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2018

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Recommended Citation
R. Wilson Freyermuth and Dale A. Whitman, The New Model Negotiated Alternative to the Foreclosure Act, 32 *Probate and Property* 36 (2018).
Available at: https://scholarship.law.missouri.edu/facpubs/738

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The New Model Negotiated Alternative to the Foreclosure Act

By R. Wilson Freyermuth and Dale A. Whitman

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One of the many painful lessons learned from the mortgage crisis that began in 2007 is that foreclosure is often a costly, slow, inefficient, and uncertain process. The additional cost and uncertainty for lenders are magnified when the balance of the mortgage debt exceeds the value of the collateral (that is, when the borrower is "underwater"), and thus full recovery by the lender of its investment is unlikely. Ways to avoid this misery are for the lender (usually represented by the servicer for a secondary market purchaser or a securitized trust) and the borrower to enter into a deed in lieu of foreclosure or for the lender to approve a short sale.

Benefits of Deeds in Lieu and Short Sales

A deed in lieu of foreclosure has many advantages for both parties. Unlike an actual foreclosure, it attracts no unwanted negative public attention, a fact that both lenders and borrowers may appreciate. From the lender's viewpoint, it provides a much quicker way of obtaining title to the real estate than foreclosure, with less uncertainty, lower legal expenses, and a reduced risk of the borrower's vandalizing or neglecting the property.

A deed in lieu also has benefits to borrowers. Its effect on the borrower's credit score is less detrimental than an actual foreclosure. If properly structured, it can ensure that the mortgage debt is fully discharged, thus avoiding the risk of a deficiency judgment against the borrower that accompanies a foreclosure in most states. Sometimes the process of negotiating a deed in lieu will even result in a modest payment from the lender to the borrower to help defray the costs of vacating the property.

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What is needed—but what standard mortgage law does not provide—is a way for a borrower to deliver a deed in lieu or short sale deed that will wipe out junior liens, at least in cases in which they have no value.

Likewise, a short sale carries the same benefits and advantages. In a short sale, the borrower conveys title to the mortgaged real estate to a third-party purchaser for a price that reflects fair market value but is less than (or "short" of) the outstanding mortgage balance. In order for the borrower to convey marketable title to the purchaser, the lender releases its mortgage lien in exchange for receipt of all of the net sale proceeds.

The Barrier of Junior Liens

In light of these mutual advantages, one might have expected a large proportion of the residential defaults that occurred during the mortgage crisis to have been resolved by deeds in lieu or short sales. To some degree, this did not occur because of structural reasons; servicers often were not sufficiently knowledgeable and well-staffed to work out these voluntary arrangements with their borrowers in a timely manner. But there is also a frequent legal barrier to deeds in lieu and short sales: the presence of junior liens. If the property is also subject to a junior lien, as a practical matter the senior mortgagee can agree to a deed in lieu or short sale only if the junior lienholder consents.

The reason is simple. A deed in lieu or a short sale is not a foreclosure. The proper foreclosure of a first priority lien will eliminate all junior liens, thus permitting the foreclosure purchaser to take clear title to the property. A deed in lieu or short sale has no such effect. Any junior lien will continue to encumber the property after the deed is delivered. Although the grantee of the deed can then foreclose against the junior lienor to clear the title of the lien, the cost and delay of doing so defeats the whole purpose of using a deed in lieu or short sale in the first place.

Particularly during a housing market decline, such as that of 2007–2010, the balance owing on some defaulted first mortgages will exceed the property's value. In this situation, a junior lien has no value; if an actual foreclosure sale were held, the proceeds would not be sufficient to pay off the first mortgage in full, much less to pay anything on the junior lien. But even if the junior lien is valueless, it clouds the property's title, frustrating the use of a deed in lieu or a short sale and effectively forcing an otherwise avoidable foreclosure. This is problematic because these foreclosures not only involve the costs to borrowers and lenders noted previously but also reduce the value of neighboring parcels and thus impose a cost on neighboring owners and communities.

What is needed—but what standard mortgage law does not provide—is a way for a borrower to deliver a deed in lieu or short sale deed that will wipe out junior liens, at least in cases in which they have no value. This article discusses a new model act intended to accomplish this result.

