold fixed-interest loans would be well served by the use of a mortgage clause or statute embodying the due-on-

sale concept. This benefit would redound to deposit insurance underwriters³⁸ and other government agencies responsible for protecting the health of financial institutions.

3. *Personal liability of the transferee.* As we have seen, the common law, still followed in the United States, permits the transferor and transferee to agree mutually as to whether the transferee will undertake personal liability on the mortgage debt. As a practical matter the mortgage lender can insist on an assumption of liability by the transferee, since the lender's has the ability to call the loan due under the due-on-sale clause, thus preventing the proposed transaction from occurring, if the transferee refuses to satisfy the lender's requirements. It is likely that most sellers of real estate and most lenders do indeed require an assumption of liability by buyers.

This result is entirely sensible from a policy viewpoint. There is no doubt that both lenders and sellers are at least marginally better off if buyers assume liability – lenders because they have the right to satisfy their loans by means of personal judgments against buyers,³⁹ and sellers because they have personal recourse against their buyers if they are forced to pay the mortgage debt directly.⁴⁰ In many cases, of course, it may be practically impossible for either the lender or seller to collect from the buyer, but the existence of the buyer's personal liability doubtless leads to actual recovery in at least a few cases, and provides a further incentive for the buyer to perform the obligation in many more. The present state of the law is desirable because it permits flexibility and enforces the parties' private agreement, permitting the buyer to avoid personal liability if she or he can convince the seller and lender that they should not insist on an assumption of liability.

4. *Personal liability of the transferor after the transfer is made.* The common law was clear that the seller of mortgaged real estate remained liable on the debt after the sale occurred, unless the lender voluntarily discharged the seller's liability.⁴¹ This seems a generally sensible rule, on the ground that the lender initially bargained for the seller's liability, and should be expected to give it up automatically by

38. The Federal Deposit Insurance Corporation is the only nationwide deposit insurer in the United States, and covers the depositors of banks, savings and loan associations, and mutual savings banks. See U.S. Gen. Accounting Office, *BANK OVERSIGHT STRUCTURE: U.S. AND FOREIGN EXPERIENCE MAY OFFER LESSONS FOR MODERNIZING U.S. STRUCTURE*, 20-30 (1996).

39. This would not follow in California, which bars both a direct action on the debt and an action for a deficiency following foreclosure in most settings. See Nelson & Whitman, *supra* note 1, at § 8.3. But California is unique among American states in this respect.

40. See *RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES* § 5.1 (1997).

41. As noted above, a discharge may also occur as a matter of law if the transferee and the lender modify the terms of the loan without the transferor's consent. Cases of this sort are rare. See *RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES* § 5.3 (1997).

virtue of approving a sale of the property to a new owner. On the other hand, the regulation of the Office of Thrift Supervision discussed above⁴² may (though it is unclear) require lenders to release borrowers from liability when they approve transfers under authority of their due-on-sale clauses in one-to-four-family residential loans. A good policy argument can be made for this approach as well: consumer borrowers are ill-equipped to assess the credit-worthiness and risk that their transferees present, and hence should not be expected to guarantee their transferees' performance of the loan obligation once a transfer is consummated.⁴³ Commercial borrowers are arguably more sophisticated, and can negotiate more intelligently with their lenders about whether they will retain liability when the real estate is sold.

At present, however, the major problem with American law is the uncertainty of the meaning of the regulation just mentioned. The regulation can be read as being either mandatory or permissive to lenders,⁴⁴ although it is difficult to see why it serves any useful purpose if it is merely permissive. To allow such an important point to remain in ambiguity for so long is unconscionable, but there is no discernable move to clarify the point. American law is seriously deficient in this respect.

Chinese Law Comparison. In this section I will summarize and comment upon the Chinese law equivalents of the legal principles described above as applicable in the United States.

1. *Lender control if loan is paid off.* Whether the lender has any control of a sale or other transfer that contemplates a retirement of the loan is uncertain under Chinese law. Two statutes appear to govern this issue. The first, "Security Law of the People's Republic of China,"⁴⁵ referred to here as "Security Law" and adopted in 1995, is general in nature. More detail is provided by "Measures Governing Mortgages of Urban Real Estate,"⁴⁶ issued in May 1997 and referred to here as "Urban Mortgage Measures." Most recently, the Supreme People's Court issued a set of interpretations of the Security Law, entitled "Several Issues Concerning the Application of the PRC, Security Law Interpretations,"

42. See *supra* note 33.

43. The potential hardship to consumer borrowers who have sold their homes but remain liable for their buyers' defaults is illustrated by *Vail v. Brown*, 841 F. Supp. 909 (D.Minn. 1994), holding that such borrowers, on loans guaranteed by the Department of Veterans' Affairs, are entitled to written notice of foreclosure.

44. See cases cited *supra* note 33.

45. The statute's background is discussed in Randolph & Lou, *supra* note 2, § 8.1, at 227 n.

4.

46. *Id.*

effective December 13, 2000, and referred to here as “2000 Interpretations.”

Under Article 49 of the Security Law, a borrower must notify the mortgage lender before making a transfer of the property.⁴⁷ Further, Urban Mortgage Measures provides that a transfer is void unless the lender consents to it in advance.⁴⁸ Neither law limits these provisions to cases in which the purchaser of the real estate is taking over payment of the loan. Hence, they may be applied even in instances in which the loan will be fully paid at the time of the transfer.⁴⁹ This would, of course, be a nonsensical result; if the lender is fully paid and the mortgage discharged, the lender simply has no legitimate interest in the sale of the property, and there is no reason the law should give the lender a power to withhold consent. It appears that an amendment to Urban Mortgage Measures is needed to clarify this point, and to establish that the lender’s power of consent is inapplicable when the loan will be fully paid.

2. *Lender rights if transferee takes over loan.* A fundamental question exists under Chinese law as to whether it is possible, as a practical matter, for a purchaser of real estate to take over an existing mortgage debt. The Security Law provides that the proceeds of any sale of the property must be applied to the mortgage debt.⁵⁰ Since in most cases the sale proceeds will exceed the amount of the debt, the debt will be fully retired and the mortgage discharged. One commentator has read the Security Law to provide that, in all cases in which the lender consents to a transfer, the transfer must be free and clear of the mortgage – even, perhaps, if the sale price is inadequate to fully pay the mortgage.⁵¹ Randolph and Lou point out that there is no express statutory or regulatory prohibition on the transfer of real estate subject to an existing mortgage.⁵² A debate exists among Chinese legal scholars as to whether a

47. Randolph & Lou, *supra* note 2, § 8.8.1.

48. *Id.* It is possible that this provision might be applied to contracts of sale as well as to outright transfers, thus making it impossible to enter into a valid contract of sale until the lender’s approval has been obtained. Randolph & Lou, *supra* note 2, § 8.8.2.1.

49. A contrary interpretation arises from the text of Urban Mortgage Measures, Art. 9, which states that a mortgage lender who wishes to restrict the borrower’s leasing, transferal, or changing of the property’s use should provide for that restriction in the mortgage agreement. The obvious implication is that the lender has no right of consent to such actions if the mortgage is silent on the point. Moreover, it suggests that the lender could waive any restriction included in the mortgage, and hence could authorize a sale of the property subject to the mortgage without a payoff of the debt. It is unknown whether this view will be accepted by the Chinese authorities.

50. Chinese Security Law, Art. 49.

51. DANBAOFA LUJIE YU SHIYONG [EXAMPLES AND APPLICATIONS OF THE SECURITY LAW] 378-381 (Kong Xiangjun ed., 1996), *paraphrased* in Randolph & Lou, *supra* note 2, § 8.8.2.3 at n.195.

52. Randolph & Lou, *supra* note 2, § 8.8.2.3.

mortgage will continue to encumber the property after a transfer;⁵³ again, the existing law is unclear, and the uncertainty cannot presently be resolved.

The 2000 Interpretations of the Supreme People's Court point to the conclusion that the mortgage will remain effective.⁵⁴ However, they appear not to contemplate that payment of the remainder of the mortgage debt will become the purchaser's responsibility, but rather than in all cases it is the seller who has the duty to discharge the debt. "The assignee who obtains ownership of the mortgaged property may discharge the entire obligation on behalf of the debtor so as to extinguish the mortgage. After discharging the obligation, the assignee has recourse against the mortgagor."⁵⁵ The evident point of view of this interpretation is that it is wrongful for the seller to pass the property to the buyer without paying the mortgage debt in full, that the seller must have deceived the buyer into believing that there was no mortgage, and that such a seller continues to have primary liability to pay, and hence must reimburse the purchaser who pays the debt in fact. This is precisely of the usual American transaction, discussed above, in which the purchaser (or in the absence of an assumption agreement, the purchaser's real estate) becomes primarily liable, and the original mortgagor is liable only as a surety.⁵⁶

If the Chinese rule does indeed require that the sale proceeds be applied against the loan, Randolph and Lou suggest that the purpose of the rule is to avoid speculation. They postulate the case in which the mortgage is initially obtained by a developer or builder, who then sells the property to a consumer upon completion of construction. They suggest that if the lender were permitted to retain the benefits of the loan after the property was sold, the lender would have an opportunity to speculate on the security value of the property – an opportunity that the Chinese leadership considers undesirable from a policy viewpoint.⁵⁷

I do not think this explanation is persuasive. With any loan made to finance construction, the lender contemplates that the value of the property will increase as the loan is disbursed, and that the property when

53. See Godwin, *supra* note 2, at 104-108. One might infer from the legislative statement of the lender's right to consent to a transfer that the mortgage will cease to encumber the land after the transfer is made. But this interpretation is by no means certain. Godwin appears to be unfamiliar with the due-on-sale controversy in the United States, and does not recognize the legitimacy of the lender's right to consent if the property is transferred subject to the mortgage.

