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Problems in Mortgage Servicing from Modification to Foreclosure: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs, 111th Cong., Nov. 16, 2010 (Statement of Associate Professor Adam J. Levitin, Geo. U. L. Center)

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Written Testimony of

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Before the
Senate Committee on Banking, Housing, and Urban Affairs
“Problems in Mortgage Servicing from Modification to Foreclosure”

November 16, 2010
2:30 pm

Witness Background Statement

Adam J. Levitin is an Associate Professor of Law at the Georgetown University Law Center, in Washington, D.C., and Robert Zinman Scholar in Residence at the American Bankruptcy Institute. He also serves as Special Counsel to the Congressional Oversight Panel, and has been the Robert Zinman Scholar in Residence at the American Bankruptcy Institute.

Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York, and served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College.

Professor Levitin has not received any Federal grants nor has he received any compensation in connection with his testimony. The views expressed in Professor Levitin's testimony are his own and do not represent the positions of the Congressional Oversight Panel.

Executive Summary

The mortgage foreclosure process is beset by a variety of problems. These range from procedural defects (including, but not limited to robo-signing) to outright counterfeiting of documents to questions about the validity of private-label mortgage securitizations that could mean that these mortgage-backed securities are not actually backed by any mortgages whatsoever. While the extent of these problems is unknown at present, the evidence is mounting that it is not limited to one-off cases, but that there may be pervasive defects throughout the foreclosure and securitization processes.

The problems in the mortgage market are highly technical, but they are extremely serious. At best they present problems of fraud on the court, clouded title to property, and delay in foreclosures that will increase the shadow housing inventory and drive down home prices. At worst, they represent a systemic risk of liabilities in the trillions of dollars, greatly exceeding the capital of the US's major financial institutions.

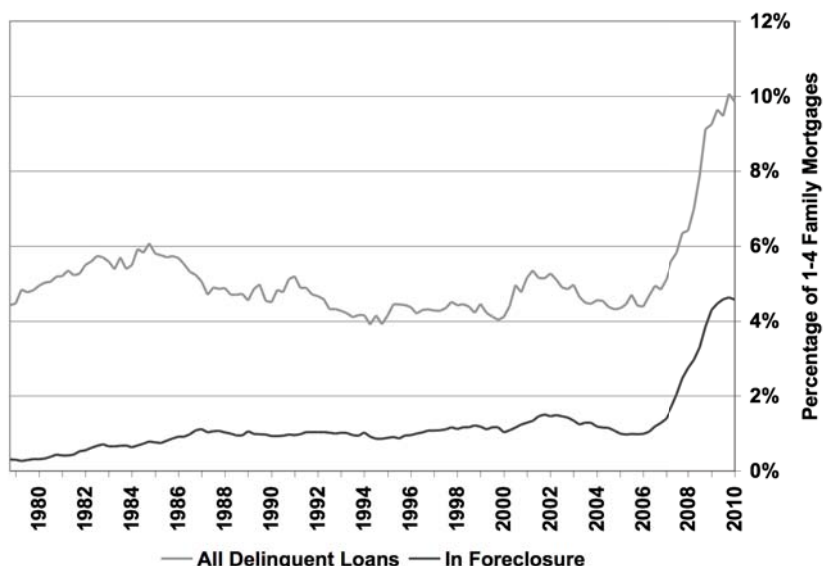
Congress would do well to ensure that federal regulators are undertaking a thorough investigation of foreclosure problems and to consider the possibilities for a global settlement of foreclosure problems, loan modifications, and the housing debt overhang that stagnate the economy and pose potential systemic risk.

Mr. Chairman, Members of the Committee:

Good morning. My name is Adam Levitin. I am an Associate Professor of Law at the Georgetown University Law Center in Washington, D.C., where I teach courses in bankruptcy, commercial law, contracts, and structured finance. I also serve as Special Counsel to the Congressional Oversight Panel for the Troubled Asset Relief Program. The views I express today are my own, however.

We are now well into the fourth year of the foreclosure crisis, and there is no end in sight. Since mid-2007 around eight million homes entered foreclosure,¹ and over three million borrowers lost their homes in foreclosure.² As of June 30, 2010, the Mortgage Bankers Association reported that 4.57% of 1-4 family residential mortgage loans (roughly 2.5 million loans) were currently in the foreclosure, process a rate more than quadruple historical averages. (See Figure 1.) Additionally, 9.85% of mortgages (roughly 5 million loans) were at least a month delinquent.³

Chart 1: Percentage of 1-4 Family Residential Mortgages in Foreclosure⁴



Private lenders, industry associations, and two successive administrations have made a variety of efforts to mitigate the crisis and encourage loan modifications and refinancings. A series of much hyped initiatives, such as the FHASecure refinancing program and the Hope4Homeowners have all met what can charitably be described as limited success. FHASecure, predicted to help 240,000 homeowners,⁵ assisted only a few thousand borrowers before it wound down,⁶ while Hope4 Homeowners, originally predicted to help 400,000

¹ HOPE Now Data Reports.

² *Id.*

³ Mortgage Bankers Association, National Delinquency Survey.

⁴ Mortgage Bankers Association, National Delinquency Surveys.

⁵ See, e.g., Press Release, US Dep't of Housing and Urban Development, Bush Administration to Help Nearly One-Quarter of a Million Homeowners Refinance, Keep Their Homes; FHA to implement new "FHASecure" refinancing product (Aug. 31, 2007), available at <http://www.hud.gov/news/release.cfm?content=pr07-123.cfm>; Press Release, US Dep't of Housing and Urban Development, FHA Helps 400,000 Families Find Mortgage Relief; Refinancing on pace to help half-million homeowners by year's end (Oct. 24, 2008), available at <http://www.hud.gov/news/release.cfm?content=pr08-167.cfm>.

⁶ Michael Corkery, *Mortgage 'Cram-Downs' Loom as Foreclosures Mount*, WALL ST. J., Dec. 31, 2008.

homeowners,⁷ had closed only 130 refinancings as of September 30, 2010.⁸ The Home Affordable Modification (HAMP) has also failed, producing 495,898 permanent modifications through September 2010. This number is likely to be a high water mark for HAMP, as new permanent modifications are decreasing rapidly while defaults on permanent modifications rise; if current trends continue, by year's end the number of active permanent HAMP modifications will actually decline.

A number of events over the past several months have roiled the mortgage world, raising questions about:

- (1) Whether there is widespread fraud in the foreclosure process;
- (2) Securitization chain of title, namely whether the transfer of mortgages in the securitization process was defective, rendering mortgage-backed securities into *non-mortgage-backed securities*;
- (3) Whether the use of the Mortgage Electronic Registration System (MERS) creates legal defects in either the secured status of a mortgage loan or in mortgage assignments;
- (4) Whether mortgage servicers' have defaulted on their servicing contracts by charging predatory fees to borrowers that are ultimately paid by investors;
- (5) Whether investors will be able to "putback" to banks securitized mortgages on the basis of breaches of representations and warranties about the quality of the mortgages.

These issues are seemingly disparate and unconnected, other than that they all involve mortgages. They are, however, connected by two common threads: the necessity of proving standing in order to maintain a foreclosure action and the severe conflicts of interests between mortgage servicers and MBS investors.

It is axiomatic that in order to bring a suit, like a foreclosure action, the plaintiff must have legal standing, meaning it must have a direct interest in the outcome of the legislation. In the case of a mortgage foreclosure, only the mortgagee has such an interest and thus standing. Many of the issues relating to foreclosure fraud by mortgage servicers, ranging from more minor procedural defects up to outright counterfeiting relate to the need to show standing. Thus problems like false affidavits of indebtedness, false lost note affidavits, and false lost summons affidavits, as well as backdated mortgage assignments, and wholly counterfeited notes, mortgages, and assignments all relate to the evidentiary need to show that the entity bringing the foreclosure action has standing to foreclose.