The Model Negotiated Alternative to Foreclosure Act

In 2015, the Uniform Law Commission (ULC) promulgated the Uniform Home Foreclosure Procedures Act (UHFPA), a large and complex act dealing with many aspects of mortgage foreclosure. The UHFPA was intended to overlay existing state foreclosure legislation, but thus far it has not achieved any enactments. This is not surprising, given its broad scope and the desires of consumer

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and lending advocates to maintain any respective advantages they have under present foreclosure law. Broad-scale reform of mortgage foreclosure law is not for the faint of heart!

In July 2017, the ULC concluded that one particular article of the UHFPA—the "Negotiated Transfer" provisions in UHFPA Article 5—had sufficient merit and potential for adoption, so the ULC carved these provisions off into a freestanding act labeled the Model Negotiated Alternative to Foreclosure Act (MNAFA). This act is a targeted response to the problem of junior liens hindering the use of deeds in lieu and short sales. It authorizes the borrower and lender to negotiate a transfer of the property to the lender and provides that "all . . . interests subordinate to the interest of the creditor that is a party to the proposed negotiated transfer are extinguished." MNAFA § 5(a).

This result is well and good if the junior liens are valueless but, if not, wiping them out in this fashion would be unwarranted and unfair. Hence, one of the act's principal objectives is to ensure that only fully underwater junior liens are terminated by the borrower's transfer of title to the lender. The act accomplishes this in a rather ingenious fashion, effectively allowing the junior lienholders to decide for themselves whether their liens are worth preserving. The procedure outlined by the act is as follows.

If the parties to the first mortgage propose a negotiated transfer, they must first send notice to all subordinate lienholders. If a judicial foreclosure is already pending, the court sends the notice; otherwise it is sent by the foreclosing creditor. MNAFA § 4(a) & (b). Each junior lienor then has 20 days from the date the notice was sent to object in writing to the proposed transfer. MNAFA § 3(a)(4). If no objections are received within the 20-day period, the parties can complete the transfer, wiping out all junior interests. MNAFA § 6(a).

If a junior lienholder objects, however, it can redeem the property from the first mortgage lien by tendering the amount of the first mortgage obligation and, in effect, buying the first lien. Obviously, the junior lienor will do so only if it believes the property is worth more than the first lien obligation. If a junior lienor makes such a tender, the creditor holding the first lien is paid in full.

Restricting junior lienholders to the option of redemption is necessary to achieve the act's primary purpose: a fair, quick, and inexpensive resolution of the foreclosure.

If a judicial foreclosure is pending, the court must set a date, not more than 30 days after receipt of the objection, for the objecting lienor to pay off the first mortgage. MNAFA § 5(a). If no judicial proceeding is pending, the creditor must initiate a judicial proceeding so the court can set a redemption date for the objecting lienor. MNAFA § 5(c). In either case, if the junior lienor fails to tender by the date set, its lien is extinguished.

To an extent, the MNAFA provides the first mortgagee with a remedy that is analogous to an Article 9 secured party's right to propose "strict foreclosure" (that is, the secured party's retention of the collateral in satisfaction of the secured obligation). UCC §§ 9-620 to 9-622. The remedies are not precisely the same, however. Under an Article 9 strict foreclosure, if a junior secured party objects to a strict foreclosure proposal, the senior effectively must proceed with a foreclosure sale. But an Article 9 foreclosure sale can be a private sale that can happen in as little as a few weeks and that has no spillover effects on other debtors. By contrast, a real estate foreclosure must occur in a public auction that may take months or years to complete and is likely to reduce the value of neighboring parcels. By requiring the objecting junior lienor to redeem its lien position (rather than allowing the junior to force a foreclosure sale), the MNAFA quite appropriately prevents the truly underwater junior lienholder from imposing these unwarranted foreclosure costs on the lender, the borrower, and third parties.

Restricting junior lienholders to the option of redemption is necessary to achieve the act's primary purpose: a fair, quick, and inexpensive resolution of the foreclosure. It might be argued, however, that it is unfair to junior lienholders who have little or no access to capital, because it requires an objecting junior to come up with the funds to redeem the senior mortgages. This is unlikely to be an issue for institutional or professional lenders, but it might be problematic for some individuals. On balance, the act's approach seems justifiable.

By its terms, the act applies only to transfers by a homeowner to a creditor. This is well and good for deeds in lieu of foreclosure, but how will it work in a short sale situation? The answer is that the chain of title for the short sale must pass through the creditor. Thus, two deeds will be necessary: one from the homeowner to the creditor and a second from the creditor to the short sale purchaser. Doubtless the creditor will insist that the deed it delivers be without warranty of title, but the act raises no objection to that.