54. See 2000 Interpretations, Article 67: "If the mortgagor assigns the mortgaged property during the existence of the mortgage without notifying the mortgagee or informing the assignee [that the property is mortgaged? - author], the mortgagee may still exercise his mortgage rights if the mortgaged property has been registered."

55. *Id.*

56. See *supra* note 27.

57. Randolph & Lou, *supra* note 2, § 8.8.2.2 at n.190.

finished will have a value adequate to secure the full loan amount with some reasonable cushion of security. What is speculative about the lender's willingness to continue to hold the loan after the property has passed from the builder to the first occupant ... or for that matter, to later occupants? Ordinary variations in market value of the property may occur after the transfer, just as they may have occurred before the transfer, but it is hard to see what socially undesirable results follow from the lender's continuing to hold the loan.

If the present Chinese rule indeed requires that the proceeds of sale must be applied to reduce or retire the mortgage, its effect is to force every buyer of real estate who cannot afford to pay the purchase price in cash to obtain her or his own new mortgage loan to finance the purchase. By comparison, in the United States the existing lender may, at its option, either insist upon a payoff of the loan or continue to hold it, substituting the new owner for the old as the person expected to make the required payments. Are there advantages to the latter system? I would suggest that there are. When a lender is asked to make a new loan, it must first "underwrite" the loan – that is, it must assess the risks associated with the loan and decide whether they are acceptable. The assessment typically focuses on two features of the loan: the value of the property and the borrower's willingness and ability to repay. The value is determined by means of an appraisal and a review of the title to the property, while the borrower's willingness and ability to pay are assessed by obtaining a loan application from the transferee, reviewing a credit report on him or her, and verifying the proposed transferee's employment and income.⁵⁸ (This statement describes the process for residential loans; loans on commercial property involve more flexible and varied methods of underwriting.)

Now consider a lender who is asked to permit a transferee to take over the payments on an existing loan. The lender must, of course, underwrite the transferee's personal ability to pay, using the same methods described above as applicable to a new loan. However, the lender contemplating approval of a transferee to take over the loan need not be concerned with underwriting the value of the property. The reason is that it already holds the mortgage on that property. The property has already been appraised in the past, and unless there has been unusual deflation of real estate prices since that time, there is ordinarily no need for a reappraisal. The acceptability of the property's title has already been determined, and the mortgage has already been recorded so as to

58. See Wayne Passmore & Roger Sparks, *THE EFFECT OF AUTOMATED UNDERWRITING ON THE PROFITABILITY OF MORTGAGE SECURITIZATION*, Board of Governors of the Federal Reserve System, Finance and Economics Discussion Series 1997-19; Federal Trade Comm'n, Bureau of Consumer Protection, *CREDIT SCORING* (1998).

establish its priority as against other legal interests in the property. No further review of the title is necessary when the property is sold subject to the mortgage.

Hence, by comparison with the making of a new loan, there is an inherent efficiency in a lender's allowing a new borrower to take over an existing loan. The expenses of appraisal and establishment of the lender's mortgage title, normally paid by the borrower, are saved. These are not trivial amounts; in the United States they can easily amount to more than a thousand dollars on the sale of a residence.⁵⁹ In addition, the lender saves administrative time, since it is unnecessary for members of its staff to review and make decisions concerning the appraisal and the property's title. The result is that, even if the lender increases the interest rate on the loan to a level that coincides with the current market, it will probably charge the new owner a lower "loan fee" or "origination fee" than would be charged in the case of a new loan. This saving, added to the saving of the appraisal and title costs, might well be in the range of one thousand to two thousand dollars.

A further saving may occur, but to the seller rather than the buyer. The loan documents may⁶⁰ permit the lender to charge a prepayment fee to the borrower in the event of a payoff prior to maturity.⁶¹ However, if the borrower is able to sell the property to a new owner who takes over payment of the loan, no prepayment will occur and no such fee will be due.

From this perspective, a rethinking of the present Chinese legal restrictions on transfers subject to existing mortgages seems to be in order. Whatever the expenses of appraisal and title establishment may be in China, they are not zero. There is no reason to deny to proposed real estate purchasers the efficiencies of taking over an existing loan if the bank or other lender is willing to permit it.

3. *Personal liability of the transferee.* There is at present no Chinese law with respect to the liability of transferees who take over

59. To illustrate, assume that a house sells for \$130,000, with a mortgage loan amount of \$100,000. (These amounts represent a relatively modest house in most areas of the United States.) One title company provided the following rates to the author: Owner's title insurance policy alone, \$490; lender's title insurance policy alone, \$342; both policies issued simultaneously, \$540. Telephone conversation with Boone-Central Title Co., Columbia, Missouri, May 4, 2001. The cost of an appraisal is commonly in the range of \$300.

60. Prepayment fees are not common in residential mortgages in the United States, largely because the two largest government-sponsored secondary mortgage market investors, Fannie Mae and the Federal Home Loan Mortgage Corporation, do not charge such fees. However, such fees are extremely common on nonresidential mortgages.

61. Such fees are generally enforceable in the United States; *see supra* note 15 and accompanying text. They are not often charged on residential loans, but are very common with loans on commercial real estate.

existing mortgages. This may simply reflect the fact that it is unclear whether such a transaction is permitted. If it is, there seems to be no prohibition on the assumption of liability by the transferee. In light of the broad apparent power of lenders in China to grant or to withhold consent to transfers of mortgaged property,⁶² it seems entirely sensible to assume that a lender could condition its consent upon the transferee's entering into an assumption agreement undertaking personal liability on the debt.⁶³ This would be analogous to United States practice under due-on-sale clauses, and would allow lenders, borrowers, and transferees to negotiate the assumption of liability in a mutually acceptable manner.

4. *Personal liability of the transferor after the transfer is made.* There is nothing in Chinese law to suggest that a transfer of the real estate collateral will automatically result in a discharge of the original borrower's liability. Of course, under the statutory provisions discussed earlier, the sale proceeds are to be applied against the debt, and may or may not be sufficient to pay it in full. If a balance remains on the debt after the sale, the original borrower presumably remains liable to that extent. The provisions requiring debt payment with the sale proceeds, as suggested above, seem to be unduly inflexible. If they can be avoided (for example, by inclusion of appropriate language in the mortgage, a point that is presently uncertain), it may be possible for Chinese lenders to authorize loan assumptions by real estate purchasers with no paydown on the indebtedness at all.

The question remains: should a seller of real estate be released from liability on the debt when a sale is made with the approval of the lender? We have seen earlier that in the United States this is left to the parties' negotiation in the case of commercial real estate, and the lender has no obligation to execute a release. However, with residential real estate it is at least arguable that the lender has, and should have, a duty to release the transferor when it approves the sale.⁶⁴ This is a sensible result, and one that the Chinese authorities should consider adopting. It avoids imposing on consumers, who usually have little or no experience in loan underwriting, the risks of default by their purchasers – risks that may extend for many years in the future. With residential loans that risk is best left with lenders who, after all, are professionals at assessing and managing it.

62. See *supra* text accompanying note 47.

63. As Randolph & Lou observe, the transferee's assumption of the debt could be an appropriate consideration for the lender's consent to the transfer. Randolph & Lou, *supra* note 2, § 8.8.3.

64. See *supra* note 33.

III. TRANSFERS OF MORTGAGES

When a lender has “originated” a loan – that is, disbursed the loan funds to the borrower and recorded the mortgage – the loan represents an asset to the lender, a secured right to future payment of money. In an efficient economy, that lender must have some simple and practical means of transferring such loans, as assets, to other investors. Transfers of this sort make up what is usually called the “secondary mortgage market,” as distinct from transactions in which mortgage loans are originated, and which occur in the “primary mortgage market.”

Why are secondary market transfers of mortgages important? Because they allow capital to flow to those who need to borrow it.⁶⁵ The flow of capital occurs in several dimensions. One is geographic: if a lender originates a loan in a region that has a deficiency of available funds to lend, and then sells the loan on the secondary market to an investor in an region with a surplus of funds, the capital flows in the reverse direction, to the region where it is needed.

Another dimension is the movement of capital among market sectors. To illustrate, assume the existence of financial firms that accumulate large amounts of capital and invest it for long terms. Typical examples are life insurance companies and pension funds. One attractive form of investment for such companies is mortgage lending, since mortgage loans also tend to be for large amounts and carry relatively long terms, thus matching the firms’ investment needs. The companies in question might open lending offices and make loans directly. However, they may conclude that doing so is inefficient for them or requires skills they do not possess and do not wish to acquire. An alternative arrangement that might be more attractive to them would be to purchase mortgage loans from other lenders who have originated them. In such purchase transactions, the flow of capital (again, as above in the direction opposite that of the movement of the mortgages themselves) is from the companies that have excess lendable funds to those who have insufficient funds.⁶⁶

65. The benefits of this capital flow are described in detail in Oliver Jones & Leo Grebler, *THE SECONDARY MORTGAGE MARKET* (1961). See also Patric H. Hendershott & Kevin E. Villani, *Secondary Mortgage Markets and the Cost of Mortgage Funds*, 8 REAL EST. ECONOMICS 50 (1980).

66. In the United States, many of these loan originators are “mortgage bankers,” a class of company that does not receive deposits from the public and that has relatively little capital of its own. On the development of the secondary mortgage market in America, see Robin P. Malloy, *The Secondary Mortgage Market: A Catalyst for Change in Real Estate Transactions*, 39 SW. L. J. 991 (1986); Jo Anne Bradner, *The Secondary Mortgage Market and State Regulation of Real Estate Financing*, 36 EMORY L. J. 971 (1987).