Concerns about securitization chain of title also go to the standing question; if the mortgages were not properly transferred in the securitization process (including through the use of MERS to record the mortgages), then the party bringing the foreclosure does not in fact own the mortgage and therefore lacks standing to foreclose. If the mortgage was not properly transferred, there are profound implications too for investors, as the mortgage-backed securities they believed they had purchased would, in fact be non-mortgage-backed securities, which would almost assuredly lead investors to demand that their investment contracts be rescinded, thereby exacerbating the scale of mortgage putback claims.

⁷ Dina ElBoghdady, *HUD Chief Calls Aid on Mortgages a Failure*, WASH. POST. Dec. 17, 2008, at A1.

⁸ See FHA Single Family Outlook, Sept. 2010, at <http://www.hud.gov/offices/hsg/rmra/oe/rpts/ooe/olcurr.xls> - 2010-11-02, Row 263 (note that FHA fiscal years begin in October, so that Fiscal Year 2009 began in October 2008).

Putback claims underscore the myriad conflicts of interest between mortgage servicers and investors. Mortgage servicers are responsible for prosecuting on behalf of MBS investors, violations of representations and warranties in securitization deals. Mortgage servicers are loathe to bring such actions, however, not least because they would often be bringing them against their own affiliates. Servicers' failure to honor their contractual duty to protect investors' interest is but one of numerous problems with servicer conflicts of interest, including the levying of junk fees in foreclosures that are ultimately paid by investors and servicing first lien loans while directly owning junior liens.

Many of the problems in the mortgage securitization market (and thus this testimony) are highly technical, but they are extremely serious.⁹ At best they present problems of fraud on the court and questionable title to property. At worst, they represent a systemic risk of liabilities in the trillions of dollars, greatly exceeding the capital of the US's major financial institutions. While understanding the securitization market's problems involves following a good deal of technical issues, it is critical to understand from the get-go that securitization is all about technicalities.

Securitization is the legal apotheosis of form over substance, and if securitization is to work it must adhere to its proper, prescribed form punctiliously. The rules of the game with securitization, as with real property law and secured credit are, and always have been, that dotting "i's" and crossing "t's" matter, in part to ensure the fairness of the system and avoid confusions about conflicting claims to property. Close enough doesn't do it in securitization; if you don't do it right, you cannot ensure that securitized assets are bankruptcy remote and thus you cannot get the ratings and opinion letters necessary for securitization to work. Thus, it is important not to dismiss securitization problems as merely "technical;" these issues are no more technicalities than the borrower's signature on a mortgage. Cutting corners may improve securitization's economic efficiency, but it undermines its legal viability.

Finally, as an initial matter, let me also emphasize that the problems in the securitization world do not affect the whether homeowners owe valid debts or have defaulted on those debts. Those are separate issues about which there is no general controversy, even if debts are disputed in individual cases.¹⁰

This written testimony proceeds as follows: Part I presents an overview of the structure of the mortgage market, the role of mortgage servicers, the mortgage contract and foreclosure process. Part II presents the procedural problems and fraud issues that have emerged in the mortgage market relating to foreclosures. Part III addresses chain of title concerns. Part IV considers the argument that the problems in foreclosures are mere technicalities being used by deadbeats to delay foreclosure. Part V concludes.

⁹ I emphasize, however, that this testimony does not purport to be a complete and exhaustive treatment of the issues involved and that many of the legal issues discussed are not settled law, which is itself part of the problem; trillions of dollars of mortgage securitization transactions have been done without a certain legal basis.

¹⁰ A notable exception, however, is for cases where the default is caused by a servicer improperly force-placing insurance or misapplying a payment, resulting in an inflated loan balance that triggers a homeowner default.

I. BACKGROUND ON SECURITIZATION, SERVICING, AND THE FORECLOSURE PROCESS

A. MORTGAGE SECURITIZATION

Most residential mortgages in the United States are financed through securitization. . . . Securitization is a financing method involving the issuance of securities against a dedicated cashflow stream, such as mortgage payments, that are isolated from other creditors' claims. Securitization links consumer borrowers with capital market financing, potentially lowering the cost of mortgage capital. It also allows financing institutions to avoid the credit risk, interest rate risk, and liquidity risk associated with holding the mortgages on their own books.

Currently, about 60% of all outstanding residential mortgages by dollar amount are securitized.¹¹ The share of securitized mortgages by number of mortgages outstanding is much higher because the securitization rate is lower for larger "jumbo" mortgages.¹² Credit Suisse estimates that 75% of outstanding first-lien residential mortgages are securitized.¹³ In recent years, over 90% of mortgages originated have been securitized.¹⁴ Most second-lien loans, however, are not securitized.¹⁵

Although mortgage securitization transactions are extremely complex and vary somewhat depending on the type of entity undertaking the securitization, the core of the transaction is relatively simple.¹⁶

First, a financial institution (the "sponsor" or "seller") assembles a pool of mortgage loans. The loans were either made ("originated") by an affiliate of the financial institution or purchased from unaffiliated third-party originators. Second, the pool of loans is sold by the sponsor to a special-purpose subsidiary (the "depositor") that has no other assets or liabilities. This is done to segregate the loans from the sponsor's assets and liabilities.¹⁷ Third, the depositor sells the loans to a passive, specially created, single-purpose vehicle (SPV), typically a trust in the case of residential mortgages.¹⁸ The SPV issues certificated securities to raise the funds to pay the depositor for the loans. Most of the securities are debt securities—bonds—but there will also be a security representing the rights to the residual value of the trust or the "equity."

¹¹ Inside Mortgage Finance, 2010 Mortgage Market Statistical Annual.

¹² *Id.*

¹³ Ivy L. Zelman et al., *Mortgage Liquidity du Jour: Underestimated No More* 28 exhibit 21 (Credit Suisse, Equity Research Report, Mar. 12, 2007).

¹⁴ Inside Mortgage Finance, 2010 Mortgage Market Statistical Annual.

¹⁵ Inside Mortgage Finance, 2010 Mortgage Market Statistical Annual. From 2001-2007, only 14% of second lien mortgages originated were securitized. *Id.* Second lien mortgages create a conflict of interest beyond the scope of this paper. In many cases, second lien loans are owned by financial institutions that are servicing (but do not own) the first lien loan. See Hearing Before the House Financial Services Committee, Apr. 13, 2009 "Second Liens and Other Barriers to Principal Reduction as an Effective Foreclosure Mitigation Program" (testimony of Barbara DeSoer, President, Bank of America Home Loans) at 6 (noting that Bank of America owns the second lien mortgage on 15% of the first lien mortgages it services); Hearing Before the House Financial Services Committee, Apr. 13, 2009 "Second Liens and Other Barriers to Principal Reduction as an Effective Foreclosure Mitigation Program" (testimony of David Lowman, CEO for Home Lending, JPMorgan Chase) at 5 (noting that Chase owns the second lien mortgage on around 10% of the first lien mortgages it services). The ownership of the second while servicing the first creates a direct financial conflict between the servicer qua servicer and the servicer qua owner of the second lien mortgage, as the servicer has an incentive to modify the first lien mortgage in order to free up borrower cashflow for payments on the second lien mortgage.

¹⁶ The structure illustrated is for private-label mortgage-backed securities. Ginnie Mae and GSE securitizations are structured somewhat differently. The private-label structure can, of course, be used to securitize any asset, from oil tankers to credit card debt to song catalogues, not just mortgages.