Multiple Objecting Junior Creditors

Because all junior creditors will receive notice of the proposed transfer, it is possible that more than one of them will file an objection. In this situation, the court must establish an orderly process for recognizing their rights of redemption. To accomplish this, the court fixes a series of dates and assigns a date to each junior lienor, in the reverse order of their priority (that is, the most junior lienor gets the earliest date). MNAFA § 5(b).

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Each objecting junior lienor must tender an amount equal to the total of the balances owing on all liens superior to its own. If any subordinate lienor fails to tender by the applicable date, its lien is extinguished and the next (more senior) lienor is entitled to its turn. MNAFA § 5(e).

This process is conceptually similar to the rights of junior lienholders in an ordinary foreclosure; all juniors are subject to being terminated by the foreclosure of a senior lien, but each has a common-law right to redeem its lien from senior liens, provided that they redeem before the foreclosure sale. The difference under MNAFA is that, once the notices of the proposed transfer are sent, redemption is the *only* course of action that will prevent an objecting junior's lien from being extinguished.

Some Refinements

Several other features of MNAFA are also worth mention. As with UHFPA, the act is limited to mortgages on one-to-four-family residential properties. MNAFA § 2(6). This restriction stems from the fact that it was residential foreclosures that severely clogged the courts and bogged down servicers during the mortgage crisis, and perhaps from the fact that UHFPA's drafters hoped it would be easier to get enactments if the support of commercial mortgage lenders were not required. Conceptually, however, the principles of MNAFA could be applied equally well to nonresidential mortgage loans.

There is also a limit on the ability of borrowers and lenders to negotiate the transfer: the lender must accept the property in *full* satisfaction of the debt. MNAFA § 3(a). Even if the property is underwater with respect to the first mortgage, the lender cannot preserve the right to a deficiency judgment. This provision may help some consumers avoid poorly negotiated transfer deals. It surely corresponds with the result most borrowers would expect and is consistent with Article 9's analogous prohibition on partial strict foreclosure in consumer transactions. UCC § 9-620(g). But nothing in the act prevents the lender from agreeing to pay the borrower some additional money ("cash for keys") to help defray moving expenses and encourage the borrower's agreement.

> **Although the act's process will be of greatest use to first mortgage lenders, it is equally available to a junior mortgagee.**

The act's procedures and restrictions apply only if the parties opt to be subject to it, and so state in their agreement. MNAFA § 3(a)(2). If the lender's title examination discloses no junior liens, the parties may prefer to use a traditional deed in lieu (in which case the act does not apply). MNAFA § 6(f). If there are multiple owners of the real estate, the choice to proceed under the act is available only if all the owners agree. MNAFA § 3(a)(1). Obligors who are liable on the debt, however, but have no interest in the real estate (for example, guarantors), need not consent because they have no downside risk.

Although the act's process will be of greatest use to first mortgage lenders, it is equally available to a junior mortgagee. The act has no effect, however, on mortgages or liens *senior* to the mortgage that is the subject of the negotiated transfer. MNAFA § 6(a), § 5 cmt. 3. For example, assume a home is subject to an unpaid property tax lien and a homeowner's association lien, both of which are superior in priority to a first mortgage. If the borrower and the mortgagee engage in a negotiated transfer under the act, the mortgagee will take title subject to the HOA and tax liens (the same result as in a conventional foreclosure).

Conclusion

As noted above, underwater junior liens impede negotiated settlements of defaulted mortgage loans and thus impose unwarranted foreclosure-related costs on borrowers, lenders, neighboring landowners, and local communities. The authors conclude that the Model Negotiated Alternative to Foreclosure Act provides a careful, balanced, and thoughtful solution to this problem. It is neither pro-borrower nor pro-lender, but is designed to facilitate cooperation between the parties to a mortgage loan when they find it in their mutual interest. It would not replace any aspect of the traditional foreclosure process but instead provides an alternative that can be advantageous to both parties. It would protect consumers who use it against the risk of a future deficiency judgment, as we think it should, and would prevent truly underwater junior lienholders from compromising efficient settlements by demanding "ransom" for the release of worthless junior liens. In sum, it is an excellent addition to the panoply of mortgage remedies and deserves favorable consideration from state legislatures throughout the nation. ■

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