In recent years, the American secondary market has expanded in a different direction, commonly termed “securitization.”⁶⁷ In a securitized transaction, a group or pool of mortgages is placed in the hands of a trustee who represents the future securities holders. Beneficial fractional share interests in this pool may then be sold to a large group of investors as “participation certificates” or “PCs.” These securities are “pass-through,” in the sense that each investor in a PC is entitled to her or his pro-rata share of all of the principal and interest paid on the mortgage loans themselves by their borrowers. In an alternative form of the transaction, the pool of mortgages serves as collateral for the issuance of “mortgage-backed securities” that are not necessarily of the “pass-through” type. A variety of classes of securities can be issued on the basis of a single pool of mortgages; some securities may pay only interest (and no return of principal) until maturity. Some may have short maturities and others long maturities. The classes (termed “tranches”) of securities can be designed to appeal to different groups of investors. The arrangements for this sort of securitization are extremely complex, but because of their broad appeal to investors, the securities can be a very effective means of raising capital that will flow into the mortgage market.⁶⁸

Because secondary market transfers of mortgages allow the movement of capital in these desirable ways, the legal system should facilitate secondary market sales and securitizations of mortgage loans, making them as simple and reliable as possible. Unfortunately, the American legal system has failed miserably in this respect. Perhaps the primary reason is that our system evolved from English law that developed in a era with few transactions, most of which were local. It has not made the journey to a modern high-volume computerized market well.

Under American law, a mortgage loan generates two basic documents – a promissory note and a mortgage or mortgage-equivalent document.⁶⁹ The promissory note is the principal evidence of the borrower’s obligation to repay the debt. The mortgage is security for

67. See Patrick D. Dolan, *Lender's Guide to the Securitization of Commercial Mortgage Loans*, 115 *BANKING L. J.* 597 (1998); Georgette C. Poindexter, *Subordinated Rolling Equity: Analyzing Real Estate Loan Default in the Era of Securitization*, 50 *EMORY L. J.* 519 (2001).

68. See Board of Governors of the Federal Reserve System and U.S. Securities and Exchange Commission, *REPORT TO THE CONGRESS ON MARKETS FOR SMALL-BUSINESS- AND COMMERCIAL-MORTGAGE-RELATED SECURITIES* (Sept. 2000); Gregory P. Pressman, *Issues in Securitized Mortgage Lending* (N.Y. Law J., Jan. 12, 1998); Alan Kronovet, *An Overview of Commercial Mortgage Backed Securitization: The Devil is in the Details*, 1 *N.C. BANKING INST.* 288 (1997).

69. About 20 states use a form of mortgage termed a “deed of trust.” A few states have more unusual forms, such as Georgia’s “deed to secure debt.” For most purposes these variations on the mortgage are unimportant.

repayment, and hence is merely ancillary to the note. When a secondary market transfer occurs, the note represents the primary right that must be transferred – the right to the money. The mortgage is said to “follow the note,” and in general no separate document or action is legally required in order to transfer the mortgage, although for some purposes a document “assigning” the mortgage is desirable.⁷⁰

However, there are two bodies of law that may govern the mechanics of transfer of the note, depending on whether the note is considered to be “negotiable” or not. Negotiability is a technical matter, and depends on the precise wording of the note.⁷¹ While in theory one can read a note and determine whether it is negotiable or not, in practice the question is often unclear.⁷² If the note is negotiable, the Uniform Commercial Code dictates that the right to payment under the note can be transferred only by delivery of the original physical document – the note itself. No other method of transfer is possible.⁷³ In effect, a negotiable note is the reified form of the obligation itself – a concept that seems quaint to the modern mind, and whose only parallels today are currency

70. There are two reasons a mortgage assignment is desirable. One is that in a number of states, one is not permitted to foreclose a mortgage unless one has a recorded chain of title to the mortgage itself, and this can be accomplished only by recording a chain of assignments in the public records. See, e.g., Idaho Code § 45-1505(1); Mich. Comp. L. Ann. § 600.3204(c); Minn. Stat. 580.02(3); S.D. Codified Laws § 21-48-2. See *Arnold v. DMR Financial Services, Inc.*, 532 N.W.2d 852 (Mich. 1995) (foreclosure by holder of note who lacked a recorded chain of assignments was voidable, not void, and would be upheld if the mortgagor was not harmed); *Family Financial Services, Inc. v. Spencer*, 41 Conn. App. 754, 677 A.2d 479 (1996), construing the Connecticut recording act to deprive a mortgage assignee of standing to foreclose where the assignment was unrecorded.

A second reason that a written, recorded assignment of the mortgage is desirable is that it is possible that the original mortgage lender will make an unrecorded assignment and then will fraudulently and improperly purport to release the mortgage to the borrower. The borrower will then appear to have unencumbered title to the real estate, and make sell or mortgage it to a bona fide purchaser (BFP). Most of the American cases uphold the BFP's claim on these facts. See, e.g., *Ameribank Sav. Banks v. Resolution Trust Corp.*, 858 F. Supp. 576 (E.D.Va. 1994); *Kansas City Mortgage Co. v. Crowell*, 239 So.2d 130 (Fla. App. 1970); *Brenner v. Neu*, 28 Ill.App.2d 219, 170 N.E.2d 897 (1960). See generally *Ann Burkhart, Third Party Defenses to Mortgages*, 1998 BYU L. REV. 1003, at nn. 43-51.

71. See *Nelson & Whitman, supra* note 1, at § 5.29.

72. Negotiability depends on the precise wording of the note, and is governed by U.C.C. § 3-104. To be negotiable, the note must contain an “unconditional promise or order to pay a fixed amount of money;” must be “payable to bearer or to order;” must be “payable on demand or at a definite time;” and must not “state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money,” with several exceptions. Each of these phrases is highly technical and subject to judicial interpretation. See *Ronald Mann, Searching for Negotiability in Payment and Credit Systems*, 44 UCLA L. REV. 951 (1997), at nn. 67-70, discussing whether the Fannie Mae/Freddie Mac one-to-four-family residential mortgage note is negotiable, and concluding that it is probably not, although the matter is uncertain.

73. U.C.C. § 3-203(a) provides that “An instrument is transferred when it is delivered by a person other than the issuer for the purpose of giving to the person receiving deliver the right to enforce the instrument.”

and bearer bonds.⁷⁴ On the other hand, a nonnegotiable note may be transferred either by delivery of the note or by a separate contractual document of assignment.

Because negotiability is often uncertain, mortgage investors in the United States nearly always use the method of physical delivery of the note to signify the sale of a mortgage loan on the secondary market. And because of the advantages of having a recorded assignment of the mortgage itself, mentioned above, such an assignment is nearly always prepared and executed.

The result is a mess. The note must be redelivered each time there is a secondary market transaction involving the mortgage. Since the parties to these transactions may be located anywhere, the notes may be transferred from one side of the country to another, and may be moved multiple times during the life of a particular loan. They are subject to being lost or mislaid. There is no central data base that shows which investor owns a particular loan. When a negotiable note representing a loan is repaid in full, the investor who holds it should, in theory, return it to the borrower, but in many cases the note cannot be located and this is not done.

The mortgage assignment is also problematic, although for different reasons. If an assignment is recorded in connection with each secondary market transaction, the recording cost, in the aggregate, is quite significant. Moreover, recorders' offices in the United States are typically organized at the county (or in a few states, the town) level. There are thousands of such offices, and some of them are far from being current in keeping up with their work load. It is not unusual for a mortgage to be assigned a second time before the assignment representing the first transfer is actually placed in the records by the relevant public officials.

This two-part system has grown increasingly unsatisfactory to American mortgage investors as the scope of the secondary mortgage market has expanded. Finally in 1997 a group of major participants in the mortgage market⁷⁵ created MERS, the Mortgage Electronic Recording system. MERS is a "book entry" clearing house that tracks both

74. The original negotiable instruments were "inland bills of exchange," typically issued by merchants, but the concept was extended to promissory notes by the end of the eighteenth century. The history of the holder in due course doctrine is described in James Steven Rogers, *THE EARLY HISTORY OF THE LAW OF BILLS AND NOTES*, 177-86 (1995); M.B.W. Sinclair, *Codification of Negotiable Instruments Law: A Tale of Reiterated Anachronism*, 21 U. TOL. L. REV. 625 (1990); Edward L. Rubin, *Learning From Lord Mansfield: Toward a Transferability Law for Modern Commercial Practice*, 31 IDAHO L. REV. 775 (1995).

75. The major organizations involved in creating MERS were Fannie Mae, Freddie Mac, Ginnie Mae (the Government National Mortgage Association), the Mortgage Bankers Association, the Department of Housing and Urban Development, and the Department of Veterans Affairs.

ownership of mortgages and transfers of servicing rights to those mortgages. Each time a new loan is made, lender who participates in MERS can put the loan into the MERS system, either by making MERS the original mortgagee or by executing an assignment to MERS immediately after closing the loan. MERS then remains the mortgagee in the public records for the life of the loan. Each mortgage is assigned a "Mortgage Identification Number" for tracking purposes. MERS maintains a record of the note-holder's identity as the note is transferred from time to time. When the loan is traded on the secondary market, MERS' records are updated to reflect the change, but no further assignment is recorded in the public records. MERS thus serves as the nominee, for purposes of holding the real estate security, of the secondary market investor or investors who may hold the loan from time to time.

MERS provides a number of advantages to mortgage investors. They do not have to worry about obtaining and recording successive assignments in local recorders' offices as loans are traded. MERS' fees for changes in ownership of mortgages are much lower than fees for recording assignments of mortgages typically charged by local public recorders. Hence, secondary market investors save substantial amounts by using MERS. Since MERS' records are entirely electronic, MERS can provide instantaneous on-line access to information about who holds a particular mortgage loan and who is servicing it.

As originally conceived and as now operating, MERS deals directly only with mortgages and not notes. Hence, it solves the problems associated with recording of mortgages, but not the problems of misdelivered and lost notes. MERS tracks changes in ownership of notes (which represent, under American law, actual ownership of the right to loan payments), but only when and to the extent that such changes are reported to it. MERS has considered, and continues to consider, modifying its operation by undertaking to hold mortgage notes directly on behalf of its investor members, but no decision to do so has been made at this point.⁷⁶

At the beginning of 2001 MERS had about 3.5 million mortgages registered in its system – less than five percent of all of the outstanding mortgages in America. But the system is expanding rapidly as new mortgages, registered under MERS, replace older mortgages that are paid off and discharged. As the MERS web page states, "our mission is to register every mortgage loan in the United States on the MERS System."