¹⁷ This intermediate entity is not essential to securitization, but since 2002, Statement of Financial Accountings Standards 140 has required this additional step for off-balance-sheet treatment because of the remote possibility that if the originator went bankrupt or into receivership, the securitization would be treated as a secured loan, rather than a sale, and the originator would exercise its equitable right of redemption and reclaim the securitized assets. Deloitte & Touche, *Learning the Norwalk Two-Step*, HEADS UP, Apr. 25, 2001, at 1.

¹⁸ The trustee will then typically convey the mortgage notes and security instruments to a "master document custodian," who manages the loan documentation, while the servicer handles the collection of the loans.

The securities can be sold directly to investors by the SPV or, as is more common, they are issued directly to the depositor as payment for the loans. The depositor then resells the securities, usually through an underwriting affiliate that then places them on the market. (See Figure 2, below.) The depositor uses the proceeds of the securities sale (to the underwriter or the market) to pay the sponsor for the loans. Because the certificated securities are collateralized by the residential mortgage loans owned by the trust, they are called residential mortgage-backed securities (RMBS).

A variety of reasons—credit risk (bankruptcy remoteness), off-balance sheet accounting treatment, and pass-through tax status (typically as a REMIC¹⁹ or grantor trust)—mandate that the SPV be passive; it is little more than a shell to hold the loans and put them beyond the reach of the creditors of the financial institution.²⁰ Loans, however, need to be managed. Bills must be sent out and payments collected. Thus, a third-party must be brought in to manage the loans.²¹ This third party is the servicer. The servicer is supposed to manage the loans for the benefit of the RMBS holders.

Every loan, irrespective of whether it is securitized, has a servicer. Sometimes that servicer is a first-party servicer, such as when a portfolio lender services its own loans. Other times it is a third-party servicer that services loans it does not own. All securitizations involve third-party servicers, but many portfolio loans also have third-party servicers, particularly if they go into default. Third-party servicing contracts for portfolio loans are not publicly available, making it hard to say much about them, including the precise nature of servicing compensation arrangements in these cases or the degree of oversight portfolio lenders exercise over their third-party servicers. Thus, it cannot always be assumed that if a loan is not securitized it is being serviced by the financial institution that owns the loan, but if the loan is securitized, it has third-party servicing.

Securitization divides the beneficial ownership of the mortgage loan from legal title to the loan and from the management of the loans. The SPV (or more precisely its trustee) holds legal title to the loans, and the trust is the nominal beneficial owner of the loans. The RMBS investors are formally creditors of the trust, not owners of the loans held by the trust.

The economic reality, however, is that the investors are the true beneficial owners. The trust is just a pass-through holding entity, rather than an operating company. Moreover, while the trustee has nominal title to the loans for the trust, it is the third-party servicer that typically exercises legal title in the name of the trustee. The economic realities of securitization do not track with its legal formalities; securitization is the apotheosis of legal form over substance, but punctilious respect for formalities is critical for securitization to work.

Mortgage servicers provide the critical link between mortgage borrowers and the SPV and RMBS investors, and servicing arrangements are an indispensable part of securitization.²² Mortgage servicing has become particularly important with the growth of the securitization market.

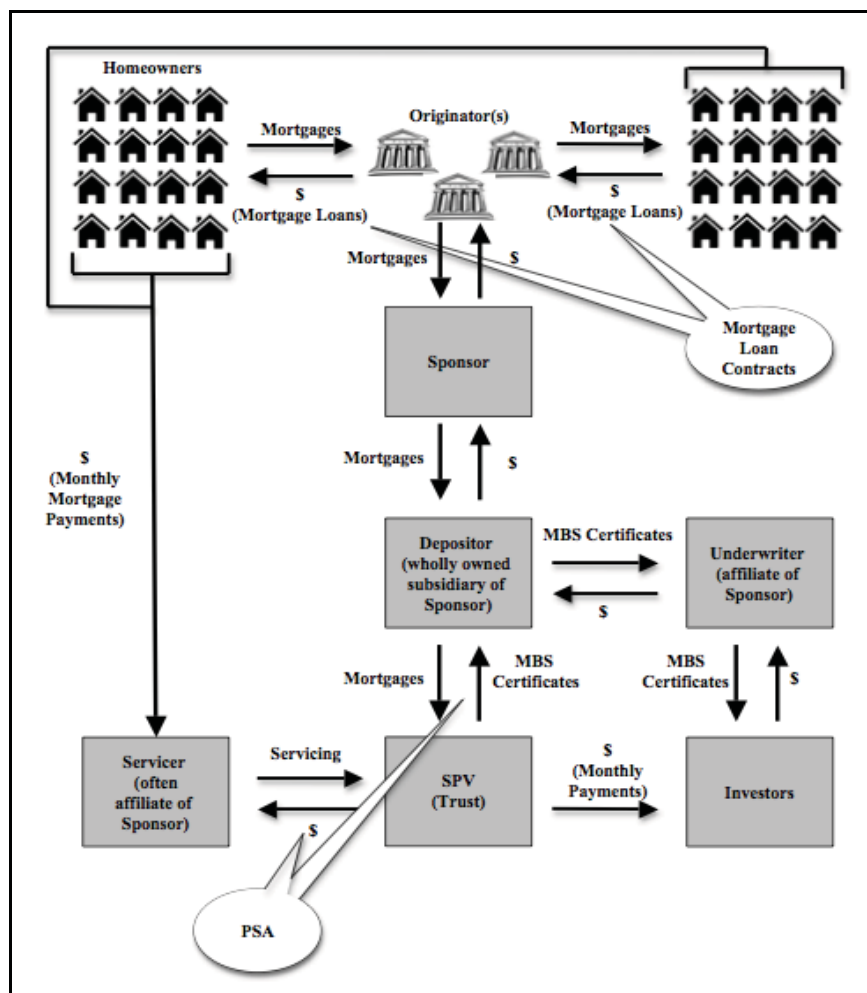
¹⁹ A REMIC is a real estate mortgage investment conduit, as defined under I.R.C. §§ 860A-860G.

²⁰ See Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage Backed Securities*, 82 S. CAL. L. REV. 1075, 1093-98. (2009).

²¹ See Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUSING POL'Y DEBATE 753, 754 (2004).

²² The servicing of nonsecuritized loans may also be outsourced. There is little information about this market because it does not involve publicly available contracts and does not show up in standard data.

Figure 2. Private-Label Mortgage Securitization Structure²³



B. THE MORTGAGE SERVICING BUSINESS²⁴

The nature of the servicing business in general militates toward economies of scale and automation. Servicing combines three distinct lines of business: transaction processing, default management, and loss mitigation. Transaction processing is a highly automatable business, characterized by large economies of scale. Default management involves collections and activities related to taking defaulted loans through foreclosure. Like transaction processing, default management can be automated,²⁵ as it does not require any negotiation with the homeowner, insurers, or junior lienholders.²⁶

²³ See ACE Sec. Corp. Home Equity Loan Trust, Series 2006-NC3, Prospectus Supplement (Form 424B5) S-11 (Nov. 21, 2006), available at http://www.sec.gov/Archives/edgar/data/1380884/000114420406049985/v058926_424b5.htm.

²⁴ This section of my testimony comes from Adam J. Levitin & Larry Cordell, *What RMBS Servicing Can Learn from CMBS Servicing*, working paper, November 2010.

²⁵ See *In re Taylor*, 407 B.R. 618 (Bankr. E.D. Pa. 2009), *rev'd* 2010 WL 624909 (E.D. Pa. 2010).