76. Discussion with William C. Hultman, Senior Vice President, MERS, in Philadelphia, PA (July 13, 2001). Having MERS hold the note would be a major convenience, but would also raise a risk of greater liability on the part of MERS.

Chinese law comparison. The discussion above of the secondary mortgage market and the securitization process will ultimately be highly relevant in China, but perhaps not for some time.⁷⁷ The reason is that investors (whether in mortgages or in mortgage securities) have only a limited tolerance for uncertainty, and there is yet a great deal of uncertainty about the value of mortgage security in China. Whether most mortgage debts will be paid without default, whether the foreclosure process will work smoothly, and whether foreclosure will return amounts that approximate market values are simply unknown; mortgage financing is too new and has too short a track record.⁷⁸ Hence, this section must be understood to apply only when and to the extent that basic economic factors permit the development of a private secondary mortgage market in China.

First, the bifurcation of a mortgage loan's documents that is customary in America, arising from the English concept of negotiable instruments, is archaic and serves no purpose except confusion. There is no reason to have two documents when one will do, and when in virtually all cases it is desirable for the right to payment (represented in American law by the note) and the security interest in the real estate (represented in American law by the mortgage) to be held by the same person or entity. There is an extremely strong presumption that the ownership of these two rights should remain in the same hands,⁷⁹ and it is difficult to postulate any situation in which ownership of them should be divided. Yet separate systems of perfection for the two documents continue to exist in the United States.

Chinese law does not fall into this trap. A single document is ordinarily used to represent these two aspects of the mortgage loan. Indeed, they are inseparable, since Article 50 of the Security Law provides that "a mortgage right cannot be separated from the debt [or] separately assigned." Hence, whoever holds the debt automatically holds

77. Secondary mortgage markets and securitizations of mortgage pools are spreading globally, although in many nations in addition to China some of the relevant laws are new and of uncertain application. See Hideki Kanda, *Securitization in Japan*, 8 DUKE J. COMP. & INT'L L. 359 (1998); Georgette C. Poindexter & Wendy Vargas-Cartaya, *The Emerging Secondary Mortgage Market in Latin America*, Paper presented at the First World Congress of the International Real Estate Society, Anchorage, Alaska (2001); *Securitization in India: Next Steps*, Inaugural address by Dr. Y.V.Reddy, Deputy Governor, Reserve Bank of India, at Seminar on Government Securities Market, Chennai, India, April, 17, 1999, <http://www.vinodkothari.com/secart.htm#regional_reviews> (last visited Nov.20, 2001).

78. See Patrick A. Randolph, *Is Securitization an Answer for China's Housing Needs?* WORLD SECURITIZATION NEWS & COMMENT, (Vol. 1, Issue 2, Dec. 1998, at 1); Randolph & Lou, *supra* note 2, at 24-5. A housing mortgage securitization "trial" was sponsored by the Bank of China in Shanghai in 1999; see Coudert Brothers, Editorial, China News, Issue 2 (June 1999), <<http://www.coudert.com/practice/chinanews.htm>> (last visited Nov.20, 2001).

79. RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 5.4 (1997).

the mortgage and vice versa.⁸⁰ Likewise, it appears that a system for public tracking of the holding of mortgages exists. It seems quite clear that registration in the appropriate land registry is required for the creation of a valid mortgage.⁸¹ It is plausible to assume that registration is also the essential method of perfecting a transfer of a mortgage from one holder or investor to another. While there is no specific statutory support for this understanding in the Security Law, it appears to follow from the fact that mortgages are regarded as property rights.⁸²

However, the present registration system in China is not well adapted to the process of transferring mortgages. The reason is the use of multiple registries. The Security Law⁸³ provides that registration must be made in the land administration department that issued the land use rights if there are no fixtures on the land. In the case of land with buildings, registration must be made in the department stipulated by the local People's Government, which may be at the county level or above. Finally, the responsible forestry department at the county level or above handles registrations for forest land. Two problems exist in this system insofar as it is used to track the movement of mortgages on the secondary market. First, mortgages on land may be registered in any one of three local registries, depending on the use and improvements on the land. Second, and more important, the registries are local in nature.

The American experience leading up to MERS demonstrates that a single nationwide system for tracking ownership of mortgages is needed to support an efficient secondary mortgage market. If mortgages are to be transferred throughout the country, a locality-based records system makes no sense. It is extremely inefficient for an investor in Boston or Beijing to be forced to examine the records in Santa Fe or Shanghai in order to determine whether the party offering to sell mortgages to the investor really owns those mortgages or not. Even if one could expect all local registrars to create on-line systems (an unrealistic expectation at present in both the United States and China), it would still be inefficient for the investor to search in multiple systems before buying a package of mortgages. MERS has gone a long way toward solving this problem in the United States, but it was necessary for MERS to enter the picture only

80. Godwin, *supra* note 2, at 54-55, 137-38.

81. Chinese Security Law Art. 41: "[R]egistration of the mortgaged property must be undertaken and the mortgage contract will take effect from the date of registration." A heated argument exists among Chinese legal scholars as to whether the rule as so stated is desirable, or whether registration should be required only as against third parties (or third parties taking interests in the property without notice of the mortgage." Most scholars seem to agree that to deny enforcement as between the original parties on account of failure to register is unnecessarily harsh, but that appears to be the purport of the existing law. See Godwin, *supra* note 2, at 112-119.

82. Godwin, *supra* note 2, at 56.

83. Chinese Security Law Art. 42.

because no government or combination of governments was willing to take the necessary steps.

No such private system should be necessary. In a nation like China, which has the opportunity to create a system in the light of modern mortgage practices, a single system of public registration of mortgages should be created. The system should be nationwide, rather than based on individual counties or provinces, since mortgages are or will be in the future traded on a national scale. It should be maintained in electronic form, and should be searchable on-line from anywhere in the world – a feature that American public real estate recorders are just now beginning to implement.⁸⁴

A further legal aspect of secondary market transfers needs clarification under Chinese law. In the United States, mortgages and their accompanying promissory notes are frequently pledged as security for other debts. For example, a mortgage banking company⁸⁵ may secure a line of credit from a commercial bank by pledging a pool of notes and mortgages that it has originated.⁸⁶ These transactions are often short in term – lasting only a few weeks or a few months. They are nonetheless commercially highly useful, and permit mortgage bankers to have access to funds for loan origination that would otherwise be unavailable or available only at a higher cost.

There is probably little demand for such transactions in China at present, since most mortgage loans are made by banks⁸⁷ using their own funds, and no significant mortgage banking industry of the sort active in the United States economy exists yet. However, as the Chinese mortgage market matures, it is likely that specialized, nonportfolio mortgage lenders will arise. They will find it very useful to be able to make use of the mortgages they hold as security for short-term borrowings. Hence,

84. See Dale A. Whitman, *Digital Recording of Real Estate Documents*, 32 J. MARSHALL L. REV. 227 (1999). Current information on the progress of U.S. local recording offices in establishing on-line electronic searching systems may be gained by a review of the internet site maintained by the Property Records Industry Joint Task Force <<http://www.prijtf.org/taskforce>> (last visited Nov.20, 2001).

85. A mortgage banker, as the term is employed in the United States, is a “non-portfolio” lender; that is, it does not hold substantial deposits or other financial assets out of which it can make mortgage loans. Instead, it operates by making loans, rather quickly selling or securitizing them on the secondary market, and thereby recouping cash with which it can originate more loans.

86. This is often termed a “warehouse” line of credit, since it provides funds with which the mortgage banker can make and accumulate a portfolio of loans. When the loans are permanently sold to other investors on the secondary market, the notes and mortgages will be retrieved from the commercial bank, and the line of credit will be paid down or paid off with the proceeds of the secondary market sale. See LaMalfa, *The Inside Line on Warehouse Lending*, MORTGAGE BANKING, Nov. 1990, at 51; Krasnowiecki, Miller & Ziff, *The Kennedy Mortgage Co. Bankruptcy Case*, 56 AM. BANKR. L. J. 325 (1982).

87. These include specialized housing banks as well as general commercial banks. See Nicholas R. Lardy, CHINA'S UNFINISHED ECONOMIC REVOLUTION, 68-69 (1998).

the question arises as to whether a mortgage can be effectively pledged as security for another debt under Chinese law.

The Security Law contains two provisions on this point which seem in practice mutually contradictory. Article 75 specifically permits the use of a promissory note as security for a debt. However, Article 50 provides that a mortgage cannot be “used to secure another debt.” Thus, if a mortgage were originated by means of the borrower signing both a promissory note and a mortgage, Article 75 would permit use of the note as collateral for another debt, but the mortgage, which would be inseparable from the note, could not be so used under Article 50.

It is not apparent that Article 50's prohibition of the use of a mortgage right to secure another debt has any justification in terms of good policy. It may simply reflect a lingering resistance on the part of the drafters to the complete commodification of mortgages and other land rights. Yet the flexibility that commodification makes possible is essential to the development of an efficient mortgage market. The prohibition in Article 50 should be removed to eliminate the inconsistency and permit collateral pledges of mortgages.

Some thought must also be given to the proper means of perfection of such pledges, an issue which seems not to have been addressed in Chinese law at this point. Given the strong Chinese preference for regarding the mortgage right as property, and for requiring registration as a condition to the creation or transfer of mortgage rights, the logical method of perfection of collateral pledges of mortgages would also be by registration. As indicated above, a single nationwide registry, accessible on-line, would be the optimal solution. Both outright transfers and collateral pledges of mortgages should be within the scope of such a registry.

The cost of registration is an important matter, especially in the context of short-term financings secured by mortgages. One hears persistent stories of individual local registries imposing outrageous fees on an *ad hoc* basis for registration of mortgages.⁸⁸ This sort of unbridled discretion is highly undesirable for the development of an efficient mortgage market, and especially so in the context of the registration of a short-term financing arrangement. It is essential for Chinese officials to address the issue of registration cost.