²⁶ Arguably servicers have a fourth line of business—the management of real estate owned (REO). REO are foreclosed properties that were not purchased by third-parties at the foreclosure sale. REO management involves caring for and marketing the REO. It does not require negotiations with the homeowner (who is evicted) or junior lienholders (whose liens are generally extinguished by the foreclosure).

Loss mitigation is considered an *alternative to foreclosure*, and includes activities such as repayment plans, loan modifications, short sales and deeds in lieu of foreclosure. Loss mitigation is always a negotiated process and is therefore labor-intensive and expensive. Not only must the homeowner be agreeable to any loss mitigation solution, but so too must mortgage insurers and junior lienholders if they are parties on the loan. Because each negotiation is separate and requires a trained employee, there are very few opportunities for automation or economies of scale. Labor expenses are also considered overhead, which are all non-reimbursable expenses to servicers. And, to the extent that loss mitigation is in the form of a loan modification, redefault and self-cure risk always lurk in the background. Moreover, loss mitigation must generally be conducted in addition to default management; the servicer must proceed with foreclosure even if attempting to find an alternative, so the cost of loss mitigation is additive. Yet, while taking a loan through foreclosure is likely to involve lower costs than pursuing loss mitigation, it may not ultimately maximize value for RMBS investors because loss severities in foreclosure can easily surpass those on a re-performing restructured loan.

The balance between these different parts of a servicer's business changes over the course of the housing cycle. When the housing market is strong, the transaction processing dominates the servicing business, but when the housing market is weak, default management and loss mitigation become more important.

The very short weighted average life (WAL) of RMBS trusts combined with very low defaults in most economic environments encouraged servicers to place disproportionate weight on performing loan servicing, which historically has been characterized by small servicing fees and enormous economies of scale. Thus, on a typical loan balance of \$200,000 today, a servicer might earn between \$500 and \$1,000 per year.²⁷ Given the low-level of annual income per loan, the short WAL of each loan, and low default rates in most economic environments before 2006, servicers had few incentives to devote resources to loss mitigation, but large incentives to invest in performing loan automation to capture the large economies of scale. This left servicers wholly unprepared for the elevated level of defaults that began in 2007.

C. RMBS SERVICER COMPENSATION

RMBS servicers' duties and compensation are set forth in a document called a "Pooling and Servicing" agreement (PSA) also governs the rights of the RMBS certificate holders. RMBS servicers are compensated in four ways. First, they receive a "servicing fee," which is a flat fee of 25—50 basis points (bps) and is a first priority payment in the RMBS trust.²⁸ This is by far the greatest portion of servicer income. This fee is paid out proportionately across all loans regardless of servicer costs through the economic cycle.

Second, servicers earn "float" income. Servicers generally collect mortgage payments at the beginning of the month, but are not required to remit the payments to the trust until the 25th of the month. In the interim, servicers invest the funds they have collected from the mortgagors, and they retain all investment income. Servicers can also obtain float income from escrow

²⁷ Servicing fees are generally 25—50 bps, which translates into \$500--\$1000 per year in servicing fees.

²⁸ Generally the servicing fee is 25 bps for conventional fixed rate mortgages, 37.5 bps for conventional ARM loans, 44 bps for government loans and 50 bps for subprime.

balances collected monthly from borrowers to pay taxes and insurance during the course of the year.

Third, servicers are generally permitted to retain all ancillary fees they can collect from mortgagors. This includes things like late fees and fees for balance checks or telephone payments. It also includes fees for expenses involved in handling defaulted mortgages, such as inspecting the property. Finally, servicers can hold securities themselves directly as investors, and often hold the junior-most, residual tranche in the securitization.

Servicers face several costs. In addition to the operational expenses of sending out billing statements, processing payments, maintaining account balances and histories, and restructuring or liquidating defaulted loans, private label RMBS servicers face the expense of “servicing advances.”²⁹ When a loan defaults, the servicer is responsible for advancing the missed payments of principal and interest to the trust as well as paying taxes and insurance on the property. They continue to pay clear through liquidation of the property, unless these advances are not deemed recoverable.

The servicer is able to recover advances it has made either from liquidation proceeds or from collections on other loans in the pool, but the RMBS servicer does not receive interest on its advances. Therefore, advances can be quite costly to servicers in terms of the time value of money and can also place major strains on servicers’ liquidity, as the obligation to make advances continues until the loan is liquidated or the servicer believes that it is unlikely to be able to recover the advances. In some cases, servicers have to advance years’ worth of mortgage payments to the trust.

While RMBS servicers do not receive interest on servicing advances, they are compensated for their “out-of-pocket” expenses. This includes any expenses spent on preserving the collateral property, including force-placed insurance, legal fees, and other foreclosure-related expenses. Large servicers frequently “in-source” default management expenses to their affiliates.

D. MONITORING OF RMBS SERVICERS

RMBS servicing arrangements present a classic principal-agent problem wherein the agent’s incentives are not aligned with the principal and the principal has limited ability to monitor or discipline the agent.

1. Investors

Investors are poorly situated to monitor servicer behavior because they do not have direct dealings with the servicer. RMBS investors lack information about servicer loss mitigation activity. Investors do not have access to detailed servicer expense reports or the ability to examine loss mitigation decisions. Investors are able to see only the ultimate outcome. This means that investors are limited in their ability to evaluate servicers’ performance on an ongoing

²⁹ In Agency securities, servicers generally stop advancing after borrowers owe their fifth payment, at 120 days past due. For GSE loans, they are then removed from the securities and taken on balance sheet. Servicer advances for the four payments are typically not reimbursed until termination.

basis. And even if investors were able to detect unfaithful agents, they have little ability to discipline them short of litigation.³⁰

2. Trustees

RMBS feature a trustee, but the name is deceptive. The trustee is not a common law trustee with general fiduciary duties. Instead, it is a limited purpose corporate trustee whose duties depend on whether there has been a default as defined UN the PSA. A failure to pay all tranches their regularly scheduled principal and interest payments is *not* an event of default. Instead, default relates to the financial condition of the servicer, whether the servicer has made required advances to the trust, whether the servicer has submitted its monthly report, and whether the servicer has failed to meet any of its covenants under the PSA.

Generally, before there is an event of default, the trustee has a few specifically assigned ministerial duties and no others.³¹ These duties are typically transmitting funds from the trust to the RMBS investors and providing investors performance statements based on figures provided by the servicer. The trustee's pre-default duties do *not* include active monitoring of the servicer.

Trustees are generally entitled to rely on servicers' data reporting, and have little obligation to analyze it.³² Indeed, as Moody's has noted, trustees lack the ability to verify most data reported by servicers; at best they can ensure that the reported data complies with any applicable covenant ratios:

The trustee is not in a position to verify certain of the numbers reported by the servicer. For example, the amount of delinquent receivables and the amount of receivables charged off in a given month are figures that are taken from the servicer's own computer systems. While these numbers could be verified by an auditor, they are not verifiable by the trustee.³³

Likewise, as attorney Susan Macaulay has observed, "In most cases, even if the servicer reports are incorrect, or even fraudulent, absent manifest error, the trustee simply has no way of knowing that there is a problem, and must allocate the funds into the appropriate accounts, and make the mandated distributions, in accordance with the servicer reports."³⁴

³⁰ Investors also arguably lack a strong incentive to care about servicer performance. See Levitin & Twomey, *supra* note **Error! Bookmark not defined.** (noting that resecuritization and investor optimism bias means that investors are likely to either be invested only derivatively in subordinated tranches or believe that they have selected a tranche that will be "in-the-money" and therefore unaffected by marginal changes in servicer behavior).

³¹ See, e.g., Wells Fargo Mortgage Backed Securities 2006-AR10 Trust § 8.01 ("Prior to the occurrence of an Event of Default of which a Responsible Officer of the Trustee shall have actual knowledge and after the curing of all such Events of Default which may have occurred, the duties and obligations of the Trustee shall be determined solely by the express provisions of this Agreement, the Trustee shall not be liable except for the performance of such duties and obligations as are specifically set forth in this Agreement, no implied covenants or obligations shall be read into this Agreement against the Trustee and, in the absence of bad faith on the part of the Trustee, the Trustee may conclusively rely, as to the truth of the statements and the correctness of the opinions expressed therein, upon any certificates or opinions furnished to the Trustee, and conforming to the requirements of this Agreement."). See also Moody's Investor Service, Structured Finance Ratings Methodology: Moody's Re-examines Trustees' Role in ABS and RMBS, Feb. 4, 2003, at 4. (noting "Some trustees have argued that their responsibilities are limited to strictly administrative functions as detailed in the transaction documents and that they have no "fiduciary" duty prior to an event of default.").

³² MBIA Ins. Corp. v. Royal Indem. Co., 519 F. Supp. 2d 455 (2007), *aff'd* 321 Fed. Appx. 146 (3d Cir. 2009) ("Royal argues that Wells Fargo [the trustee] had the contractual obligation to analyze data using certain financial accounting principles and to detect any anomalies that analysis might have uncovered. As Royal suggests, this analysis may not have been very labor-intensive. Yet, the contract did not call for any analysis at all. It simply required Wells Fargo to perform rote comparisons between that data and data contained in various other sources, and to report any numerical inconsistencies. Wells Fargo did just that.").

³³ Moody's Investor Service, *supra* note 31, at 4.

³⁴ Susan J. Macaulay, *US: The Role of the Securitisation Trustee*, GLOBAL SECURITISATION AND STRUCTURED FINANCE 2004. Macaulay further notes that:

Similarly, trustees usually wait for servicers to notify them of defaults,³⁵ and Moody's has noted that trustees are often unresponsive to information from third parties indicating that an unreported default might have occurred.³⁶ Thus, trustees enforce servicer representations and warranties largely on the honor system of servicer self-reporting.

For private-label securities, trustees also lack the incentive to engage in more vigorous monitoring of servicer loss mitigation decisions. The trustee does not get paid more for more vigorous monitoring. The trustee generally has little ability to discipline the servicer except for litigation. Private-label RMBS trustees have almost no ability to fire or discipline a servicer. Servicers can only be dismissed for specified acts, and these acts are typically limited to the servicer's insolvency or failure to remit funds to the trust. Occasionally servicers may be dismissed if default levels exceed particular thresholds.

Trustees also have no interest in seeing a servicer dismissed because they often are required to step in as back-up servicer.³⁷ In the event of a servicer default, the trustee takes over as servicer (which includes the option of subcontracting the duties), and assumes the duty of making servicing advances to the trust. The back-up servicer role is essentially an insurance policy for investors, and activation of that role is equivalent to payment on a claim; a trustee that has to act as a back-up servicer is likely to lose money in the process, especially when some of the trustees do not themselves own servicing operations.

Trustees also often have close relationships with particular servicers. For example, Professor Tara Twomey and I have shown that Bank of America/Countrywide accounts for nearly two-thirds of Deutsche Bank's RMBS trustee business.³⁸ In such circumstances, trustees are unlikely to engage in meaningful monitoring and disciplining of servicers.³⁹ Amherst Securities points out that early payment default provisions are not effectively enforced by trustees, to the point where in cases where borrowers did not make a single payment on the mortgage, only 37 percent were purchased out of the trust, much smaller amounts for loans making only one to six payments.⁴⁰ Thus, for private-label RMBS, there is virtually no supervision of servicers.⁴¹

GSE and Ginnie Mae securitization have greater oversight of servicers. The GSEs serve as master servicers on most of their RMBS; they therefore have a greater ability to monitor servicer compliance. The GSEs require servicers to foreclose according to detailed timelines, and

It is almost always an event of default under the indenture if the trustee does not receive a servicer report within a specified period of time, and the trustee must typically report such a failure to the investors, any credit enhancement provider, the rating agencies and others. However, the trustee generally has no duties beyond that with respect to the contents of the report, although under the TIA, the trustee must review any reports furnished to it to determine whether there is any violation of the terms of the indenture. Presumably this would include verifying that any ratios represented in any reports conform to financial covenants contained in the indenture, etc. It would not however, require the trustee to go beyond the face of the report, i.e. to conduct further investigation to determine whether the data underlying the information on the reports presented to it were, in fact, true. Virtually all indentures, whether or not governed by the TIA, explicitly permit the trustee to rely on statements made to the trustee in officers' certificates, opinions of counsel and documents delivered to the trustee in the manner specified within the indenture.

Id.

³⁵ Moody's Investor Service, *supra* note 31, at 4.

³⁶ *Id.*

³⁷ Eric Gross, *Portfolio Management: The Evolution of Backup Servicing*, Portfolio Financial Servicing Company (PFSC) (July 11, 2002) at <http://www.securitization.net/knowledge/article.asp?id=147&aid=2047>.

³⁸ Levitin & Twomey, *supra* note **Error! Bookmark not defined.**

³⁹ See *Ellington Credit Fund, Ltd. v. Select Portfolio, Inc.*, No. 1:07-cv-00421-LY, W.D. Tex., Plaintiffs' First Amended Complaint, July 10, 2007 (RMBS residual tranche holder alleging that trustee was aware that servicer was in violation of PSA and failed to act).

⁴⁰ See Amherst Mortgage Insight, *supra* note **Error! Bookmark not defined.**, at 15.

⁴¹ For MBS with separate master and primary servicers, the master servicer may monitor the primary servicer(s), but often the master and primary servicers are the same entity.

servicers that fail to comply face monetary penalties. Recognizing the benefits inherent in effective loss mitigation, Fannie Mae places staff directly in all of the largest servicer shops to work alongside loss mitigation staff at their servicers.⁴² Freddie Mac constructed servicer performance profiles to directly monitor servicers, sharing results directly with servicers and rating agencies. Since each GSE insures against credit losses on the loans, their ongoing monitoring provides consistent rules and a single point of contact to approve workout packages and grant exceptions, something absent in private label RMBS.

3. Ratings and Reputation

Like any repeat transaction business, servicers are concerned about their reputations. But reputational sanctions have only very weak discipline on servicer behavior.

While Regulation AB requires servicers to disclose information about their experience and practices,⁴³ they are not required to disclose information about performance of past pools they have serviced. In any event, reputational sanctions are ineffective because loss severities are more likely to be attributed to underwriting quality than to servicing decisions.

Rating agencies also produce servicer ratings, but these ratings are a compilation of the evaluation of servicers on a multitude of characteristics. Rating agencies have been known to incorporate features of Freddie Mac's servicer performance profiles in their servicer assessments and to incorporate loss mitigation performance into their ratings. But details of their methodology used to measure these assessments are not disclosed. They give no indication of whether a servicer is likely to make loss mitigation decisions based solely on the interests of the securitization trust. Ratings are also combined with other criteria, such as the servicer's own financial strength and operational capacity. In other words, servicer ratings go to the question of whether a servicer will have to be replaced because it is insolvent or lacks the ability to service the loans, with much less weight given to whether the servicer acts in the investors' interests.