IV. FORECLOSURE OF MORTGAGES

88. Several incidents of this kind were reported at CHINESE PROPERTY LAW & REAL ESTATE LAW SYMPOSIUM: THE IMPLICATION OF AMERICAN EXPERIENCES FOR CHINA, held at Beijing University, June 16-17, 2001, and attended by the author.

When an obligation secured by an interest in real estate is not performed, the secured creditor usually seeks to realize on the real estate collateral to pay the obligation. This process combines two distinct functions: (1) determining the value of the collateral, and (2) marketing and transferring the collateral to a new owner. The determination of value is necessary because value establishes whether the secured creditor is entitled to a deficiency judgment, to be collected out of the debtor's other assets, or whether the debtor is entitled to a surplus, a return of the part of the real estate's value that exceeds the amount owing on the secured debt. Marketing is necessary because the mortgagee ordinarily is not in the business of real estate ownership, and therefore needs to liquidate the asset.

The efficacy of auctions. In most American states, foreclosure is routinely conducted by means of an auction.⁸⁹ The auction combines the two functions above: it determines the land's value, and transfers it to a new owner at the same time. Unfortunately, it often does these tasks poorly.

A great deal of theoretical and empirical work has been done on auctions, including auctions of real property. One of the core questions this work addresses is whether the price produced at by an auction sale is likely to be equivalent to, higher than, or lower than the price that the same property would bring in a negotiated sale. The question is highly relevant to the development of Chinese foreclosure law; if auctions usually bring equivalent or higher prices than negotiated sales, they should be a favored, or perhaps the only, foreclosure mechanism. On the other hand, if auctions tend to bring prices that are systematically lower than negotiated sales, they should be disfavored, and other marketing mechanisms should be employed in foreclosure. There seem to be no empirical data on real estate auctions in China, perhaps because private real estate sales have occurred there for a relatively short time. Studies of the efficacy of real estate auctions in other countries may, however, be illuminating.

There are, of course, many ways of arranging auction sales.⁹⁰ However, the sort of auction I address here, and the sort nearly always employed for foreclosure sales in the United States, is often termed the

89. Robert M. Washburn, *The Judicial and Legislative Response to Price Inadequacy in Mortgage Foreclosure Sales*, 53 S. CAL. L. REV. 843, 846 (1980); Nelson & Whitman, *supra* note 2, at § 7.19.

90. For example, bids may be submitted only in writing, each bidder may be limited to a single bid, and so on.

“English auction.”⁹¹ In an English auction, bidders physically congregate in a single location. They call their bids orally, so that each bidder is immediately aware of the bids of others. Bids move progressively upward. An individual may bid multiple times, and the sale is awarded to the highest bidder. The selling price in an English auction is determined by the opinion of value of the second-highest bidder – the runner-up. This follows from the fact that the second-highest bidder, by definition, has decided not to increase his or her bid, suggesting that that bid is the limit of the runner-up bidder’s opinion of value. The high bidder need bid only a nominal amount – say, one dollar – above the runner-up’s top bid in order to take the property, even if the high bidder’s opinion of the property’s value is much greater than that amount.

Auctions can have significant advantages over a negotiated sale for both buyers and seller. Assuming that any reserve price has been met, the seller cannot withdraw or renege on the transaction; hence, indeterminacy is reduced for the buyer. From the seller’s viewpoint, the auction is quick and permits a rapid liquidation of the asset. In addition, if there are numerous well-informed bidders, even a seller who is relatively uninformed or ignorant of market conditions can expect to obtain a market price.⁹²

However, there is at least one theoretical reason for expecting English auctions to produce prices that are inferior to prices in negotiated sales. It arises from the fact that it must, by its nature, occur at a given point in time, and can only attract potential buyers who are in the market at that time. By contrast, a negotiated sale typically results from the marketing of the property over some period of time – often several weeks or months. Since prospective buyers may enter or leave the market at random intervals, a longer exposure time is likely to result in exposure to more potential buyers, and thus to a higher probable price.⁹³ An auction’s appeal is inherently limited to the potential buyers who are active on the date the auction is held.⁹⁴ Moreover, in a small market or one that is

91. See P.R. Milgrom & R.J. Weber, *A Theory of Auctions and Competitive Bidding*, 50 *ECONOMETRICA* 1089 (1982).

92. See Mark G. Dotzour, Everard Moorhead, and Daniel T. Winker, *The Impact of Auctions on Residential Sales Prices in New Zealand*, 16 *J. REAL EST. RES.* 57, 58 (1998).

93. There is evidence that, even with negotiated sales, longer periods of time on the market are associated with higher prices paid. See John D. Benjamin, G. Donald Jud, & G. Stacy Sirmans, *What Do We Know About Real Estate Brokerage*, 20 *J. REAL EST. RES.* 6, 14-16 (2000).

94. In recent years, there has been some experimentation with on-line auctions of real estate by means of the internet. See, e.g., <<http://www.bid4assets.com>>; <<http://www.realauctionreferral.com/realestate.html>> (both sites last visited Nov.20, 2001); Jackie Spinner, *Uncle Sam Gets Web Auction Bug; GSA Finds Public Ready and Willing to Buy*, WASH. POST, June 12, 2001, at E1 available at 2001 WL 23173507; Gus G. Sentementes, *Web Auctions Have Homes to Sell Going, Going: Several Dot-Com Companies See a Future in Selling Real Estate via Bidding Through the Internet*, BALTIMORE SUN, Oct. 22, 2000, at 1L. There is some *a priori*

already “glutted” by oversupply, an auction in which a large number of properties are offered may itself depress prices as a consequence of the increase in supply resulting from “dumping” the entire auction inventory on the market in a single day.⁹⁵

A number of factors may influence prices brought by auctions. In the United States, auctions have historically been associated in the public mind with distress sales. Most auctions in America result from mortgage foreclosures, judgment sales, property tax sales, bankruptcy sales, and estate sales. Well-publicized auctions have also been held in recent years in the United States by the Resolution Trust Corporation, which was charged with the responsibility for liquidating the assets of insolvent savings and loan associations from 1989 through 1997,⁹⁶ and by the Department of Housing and Urban Development, which holds an inventory of foreclosed houses whose owners defaulted on mortgage loans insured by the Federal Housing Administration.⁹⁷ These, too, are examples of distress sales. The properties involved are often of less than stellar quality. There are exceptions, of course; auctions have occasionally been used in the United States to market unique, high-value real estate,⁹⁸ or to market large quantities of subdivision houses or condominium units⁹⁹ in extremely high-demand market conditions.

reason to expect this approach will produce higher prices than in-person auctions, since an on-line auction can be conducted over several days or weeks, rather than occurring on a single day, thus exposing the properties to a larger set of prospective buyers.

95. This point is made in Martin Ginsburg, *The New Wave of Auctioning Will Not Wash in a Soft Market*, 7 REAL EST. FIN. J. 72 (1991). See also Christopher J. Mayer, *Assessing the Performance of Real Estate Auctions*, 26 REAL EST. ECON. 41 (1998).

96. See Federal Deposit Insurance Corporation, *MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE 1980–1994* (1998). For an overview of the events leading to the creation of the RTC, see Edward L. Rubin, *Communing with Disaster: What We Can Learn from the Jusen and the Savings and Loan Crises*, 29 LAW & POL'Y INT'L BUS. 79 (1997); Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. BANKING INST. 221 (2000).

97. See Marcus T. Allen, *Discounts in Real Estate Auction Prices: Evidence from South Florida*, 69 APPRAISAL J. 3843 (2001); Allen & Swisher, *An Analysis of the Price Formation Process at a HUD Auction*, 20 J. REAL EST. RES. 179 (2000).

98. See Mayer, *supra* note 95; Jim Szymanski, *Going Once, Going Twice Real Estate: Banking on a New Trend, Edgewood Estate Is on the Auction Block, after Six Months with a Realtor*, TACOMA MORNING NEWS TRIBUNE, Feb. 23, 2001, at D1 (auction of 17,000 square foot estate valued at \$2 million); Larry Finley, *Under the Gavel: Real Estate Auctions Play Big Role in Builder Closeouts and Bankruptcies*, CHICAGO SUN-TIMES, July 28, 2000, at 1N (auction of 5,000 square foot home on private island, valued at \$3 million).

99. See *Ryland Sizzles in Bay Area Home Auctions With \$10.8 Million in Sales*, P.R. NEWSWIRE, Nov. 16, 2000 (14 new houses in highly desirable location in Bay area, California, sold in on-line auction for average of \$771,300, nearly \$25,000 more than average asking price); Randy Drummer, *Real Estate & Retail: Internet Auction Set for Kaufman & Broad Homes, Ontario*, CALIFORNIA BUSINESS PRESS, Oct. 16, 2000, at 10 (65 new houses in Southern California sold by internet auction). See also *Auctions are Growing in Popularity Again, with Benefits for Both Developers and Home Buyers: Property Auctions Back in Vogue*, BANGKOK POST, Apr. 19, 2001, available at 2001 WL 17378261.

Nonetheless, auctions generally have the reputation in America for offering properties that are substandard or problematic, and that may not be of interest to a broad segment of the market. This reputation *per se* may discourage some prospective buyers from participating.