C. THE MORTGAGE CONTRACT AND FORECLOSURE PROCESS

The mortgage contract consists of two documents, a promissory note (the "note" or the "mortgage loan") and a security instrument (the "mortgage" or the "deed of trust").⁴⁴ The note is the IOU that contains the borrower's promise to repay the money loaned. If the note is a negotiable instrument, meaning that it complies with the requirements for negotiability in Article 3 of the Uniform Commercial Code,⁴⁵ then the *original physical note* is itself the right to payment.⁴⁶

The mortgage is the document that connects the IOU with the house. The mortgage gives the lender a contingent right to the house; it provides that *if* the borrower does not pay according to the terms of the note, then the lender can foreclose and have the property sold *according to the*

⁴² PMI insurers have recently started to embed staff in servicer shops to monitor loss mitigation efforts. Harry Terris & Kate Berry, *In the Trenches*, AM. BANKER, Aug. 27, 2009.

⁴³ 17 C.F.R. § 229.1108.

⁴⁴ The note and the mortgage can be combined in a single document, but that is not common practice, both because the mortgage can be granted subsequent to the creation of the debt and because of borrower privacy concerns about the terms of the note, which would become public if the note and mortgage were combined and recorded in local property records.

⁴⁵ See UCC 3-104.

⁴⁶ UCC 3-203, Cmt. 1 ("An instrument is a reified right to payment. The right is represented by the instrument itself.")

terms of the mortgage and applicable state and federal law. The applicable law governing foreclosures is state law.⁴⁷

State real estate law, including foreclosure law, is non-uniform, making it difficult to state what the law is as a generic matter; there is always the possibility that some jurisdictions may deviate from the majority rule. That said, no state requires a borrower's note to be recorded in local land records for the note to be valid, and, as a general matter, state law does not require the mortgage to be recorded either in order for the mortgage to be enforceable against the borrower. Recording of the mortgage is necessary, however, to establish the mortgage's priority relative to the claims of other parties, including other mortgagees, judgment lien creditors and tax and workmen's' liens against the property. The basic rule of priority is first in time, first in right; the first mortgage to be recorded has senior priority. An unrecorded mortgage will thus, generally have junior priority to a subsequently issued, but recorded mortgage. The difference between enforceability and priority is an important one, discussed in more detail below, in the section of this testimony dealing with MERS.

State law on foreclosures is also non-uniform. Roughly, however, states can be divided into two groups: those where foreclosure actions are conducted through the courts ("judicial foreclosure") and those where foreclosure actions are conducted by private sales ("nonjudicial foreclosure"). This division maps, imperfectly, with whether the preferred security instrument is a mortgage or a deed of trust.⁴⁸

Mortgage loans cost more in states that have judicial foreclosure; what this means is that borrowers in judicial foreclosure states are paying more for additional procedural rights and legal protections; those procedural rights are part of the mortgage contract; failure to honor them is a breach of the mortgage contract. Note, that a default on the mortgage note is not a breach of the contract per se; instead it merely triggers the lender's right to foreclose per the applicable procedure.

In a typical judicial foreclosure proceeding, the homeowner receives a notice of default and if that default is not cured within the required period, the mortgagee then files a foreclosure action in court. The action is commenced by the filing of a written complaint that sets forth the mortgagee's allegations that the homeowner owes a debt that is secured by a mortgage and that the homeowner has defaulted on the debt. Rules of civil procedure generally require that legal actions based upon a writing include a copy of the writing as an attachment to the complaint, although there is sometimes an exception for writings that are available in the public records. While the mortgage is generally filed in the public records, assignments of the mortgage are often not (an issue complicated by MERS, discussed below), and the note is almost never a matter of public record.

It is important to understand that most judicial foreclosures do not function like the sort of judicial proceeding that is dramatized on television, in which all parties to the case appear in court, represented by attorneys and judgment only follows a lengthy trial. Instead, the norm in foreclosure cases is a default judgment. Most borrowers do not appear in court or contest their foreclosures, and not all of those who do are represented by competent counsel, not least because

⁴⁷ There is a federal foreclosure statute that can be utilized by FHA...

⁴⁸ Mortgages sometimes also include a power of sale, permitting nonjudicial foreclosure. In a deed of trust, the deed to the property is transferred in trust for the noteholder to a deed of trust trustee, often a local attorney. The note remains the property of the lender (the deed of trust beneficiary). When there is a default on the note, the lender notifies the deed of trust trustee and the lender or its agent is typically appointed as substitute deed of trust trustee to run the foreclosure sale.

of the difficulties in paying for counsel. Most borrowers that the borrower does not contest the foreclosure or appear in court. In most cases, only the lender's attorney appears, and judges routinely dispatch dozens or hundreds of foreclosure cases in a sitting. Homeowners in foreclosure actions are among the most vulnerable of defendants, the least able to insist up on and vindicate their rights, and accordingly the ones most susceptible to abuse of legal process.

II. PROCEDURAL PROBLEMS AND FRAUD

The first type of problems in the mortgage market are what might generously be termed "procedural defects" or "procedural irregularities." There are numerous such problems that have come to light in foreclosure cases. The extent and distribution of these irregularities is not yet known. No one has compiled a complete typology of procedural defects in foreclosures; there are, to use Donald Rumsfeld's phrase, certainly "known unknowns" and well as "unknown unknowns."

A. AFFIDAVITS FILED WITHOUT PERSONAL KNOWLEDGE (ROBOSIGNING)

Affidavits need to be based on personal knowledge to have any evidentiary effect; absent personal knowledge an affidavit is hearsay and therefore generally inadmissible as evidence. Accordingly, affidavits attest to personal knowledge of the facts alleged therein.

The most common type of affidavit is an attestation about the existence and status of the loan, namely that the homeowner owes a debt, how much is currently owed, and that the homeowner has defaulted on the loan. (Other types of affidavits are discussed in sections II.B. and II.C., *infra*). Such an affidavit is typically sworn out by an employee of a servicer (or sometimes by a law firm working for a servicer). Personal knowledge for such an affidavit would involve, at the very least, examining the payment history for a loan in the servicer's computer system and checking it against the facts alleged in a complaint.

The problem with affidavits filed in many foreclosure cases is that the affiant lacks any personal knowledge of the facts alleged whatsoever. Many servicers, including Bank of America, Citibank, JPMorgan Chase, Wells Fargo, and GMAC, employ professional affiants, some of whom appear to have no other duties than to sign affidavits. These employees cannot possibly have personal knowledge of the facts in their affidavits. One GMAC employee, Jeffrey Stephan, stated in a deposition that he signed perhaps 10,000 affidavits in a month, or approximately 1 a minute for a 40-hour work week.⁴⁹ For a servicer's employee to ascertain payment histories in a high volume of individual cases is simply impossible.

When a servicer files an affidavit that claims to be based on personal knowledge, but is not in fact based on personal knowledge, the servicer is committing a fraud on the court, and quite possibly perjury. The existence of foreclosures based on fraudulent pleadings raises the question of the validity of foreclosure judgments and therefore title on properties, particularly if they are still in real estate owned (REO).

⁴⁹ See Deposition of Jeffrey Stephan, GMAC Mortgage LLC v. Ann M. Neu a/k/a Ann Michelle Perez, No. 50 2008 CA 040805XXXX MB, (15th Judicial Circuit, Florida, Dec. 10, 2009) at 7, available at <http://api.ning.com/files/s4SMwlZXvPu4A7kq7XQUsGW9xEcYtqNMPCm0a2hISJu88PoY6ZNqanX7XK41Fyf9gV8JIHDme7KcFO2cvHqSE/McpJ8vwnDT/091210gmacmortgagevsannmneu1.pdf> (stating that Jeffrey Stephan, a GMAC employee, signed approximately 10,000 affidavits a month for foreclosure cases).

B. LOST NOTE AFFIDAVITS FOR NOTES THAT ARE NOT LOST

The plaintiff in a foreclosure action is generally required to produce the note as evidence that it has standing to foreclose. Moreover, under the Uniform Commercial Code, if the note is a negotiable instrument, only a holder of the note (or a subrogee)—that is a party in possession of the note—may enforce the note, as the note is the reified right to payment.⁵⁰

There is an exception, however, for lost, destroyed, or stolen notes, which permits a party that has lost possession of a note to enforce it.⁵¹ If a plaintiff seeks to enforce a lost note, it is necessary “to prove the terms of the instrument” as well as the “right to enforce the instrument.”⁵² This proof is typically offered in the form of a lost note affidavit that attests to the prior existence of the note, the terms of the note, and that the note has been lost.

It appears that a surprisingly large number of lost note affidavits are filed in foreclosure cases. In Broward County, Florida alone, over 2000 such affidavits were filed in 2008-2009.⁵³ Relative to the national population, that translates to roughly 116,000 lost note affidavits nationally over the same period.⁵⁴

There are two problems with the filing of many lost note affidavits. First, is a lack of personal knowledge. Mortgage servicers are rarely in possession of the original note. Instead, the original note is maintained in the fireproof vault of the securitization trustee’s document custodian. This means that the servicer lacks personal knowledge about whether a note has or has not been lost.⁵⁵ Merely reporting a communication from the document custodian would be hearsay and likely inadmissible as evidence.

The second problem is that the original note is frequently not in fact lost. Instead, it is in the document custodian’s vault. Servicers do not want to pay the document custodian a fee (of perhaps \$30) to release the original mortgage, and servicers are also wary of entrusting the original note to the law firms they hire. Substitution of counsel is not infrequent on defaulted mortgages, and servicers are worried that the original note will get lost in the paperwork shuffle if there is a change in counsel. When pressed, however, servicers will often produce the original note, months after filing lost note affidavits. The Uniform Commercial Code (UCC) requires that a party seeking to enforce a note be a holder (or subrogee to a holder) or produce evidence that a note has been lost, destroyed, or stolen; the UCC never contemplates an “inconvenience affidavit” that states that it is too much trouble for a servicer to bother obtaining the original note. But that is precisely what many lost note affidavits are effectively claiming.

Thus, many lost note affidavits are doubly defective: they are sworn out by a party that does not and cannot have personal knowledge of the alleged facts and the facts being alleged are often false as the note is not in fact lost, but the servicer simply does not want to bother obtaining it.

⁵⁰ UCC 3-301; 1-201(b)(21) (defining “holder”).

⁵¹ UCC 3-309. Note that UCC 3-309 was amended in the 2001 revision of Article 3. The revision made it easier to enforce a lost note. Not every state has adopted the 2001 revisions. Therefore, UCC 3-309 is non-uniform law.

⁵² UCC 3-309(b).

⁵³ Cite NY Times.

⁵⁴ According to the US Census Bureau, Broward County’s population is approximately 1.76 million, making it .57% of the total US population of 307 million. Broward does have a significantly higher than average foreclosure rate, roughly 12% over the past two years, according to Core Logic Loan Performance data, making it approximately 3 times the national average.

⁵⁵ The 2001 version of UCC 3-309 permits not only a party that has lost a note but a buyer from such a party to enforce a lost note.

C. JUNK FEES

The costs of foreclosure actions are initially incurred by servicers, but servicers recover these fees off the top from foreclosure sale proceeds before MBS investors are paid. This reimbursement structure limits servicers' incentive to rein in costs and actually incentivizes them to pad the costs of foreclosure. This is done in two ways. First, servicers charge so-called "junk fees" either for unnecessary work or for work that was simply never done. Thus, Professor Kurt Eggert has noted a variety of abusive servicing practices, including "improper foreclosures or attempted foreclosures; imposition of improper fees, especially late fees; forced-placed insurance that is not required or called for; and misuse of escrow funds."⁵⁶ Servicers' ability to retain foreclosure-related fees has even led them to attempt to foreclose on properties when the homeowners are current on the mortgage or without attempting any sort of repayment plan.⁵⁷ Consistently, Professor Katherine Porter has documented that when mortgage creditors file claims in bankruptcy, they generally list amounts owed that are much higher than those scheduled by debtors.⁵⁸

There is also growing evidence of servicers requesting payment for services not performed or for which there was no contractual right to payment. For example, in one particularly egregious case from 2008, Wells Fargo filed a claim in the borrower's bankruptcy case that included the costs of two brokers' price opinions allegedly obtained in September 2005, on a property in Jefferson Parish, Louisiana when the entire Parish was under an evacuation order due to Hurricane Katrina.⁵⁹

Similarly, there is a frequent problem of so-called "sewer summons" issued (or actually not issued) to homeowners in foreclosures. Among the costs of foreclosure actions is serving notice of the foreclosure (a court summons) on the homeowner. There is disturbing evidence that homeowners are being charged for summons that were never issued. These non-delivered summons are known as "sewer summons" after their actual delivery destination.

One way in which these non-existent summons are documented is through the filing of "affidavits of lost summons" by process servers working for the foreclosure attorneys hired by mortgage servicers. A recent article reports that in Duval County, Florida (Jacksonville) the number of affidavits of lost summons has ballooned from 1,031 from 2000-2006 to over 4,000 in the last two years, a suspiciously large increase that corresponds with a sharp uptick in foreclosures.⁶⁰

Because of concerns about illegal fees, the United States Trustee's Office has undertaken several investigations of servicers' false claims in bankruptcy⁶¹ and brought suit against

⁵⁶ Kurt Eggert, *Comment on Michael A. Stegman et al.'s "Preventive Servicing Is Good for Business and Affordable Homeownership Policy": What Prevents Loan Modifications?*, 18 HOUSING POL'Y DEBATE 279 (2007).

⁵⁷ Eggert, *Limiting Abuse*, *supra* note 21, at 757.

⁵⁸ Katherine M. Porter, *Mortgage Misbehavior*, 87 TEX. L. REV. 121, 162 (2008).

⁵⁹ *In re Stewart*, 391 B.R. 327, 355 (Bankr. E.D. La. 2008).

⁶⁰ Matt Taibi, *Courts Helping Banks Screw Over Homeowners*, ROLLING STONE, Nov. 25, 2010, at http://www.rollingstone.com/politics/news/17390/232611?RS_show_page=7.

⁶¹ Ashby Jones, *U.S. Trustee Program Playing Tough With Countrywide, Others*, LAW BLOG (Dec. 3, 2007, 10:01 AM), <http://blogs.wsj.com/law/2007/12/03/us-trustee-program-playing-tough-with-countrywide-others>.

Countrywide,⁶² while the Texas Attorney General has sued American Home Mortgage Servicing for illegal debt collection practices.⁶³

The other way in which servicers pad the costs of foreclosure is by in-sourcing their expenses to affiliates at above-market rates. For example, Countrywide, the largest RMBS servicer, force places insurance on defaulted properties with its captive insurance affiliate Balboa.⁶⁴ Countrywide has been accused of deliberately extending the time to foreclosure in order to increase the insurance premiums paid to its affiliate, all of which are reimbursable by the trust, before the RMBS investors' claims are paid.⁶⁵ Similarly, Countrywide in-sources trustee services in deed of trust foreclosures to its subsidiary Recon Trust.⁶⁶

Thus, in Countrywide's 2007 third quarter earnings call, Countrywide's President David Sambol emphasized that increased revenue from in-sourced default management functions could offset losses from mortgage defaults.