The quickness with which an auction can be completed is obviously an advantage to the seller. It can drastically reduce carrying costs – property taxes, insurance, security, management expense, and most significantly, the loss of revenue from the seller's capital if the property is currently vacant or is producing only a submarket income.¹⁰⁰ However, the rapidity of the auction and its “cookie-cutter” standardization¹⁰¹ of the transaction can also discourage potential buyers. For example, seller financing is difficult to arrange in an auction. There is no opportunity to engage in face-to-face negotiation of the financing, or to tailor it to needs and qualifications of an individual buyer. Hence, unless the seller is willing to negotiate and announce a prearranged financing package that will be available to all bidders, it will be up to the bidders to arrange their own financing.¹⁰² In addition, auctions usually call for the successful bidder to make a substantial deposit¹⁰³ – as much as 10% to 20% of the total price¹⁰⁴ – on the date the auction is held, and to pay the remainder of the price within a short time. The deposit must typically be in “good funds,” and a personal check is unlikely to be acceptable. Thus, the bidders must come to the auction armed with letters of credit, cashiers' checks, or the like, and must have pre-arranged financing for the rest of the price.¹⁰⁵ This preparation is a considerable effort for a bidder, particularly in light of the fact that no individual bidder has any assurance of prevailing at the auction. Only professionals or quite dedicated and knowledgeable amateurs are likely to bid.

100. See Alan R. Kravets, *Going, Going, Gone! Real Estate Auctions in the 90s*, PROBATE AND PROPERTY, May/June 1993, at 38.

101. See Kravets, *supra* note 100: “What contingencies can a prospective purchaser put into the sales contract? None. The prospective purchaser does not have the ability to renegotiate the sales contract. This is why the sales agreement drafted by the seller has to be fair and commercially reasonable.”

102. Steven L. Grood & Sheldon Gottlieb, *Real Estate Auctions: A Guide for the Seller's Lawyer*, PROBATE & PROPERTY, Sept./Oct. 1988, at 41.

103. HUD requires only a \$2,000 deposit; see Allen & Swisher, *supra* note 97, at 282. Cf. Szymanski, *supra* note 98 (\$50,000 deposit required).

104. This is the amount typically required in house auctions in New Zealand; Dotzour, *supra* note 92, at 60 and n.2 (1998).

105. Indeed, the seller or auctioneer may require bidders to produce evidence that they are pre-qualified for financing, in order to weed out those who will be unable to complete the purchase if they are successful bidders. See Doug LeDuc, *Indiana Real Estate Giants to Join in Huge Real Estate Auction*, FT. WAYNE NEWS-SENTINEL, Mar. 6, 2001, available at 2001 WL 15016294. In its auctions of foreclosed houses, HUD requires bidders to have prequalified for purchase financing; see Allen, *supra* note 97.

The sort of standardized contract that is inherent in auctions argues against their use for some types of properties – those in which individual negotiation is desirable to deal with idiosyncratic problems. For example, if the property is in poor physical condition, has structural problems, or is contaminated with hazardous waste, an auction provides no way for an individual buyer to arrange for extra inspections or engineering studies, the creation of an escrowed fund to cover the costs of remediation, or other creative solutions.¹⁰⁶ In these situations, one would expect an auction to perform relatively poorly in terms of price maximization, as bidders build “worst-case” estimates of future expenses into their bids.

Empirical evidence on the capacity of auctions to bring “true” market prices varies. The effectiveness of auctions probably depends on the culture of the marketplace. In most areas of the world, real estate sales by private negotiation far outnumber sales by auction.¹⁰⁷ However, there are exceptions. In some parts of Australia and New Zealand, auctions are often employed to sell desirable high-quality houses.¹⁰⁸ The practice is well established there, and the reported evidence indicates that those auctions produce prices commanding a significant premium over negotiated sale prices.¹⁰⁹ On the other hand, studies of auctions in the United States suggest that they nearly always produce selling prices lower than would be obtained by conventional marketing methods.¹¹⁰ The discount borne by the seller in an auction in America varies; it tends to be greatest when low-quality properties are sold in weak markets, and to be

106. See Lusht, *A Comparison of Prices Brought by English Auctions and Private Negotiations*, 24 REAL EST. ECO. 517 (1996); Mayer, *supra* note 95 (single-site auctions, typically involving clustered groups of new or relatively new houses, resulted in discounts below expected negotiated sale prices that were much smaller than scattered-site auctions involving older, more heterogeneous groups of houses).

107. Lusht, *supra* note 106, notes that auctions are least likely to be used in Melbourne for older houses and those in poor condition. In the United States, HUD auctions of previously-foreclosed houses may include an escrowed fund for repairs, but the amount is set by HUD and may or may not be satisfactory to a particular bidder; any cost overages must be borne by the buyer. See Allen & Swisher, *supra* note 97, at 282.

108. Lusht, *supra* note 106, reports that in 1988 about 50% of the houses shown for sale in classified advertisements in Melbourne were listed for sale by auction.

109. See Dotzour et al, *supra* note 92 (auctioned houses sold for a premium of 5.9% to 9.5% over houses sold by negotiation in highly desirable areas of Christchurch, New Zealand); Lusht, *supra* note 30 (auctioned houses sold for a premium of about 8% over houses sold by negotiation in middle-priced to high-priced areas of Melbourne, Australia).

110. See Allen & Swisher, *supra* note 97, at 285 (auctions of HUD-owned houses in Florida produced prices 17.45% below predicted market values, with greater disparities on the west coast of Florida and smaller disparities in Miami-Dade County); Mayer, *supra* note 95 (auctions of houses in a strong market in Los Angeles produced prices only 1% below expected negotiated sale prices, while auctions of houses in a weak market in Dallas brought prices 19% to 21% below expected negotiated sale prices). Mayer, *id.*, also cites unpublished studies showing even greater price discounts in U.S. auctions, in the range of 33% to 37%.

least or nearly to disappear when high-quality properties are sold in strong markets. To some extent, the difference may be explained on the basis of popular expectations. In Australia and New Zealand, prospective buyers may think, "This must be a great property, since they're auctioning it."¹¹¹ In the United States, prospective buyers are more apt to think, "This must be a substandard property, since they're auctioning it."¹¹²

Additional problems with foreclosure auctions. Foreclosure auctions raise additional problems that do not arise with other types of real estate auctions. These problems include (1) the requirement for a very quick "closing" and payment of the remaining price – often only a few days;¹¹³ (2) the absence of any warranty of title or of physical quality of the property or its improvements;¹¹⁴ (3) in many states, the inability of buyers to inspect the property or to obtain inspections by professionals prior to the auction;¹¹⁵ and (4) the uncertainties created by the fact that the title passed at the sale will be subject to any other mortgages or liens that

111. See Lusht, *supra* note 30 (real estate agents surveyed in Melbourne, Australia, estimated that an auction would produce a mean price premium of 11% over a negotiated sale, with a range of 5% to 15%; during the period studied, 74% of the houses in the area studied were sold by auction and 26% by negotiated sale).

112. See Greg Botonis, *No Gift-wrapped Houses: Bidders Balk at Holiday Real Estate Auction*, L.A. TIMES, Dec. 11, 2000, at AV1 (no bids made on attempted auction of 60 houses in Lancaster, California). But see Michael Paulk, *Auctions a Growing Option in Residential Real Estate Sales*, MEMPHIS BUS. J., June 2, 2000, at 28, suggesting that the low-quality image of real estate auctions in the U.S. is changing; Lidia Kelly, *Real Estate Auction Popular for High-End Properties*, ARIZONA REPUBLIC, Mar. 10, 2000, at D2 (same); Jolie Gorchov, *Kennedy-Wilson Takes Real Estate Auctions Online*, L.A. BUS. J., Jan. 24, 2000, at 75 (same).

113. Non-distress auctions often allow considerable time – say, 30 to 60 days after the auction – for payment of the remainder of the price. See Allen & Swisher, *supra* note 97 (HUD allows 30 days, but gives a cash rebate of \$450 to \$900 if closing occurs within 15 days); Lusht, *supra* note 106 (Australian practice allows 60 days after auction to close); Sentementes, *supra* note 94 (U.S. auction company allows buyer 30 days to sign contract and make 5% deposit, and an additional 30 days to close); Kelly, *supra* note 112 (U.S. auction company allows buyers 30 days to close). By comparison, foreclosures commonly require the buyer to pay the full remaining price within 5 to 10 days. See Debra P. Stark, *Facing the Facts: An Empirical Study of the Fairness and Efficiency of Foreclosures and a Proposal for Reform*, 30 MICH. J. L. REFORM 639, 649 (1997) (Illinois practice allows only 48 hours).

114. HUD auctions are also "as-is," with no warranty of physical quality; see Allen, *supra* note . However, in other non-distress auctions a warranty may be offered by the seller.

115. HUD permits and encourages inspections prior to auction by prospective bidders; see Allen, *supra* note 29. Non-distress auction sales, in the United States and elsewhere, nearly always permit preinspection by bidders. See Lusht, *supra* note 106 (preinspections of houses sold by auction in Melbourne). Foreclosure sales are another matter. In most U.S. states the mortgagor will remain in possession of the property until the foreclosure (or even afterward, during a statutory redemption period, if any). Hence, inspection is dependent on the mortgagor's cooperation, which in most cases is not likely to be forthcoming. In Connecticut it is customary for the debtor to permit inspection, but there is no legal recourse if the debtor refuses to do so; see Denis R. Caron, *CONNECTICUT FORECLOSURES* § 6.01G (1997); *Second Nat'l Bank of New Haven v. Burtchell*, 166 Conn. 388, 392-93, 349 A.2d 831, 833 (1974).

have higher priority than the mortgage being foreclosed, and even to mortgages or liens lower in priority if their owners have not been properly made parties to the foreclosure proceeding.¹¹⁶ Because of this last factor, no knowledgeable individual will bid at a foreclosure sale without first having obtained a preliminary title report and commitment to insure from a title insurance company. This is an additional element of advance preparation to bid, one that would usually be handled by a real estate agent in a negotiated sale.

In about twenty American states, there is a further uncertainty for foreclosure auction buyers that derives from the right of "statutory redemption." In these states the former mortgagor (and in some cases, sold-out junior lien holders) can "redeem" the property *after* the foreclosure sale by buying it back from the foreclosure purchaser.¹¹⁷ The right is time-limited, lasting from a few weeks to a year, depending on the state. If the right is exercised, the foreclosure bidder must give up the property, and will receive a "refund" of the amount bid, and in some states interest and reimbursement for expenditures such as taxes, insurance, and improvements. In theory the right of statutory redemption is supposed to encourage higher bids, with bidders setting their prices high enough to make redemption uneconomical. In reality, however, the result is probably just the contrary. Since a foreclosure purchaser in a state with statutory redemption can have no assurance that she or he will be able to keep the property after buying at the sale, many potential third-party purchasers are probably discouraged from participating in the process at all,¹¹⁸ thus reducing competition and lowering ultimate prices paid.

The marketing effort that precedes foreclosure auctions in the United States is laughably inadequate when compared with non-distress real estate auctions. The professionals who sell real estate at auction know that very substantial advance efforts are essential to ensure that many bidders are present, that they have the information they need to bid, and that they are qualified bidders. To accomplish this in non-foreclosure auctions, a bidder's package of materials is usually made widely available to prospective bidders, and will include plans, photographs, surveys, inspection reports, appraisals, title reports and underlying documents,

116. See Nelson & Whitman, *supra* note 1, at § 7.15 for a discussion of the problem of the "omitted party." HUD guarantees the title to the foreclosed houses that it auctions; see Allen, *supra* note 97. However, there is typically no such seller's warranty in a foreclosure sale.

117. See Nelson & Whitman, *supra* note 1, at §§ 8.4-8.7.

118. *Id.* at § 8.4, pp. 611-12; Steven Wechsler, *Through the Looking Glass: Foreclosure by Sale as De Facto Strict Foreclosure – An Empirical Study of Mortgage Foreclosure and Subsequent Resale*, 76 CORNELL L. REV. 850, 860-61 (1985); Comment, *Statutory Redemption: The Enemy of Home Financing*, 28 WASH. L. REV. 39 (1953).

condominium formation documents, and a copy of the intended contract of sale to the successful bidder. If the property is rented, copies of the leases, financial statements, and service contracts may be included in the package.¹¹⁹ As noted above, ample pre-auction opportunity for bidders to inspect the property will also be provided.

In foreclosure auctions, by contrast, the only “marketing” is typically a classified advertisement in the local newspaper that gives the legal description of the land and perhaps a little additional information, such as its street address and the type of improvements located on it. A notice may also be recorded in the public records and posted on the land itself, containing the same data. It is up to the individual bidders to accumulate the additional information they need to formulate intelligent bids. The foreclosing mortgagee may or may not have this information, and may or may not be cooperative in passing it to prospective bidders.

The result of all of these factors is that prices bid at foreclosure sales are often well below the fair market value of the property being foreclosed.¹²⁰ In most cases, the successful bid is made by the lender who holds the loan, and there are no bids at all by third parties in many cases.¹²¹ Of course, if a bid is made by the mortgage lender, the lender has already invested the amount of the loan balance in the property, so that in economic terms it matters little whether the lender bids the full loan balance, a nominal amount such as one dollar, or any amount in between. Nevertheless, the absence of third party bidders may give the lender an opportunity to deprive the borrower of significant economic value, either by (1) bidding less than the property’s value, so as to deprive the borrower of the opportunity to recover a surplus from the sale, or (2) bidding less than both the value and the debt, so as to create a liability for a deficiency on the part of the borrower.¹²²

Empirical evidence of adequacy of foreclosure prices. The statements in the foregoing paragraph should not be taken as an assertion that most or nearly all foreclosure auctions bring inadequate prices. Two empirical studies done in recent years shed considerable light on the

119. See Kravets, *supra* note 100.

120. See Washburn, *supra* note 89, at 848-50; Steven Wechsler, *Through the Looking Glass: Foreclosure by Sale As De Facto Strict Foreclosure – An Empirical Study of Mortgage Foreclosure and Subsequent Resale*, 70 CORNELL L. REV. 850 (1985); Stark, *supra* note 113.

121. The lender has the advantage of being able to make a “credit bid” in any amount up to the balance owing on the mortgage debt without having to put up any cash. See Washburn, *supra* note 89, at 849-51. Professor Debra Stark’s study of foreclosures in Cook County, Illinois indicated that third parties (those other than the lender) were the *successful* bidders in only 9.6% to 11.2% of all judicial foreclosure sales; Stark, *supra* note 113, at 663.

122. Stark found that this actually occurred in only 6% to 7% of the foreclosures in Cook County, Illinois; see Stark, *supra* note 113, at 665.

issue. Professor Debra Stark's study of foreclosures in Cook County, Illinois during 1993 and 1994 revealed that lenders who purchased at their own foreclosure sales were able to resell the property at a profit¹²³ only about 10% to 20% of the time.¹²⁴ Third party bidders (although less commonly successful bidders) did much better; in Stark's 1993 study they resold the foreclosed property at a profit in 75% of the cases, and their profits were often quite substantial, ranging from 32% to 326% of the bid amount.¹²⁵

Professor Steven Wechsler reported similar results in a study of foreclosures in Onondaga County, New York in 1979. Wechsler found that when mortgagees purchased at their own foreclosures, they were able to resell the properties at a profit in about half of all cases.¹²⁶ When third parties purchased, Wechsler found that they were much more likely than mortgagees to make a profit upon resale, and that the profits they made were typically much larger than those made by mortgagees. The data from these two studies suggest that submarket sale prices, while not occurring in the majority of foreclosure, are nonetheless a significant problem and effectively rob many borrowers of considerable economic value.¹²⁷

123. When a bidder makes a profit upon resale of the foreclosed property (after taking the bidder's holding and marketing costs into account), that is fairly strong evidence that the bid price was sub-market. The only alternative explanation for the profit is a general rise in real estate prices in the market between the date of the foreclosure and the date of the resale. Stark considered only resales within one year of the foreclosure; Stark, *supra* note 113, at 665. Wechsler found that about 95% of the resales occurred within 2 years of the foreclosure. Wechsler, *supra* note 118, at 879-880. There is no indication that unusually rapid market price increases were occurring during the relevant periods.

124. *Id.* at 667. In determining whether a profit was made, Stark estimated a cost to the successful bidder of 10% of the foreclosure bid to account for a sales commission on resale and for holding costs, such as property taxes, insurance, and management expense. While profits to lender were relatively rare, in two cases lender made very large profits of 98% and 379%; *id.* at 668.

125. *Id.*

126. Wechsler's profit data are not directly comparable with Stark's because Wechsler made no allowance for the successful bidder's cost of holding and reselling the property. However, the median loan balance on the mortgages he studied was about \$20,000, so median holding costs consistent with Stark's estimates would have been about \$2,000. Wechsler, *supra* note 118, at 872. Wechsler reported that in cases in which the mortgagee made a profit, the median profit was about \$5,000. *Id.* at 880. Hence, his results are consistent with Stark's, suggesting that mortgagees made a profit in a substantial number, but less than half, of the foreclosure purchases.

127. Borrowers are not always harmed by inadequate foreclosure prices. In the case of mortgagee bidders who do not intend to seek a deficiency, there is no economic difference between a bid of \$1 and a bid equal to the full amount owing on the mortgage debt, since with any bid in this range, the mortgagor will not be entitled to any surplus. Most lenders do not seek deficiencies most of the time. Wechsler found that a lender obtained a deficiency judgment in only one case out of 94 foreclosures in his study in which a deficiency existed; Wechsler, *supra* note 118, at 878. Stark found that lenders pursued deficiency judgments in about 28% and 13% of the cases she studied in 1993 and 1994, respectively; Stark, *supra* note 113, at 664.

The legal response to price inadequacy. A variety of techniques have been developed by courts and legislatures to forestall these results.¹²⁸ Judges may set aside foreclosure sales for price inadequacy, but only if the price is “grossly inadequate” or “shocks the conscience” of the court;¹²⁹ only extremely low prices are likely to fall within such a definition.¹³⁰ In a number of states, statutes require that a court make a determination of fair market value, and use that value for the purpose of computing deficiency judgments.¹³¹ Another more stringent measure, adopted in California, is to simply to prohibit the obtaining of deficiency judgments in most situations.¹³² These techniques have had some success, but at the cost of impeding flexibility and making the foreclosure process more cumbersome.

It is perhaps surprising that few American states have considered alternatives to auction sales as foreclosure mechanisms. In about 20 states, a so-called “power of sale” may be given to a mortgage lender,¹³³ but this simply allows a trustee designated by the lender to conduct the auction without court supervision. Some savings of time and attorneys’ fees result, and most lenders in the states that authorize “power of sale” foreclosure consider it the preferable method of foreclosure and use it routinely. But it does nothing to eliminate the inherent problems of auction sales and the absence of warranties mentioned above.

The Uniform Land Transactions Act (ULTA), and the Uniform Land Security Interest Act (ULSIA which was derived from ULTA), both promulgated by the National Conference of Commissioners on Uniform State Laws, attempted to introduce greater flexibility into the foreclosure process in the United States. To a considerable extent the foreclosure provisions of these acts were derived from Article 9 of the Uniform Commercial Code, which covers security interests in personal property. These acts provided that foreclosure sales were not strictly limited to an auction format, but could be conducted in any “reasonable” manner,¹³⁴ a provision derived from Article 9’s requirement of “commercially reasonable” dispositions of personal property.¹³⁵ This flexibility was viewed as unacceptable vagueness in the state legislatures, and for this

128. See Washburn, *supra* note 89.

129. RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 8.3 (1997).

130. The RESTATEMENT suggests a rule of thumb, based on a review of the case law, that a price less than 20% of market value is “grossly inadequate;” *id.* at § 8.3 cmt. b.

131. RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 8.4 (1997) adopts this rule and lists 15 states that follow it by statute; *id.* at Reporters’ Note to cmt. b.

132. Nelson & Whitman, *supra* note 2, at § 8.3.

133. *Id.* at § 7.19.

134. U.L.S.I.A. § 509(a);

135. See Marion W. Benfield, *Wasted Days and Wasted Nights: Why the Land Acts Failed*, 20 NOVA L. REV. 1037, 1049 (1996).

reason (among numerous others), neither of these uniform acts was adopted by any state in the United States.

There is precedent in England for such a flexible approach to mortgage foreclosure. The term "power of sale" is used in English mortgages, but it has a greatly different meaning than that employed in the United States. Under an English "power of sale," the lender is permitted to foreclose simply by selling the real estate to any buyer other than itself or its agents.¹³⁶ The price must be reasonable, although it need not be shown to be the highest possible price obtainable. Lenders in England commonly use real estate brokers ("estate agents") and other means of conducting foreclosure sales, just as with other sales of real property. Foreclosures by judicial sale (auction) are also permissible,¹³⁷ but are rare in practice.

Perhaps there is an inherent mistrust of lenders in America, which translates into a sense that foreclosures must be rather strictly regulated or borrowers – and especially homeowners – will be taken advantage of. The Uniform Nonjudicial Foreclosure Act (UNFA), currently in the drafting process under the sponsorship of the Commissioners on Uniform Laws, attempts to combine the flexibility of the English and ULTA/ULSIA approaches with this need for careful regulation of lenders.¹³⁸ In brief, the UNFA recognizes three distinct foreclosure methods available to lenders. The first is the auction sale, which (like the statutes of more than 20 American states) may be held without judicial supervision.¹³⁹ However, lenders have two alternatives. The first, termed "foreclosure by negotiated sale," permits the lender to enter into a contract of sale for the property with a buyer. The lender may use brokers or any other means of marketing the property for this purpose. The lender, having arranged for such a sale, then notifies the borrower of its terms, and also states a price that the lender is willing to credit against the debt. This price need not be identical to the contract price that the lender has arranged with the third party buyer, but the contract price gives the borrower at least one reference point in determining whether to accept the lender's offer.

136. Law of Property Act §§ 101-107 (1925); Bernard Rudden & Hywel Moseley, NOTES ON MORTGAGES, 52-57 (3d ed.1967).

137. *Id.* at 67.

138. Descriptions of UNFA here are based on preliminary drafts, and changes may occur before the act is adopted by the National Conference of Commissioners on Uniform Laws. The act is expected to be presented for final reading at the annual meeting of the Conference in Tucson, Arizona in Summer 2002.

139. The UNFA gives the lender the power to conduct this sort of sale personally, while nearly all of the American states recognizing a similar power require that it be exercised by a trustee who is, at least nominally, distinct from the lender. This distinction is hardly meaningful, since the trustee may, in most states, be an employee or attorney of the lender.

The third method of foreclosure authorized by the UNFA, termed “foreclosure by appraisal,” permits the lender to obtain and give to the debtor an appraisal of the property, and to accompany it with an offer of a proposed net amount that the lender agrees to allow in return for taking title to the property. This latter method is somewhat like strict foreclosure, in the sense that the lender winds up owning the real estate.

In both of these latter methods of foreclosure, the debtor and the holders of junior interests given an opportunity to decide whether to accept or reject the lender’s proffered offer. The proposed selling price of the property (in the case of “foreclosure by negotiated sale”) or the appraised value of the property (in the case of “foreclosure by appraisal”) provides some information that can help these parties decide whether to accept the lender’s offer or not. However, the lender’s offer may be lower or higher than negotiated sale price or the appraised value. If the lender’s offer is rejected, the usual result is that the proposed foreclosure by negotiate sale or by appraisal is dropped, and the foreclosure must be carried out under the traditional auction format instead.

If the lender’s offer under either of these latter methods of foreclosure is a reasonable one, the debtor and junior lien holders are likely to accept it, particularly in light of the widely-recognized fact that auction foreclosure sales rarely bring fair market value. However, if the debtor or juniors insist on having an auction sale, that is their right. Hence, no debtor protections are lost as a consequence of availability of the other two methods of foreclosure. In most cases it is believed that lenders will use these other methods and will make reasonable offers, which it will be in the interest of debtors and junior interest-holders to accept. In the long run, both lenders and debtors should be better off – lenders because they can avoid some the delays and uncertainties associated with auction sales, and debtors because they will in general be credited with higher prices for their properties, thus reducing their risk of deficiency liability and increasing the probability of a surplus.

The acts adopted by the National Conference of Commissioners on Uniform State Laws are not binding on any state; they become law only if and as individual state legislatures adopt them. UNFA may meet the same fate as its predecessors, ULTA and ULSIA, and fail to be adopted in any state. But there is reason to hope and expect that its creative approach to foreclosure, combined with the fact that about 20 American states have no non-judicial foreclosure process and are therefore likely targets for adoption, will result in UNFA’s having a significant impact on American foreclosure law.

Chinese law comparison. Under Chinese law, if there is a default in payment of the mortgage debt, the mortgagor and mortgagee may agree to sell the property or otherwise liquidate it, and to apply the proceeds toward the debt.¹⁴⁰ The sale may presumably be made in any manner to which the parties agree. However, if no agreement is reached, at present the sole method of foreclosing a mortgage in China appears to be by court-ordered auction.¹⁴¹ Licensed auction specialists are used for this purpose.¹⁴² Ordinarily all mortgages on the same property are foreclosed together, with the proceeds distributed to the mortgage holders in the order of their priority.¹⁴³

Is the auction an effective method of disposition of real estate in China? Auctions have often been used by the Chinese government to place initial granted land use rights to large parcels of surplus real estate in private hands.¹⁴⁴ On the other hand, resales of individual parcels by private owners are more likely to be conducted by negotiations assisted by real estate brokers, although auctions are sometimes used, especially with very large and valuable parcels.¹⁴⁵ Small parcels or ordinary residential units are likely to be resold at auction only if they exist in an

140. Chinese Security Law, Art. 53.

141. Urban Real Estate Law Art. 46; Randolph & Lou, *supra* note 2, at § 8.14.2. The Security Law provides no details of the foreclosure procedure, but merely states that the mortgagee may bring an action in a People's Court; Chinese Security Law, Art. 53.

142. Chinese Auction Law, Art.9.

143. Randolph & Lou, *supra* note 2, at 8.14.3. The 2000 Interpretations of the Supreme People's Court suggest that a form of "deed in lieu of foreclosure" (to use American terminology), in which the foreclosed property is transferred to the mortgagee rather than being auctioned, is possible. *See* 2000 Interpretations, Art. 57:

"If the parties to a mortgage contract stipulate therein that the ownership of the mortgaged property will pass to the creditor if the mortgagee has not received fulfillment of the obligation at the expiration of the term for the performance of such obligation, such stipulation is void. * * * If the mortgagee has not received fulfillment of the obligation at the expiration of the term for performance of such obligation, the mortgagee and mortgagor may agree that the mortgagee obtain the mortgaged property subsequent to its evaluation in terms of money."

Thus, the agreement to give a "deed in lieu of foreclosure" must be not only subsequent to the original mortgage (just as in American practice, so as to avoid the deed being struck down as a "clog on the equity of redemption"), but also subsequent to a court's evaluation of the property (a protection for borrowers than American practice does not offer, and which may well be useful in helping a borrower avoid giving up more value than necessary to cover the balance owing on the debt).

144. *See e.g., Real Estate: Beijing to Auction Land-Use Rights*, XINHUA NEWS AGENCY, Jan. 24, 2000, available at 2000 WL 4105146 (government auction of 200,000 square meters of land, vacated by five factories, for residential development); Randolph & Lou, *supra* note 2, at 148-150. Land auctions have also been widely used in Hong Kong to place large tracts of government-owned land in the hands of private developers; *see* Stephen Ching, EXAMINING COMPETITION IN LAND MARKET: AN APPLICATION OF EVENT STUDY TO LAND AUCTIONS IN HONG KONG, 6-7 (Research Working Paper, University of Wisconsin Center for Urban Land Economics, Feb. 2001).

145. E-mail message from Professor Lou Jianbo to the author, July 24, 2001.

overheated market characterized by extremely strong demand,¹⁴⁶ much as has sometimes occurred in the United States in similar circumstances.¹⁴⁷

If auction resales of land use rights become a widespread and customary method of marketing individual parcels and dwelling units in China, then there is certainly no objection to the use of the auction as a foreclosure device. However, if negotiated sales of real estate are more commonly used in ordinary sale transactions, as currently appears to be true, it would be desirable to amend the existing law to permit court-ordered negotiated sales in foreclosure as well, or even to adopt a nonjudicial procedure for negotiated sales as is done in England¹⁴⁸ and would be permitted by the Uniform Nonjudicial Foreclosure Act¹⁴⁹ in the United States. If there is concern that giving lenders an unfettered right to sell the property would be too broad a right, and too subject to abuse, the concepts of the UNFA described above might be considered as a means of constraining the power of lenders while still allowing them to use standard market mechanisms for disposing of property. The overriding objective should be for foreclosed properties to bring prices comparable to those that would be derived from non-distress market sales.

V. CONCLUSION

The experience of the United States, and increasingly the experience of other developed nations, has shown that an efficient private market in mortgage finance can provide enormous benefits to a country's citizens. Such a market can minimize the costs of homeownership and rental of dwellings, and can also keep the prices of all internally-manufactured and distributed goods low, since as those prices inevitably reflect the costs paid by firms for their land and buildings.

Chinese government authorities seem well aware of these benefits, and have attempted to design a legal regime that will support an efficient mortgage market. In many ways they have been remarkably successful. However, the legal regime's effectiveness is undercut to some extent by a combination of ambiguous legal provisions, unnecessary restrictions on some types of mortgage transactions, and a lack of flexibility in methods of foreclosure of mortgages. I have attempted here to identify some of the changes needed to cure these problems. The needed changes are not vast, and should not be politically charged. If

146. E-mail message from Professor Patrick Randolph to the author, July 23, 2001.

147. See *supra* text accompanying note 99.

148. See *supra* text accompanying note 136.

149. See *supra* text accompanying note 138.

they are made, the benefits for China's citizens can be extremely significant.