Now, we are frequently asked what the impact on our servicing costs and earnings will be from increased delinquencies and loss mitigation efforts, and what happens to costs. And what we point out is, as I will now, is that *increased operating expenses in times like this tend to be fully offset by increases in ancillary income in our servicing operation, greater fee income from items like late charges, and importantly from in-sourced vendor functions* that represent part of our diversification strategy, a counter-cyclical diversification strategy such as our businesses involved in foreclosure trustee and default title services and property inspection services.⁶⁷

In June, 2010, Countrywide settled with the FTC for \$108 million on charges that it overcharged delinquent homeowners for default management services. According to the FTC,

Countrywide ordered property inspections, lawn mowing, and other services meant to protect the lender's interest in the property... But rather than simply hire third-party vendors to perform the services, Countrywide created subsidiaries to hire the vendors. The subsidiaries marked up the price of the services charged by the vendors – often by 100% or more – and Countrywide then charged the homeowners the marked-up fees.⁶⁸

Among the accusations brought against Countrywide in a recent investor notice of default filed by the Federal Reserve Bank of New York along with BlackRock and PIMCO, is that Countrywide has been padding expenses via in-sourcing on the 115 trusts covered by the letter.⁶⁹

62 Complaint, *Walton v. Countrywide Home Loans, Inc. (In re Atchely)*, No. 05-79232 (Bankr. N.D. Ga. filed Feb. 28, 2008).

63 Complaint, *State v. Am. Home Mtg. Servicing, Inc.*, No. 2010-3307 (Tex. Dist. Ct. 448th Jud. Dist. filed Aug. 30, 2010).

64 Amherst Mortgage Securities, *supra* note **Error! Bookmark not defined.**, at 23.

65 *Id.*

66 Center for Responsible Lending, *Unfair and Unsafe: How Countrywide's irresponsible practices have harmed borrowers and shareholders*, CRL Issue Paper, Feb. 7, 2008, at 6-7.

67 Transcript, "Countrywide Financial Corporation Q3 2007 Earnings Call," Oct. 26, 2007 (emphasis added) (also mentioning "Our vertical diversification businesses, some of which I mentioned, are counter-cyclical to credit cycles, like the lender-placed property business in Balboa and like the in-source vendor businesses in our loan administration unit.").

68 FTC, Press Release, June 7, 2010, *Countrywide Will Pay \$108 Million for Overcharging Struggling Homeowners; Loan Servicer Inflated Fees, Mishandled Loans of Borrowers in Bankruptcy*.

69 Kathy D. Patrick, Letter to Countrywide Home Loan Servicing LP and the Bank of New York, dated Oct. 18, 2010, available at <http://www.scribd.com/Bondholders-Letter-to-BofA-Over-Countrywide-Loans-inc-NY-Fed/d/39686107>.

Countrywide is hardly the only servicer accused of acting in its interests at the expense of investors. Carrington, another major servicer, also owns the residual tranche on many of the deals it services. Amherst Mortgage Securities has shown that Carrington has been much slower than other servicers to liquidate defaulted loans.⁷⁰ Delay benefits Carrington both as a servicer and as the residual tranche investor. As a servicer, delay helps Carrington by increasing the number of monthly late fees that it can levy on the loans. These late fees are paid from liquidation proceeds before any of the MBS investors.

As an investor in the residual tranche, Carrington has also been accused of engaging in excessive modifications to both capture late fees and to keep up the excess spread in the deals, as it is paid directly to the residual holders.⁷¹ When loans were mass modified, Carrington benefited as the servicer by capitalizing late fees and advances into the principal balance of the modified loans, which increased the balance on which the servicing fee was calculated. Carrington also benefited as the residual holder by keeping up excess spread in the deals and delaying delinquency deal triggers that restrict payments to residual holders when delinquencies exceed specified levels. Assuming that the residual tranche would be out of the money upon a timely foreclosure, delay means that Carrington, as the residual holder, receives many more months of additional payments on the MBS it holds than it otherwise would.⁷²

It is important to emphasize that junk fees on homeowners ultimately come out of the pocket of MBS investors. If the homeowner lacks sufficient equity in the property to cover the amount owed on the loan, including junk fees, then there is a deficiency from the foreclosure sale. As many mortgages are legally or functionally non-recourse, this means that the deficiency cannot be collected from the homeowner's other assets. Mortgage servicers recover their expenses off the top in foreclosure sales, before MBS investors are paid. Therefore, when a servicer lards on illegal fees in a foreclosure, it is stealing from investors such as pension plans and the US government.

D. COMPLAINTS THAT FAIL TO INCLUDE THE NOTE

Rule of civil procedure generally require that a complaint based on a writing include, as an attachment, a copy of a writing. In a foreclosure action, this means that both the note and the mortgage and any assignments of either must be attached. Beyond the rules of civil procedure requirement, these documents are also necessary as an evidentiary matter to establish that the plaintiff has standing to bring the foreclosure. Some states have exceptions for public records, which may be incorporated by reference, but it is not always clear whether this exception applies in foreclosure actions. If it does, then only the note, which is not a public record, would need to be attached.

⁷⁰ Amherst Mortgage Insight, 2010, "The Elephant in the Room—Conflicts of Interest in Residential Mortgage Securitizations", pp. 22-24, May 20, 2010.

⁷¹ See Amherst Mortgage Insight, "Why Investors Should Oppose Servicer Safe Harbors", April 28, 2009. Excess spread is the difference between the income of the SPV in a given period and its payment obligations on the MBS in that period, essentially the SPV's periodic profit. Excess spread is accumulated to supplement future shortfalls in the SPV's cashflow, but is either periodically released to the residual tranche holder. Generally, as a further protection for senior MBS holders, excess spread cannot be released if certain triggers occur, like a decline in the amount of excess spread trapped in a period beneath a particular threshold.

⁷² Carrington would still have to make servicing advances on any delinquent loans if it stretched out the time before foreclosure, but these advances would be reimbursable, and the reimbursement would come from senior MBS holders, rather than from Carrington, if it were out of the money in the residual.

Many foreclosure complaints are facially defective and should be dismissed because they fail to attach the note. I have recently examined a small sample of foreclosure cases filed in Allegheny County, Pennsylvania (Pittsburgh and environs) in May 2010. In over 60% of those foreclosure filings, the complaint failed to include a copy of the note. Failure to attach the note appears to be routine practice for some of the foreclosure mill law firms, including two that handle all of Bank of America's foreclosures.

I would urge the Committee to ask Bank of America whether this was an issue it examined in its internal review of its foreclosure practices.

E. COUNTERFEIT AND ALTERED DOCUMENTS AND NOTARY FRAUD

Perhaps the most disturbing problem that has appeared in foreclosure cases is evidence of counterfeit or altered documents and false notarizations. To give some examples, there are cases in which multiple copies of the "true original note" are filed in the same case, with variations in the "true original note;"⁷³ signatures on note allonges that have clearly been affixed to documents via Photoshop;⁷⁴ "blue ink" notarizations that appear in blank ink; counterfeit notary seals;⁷⁵ backdated notarizations of documents issued before the notary had his or her commission;⁷⁶ and assignments that include the words "bogus assignee for intervening asmts, whose address is XXXXXXXXXXXXXXXXXXXX."⁷⁷

Most worrisome is evidence that these frauds might not be one-off problems, but an integral part of the foreclosure business. A price sheet from a company called DocEx that was affiliated with LPS, one of the largest servicer support firms, lists prices for various services including the "creation" of notes and mortgages. While I cannot confirm the authenticity of this price sheet or date it, it suggests that document counterfeiting is hardly exceptional in foreclosure cases.

While the fraud in these cases is not always by servicers themselves, but sometimes by servicer support firms or attorneys, its existence should raise serious concerns about the integrity of the foreclosure process. I would urge the Committee to ask the servicer witnesses what steps they have taken to ascertain that they do not have such problems with loans in their servicing portfolios.

G. THE EXTENT OF THE PROBLEM

The critical question for gauging the risk presented by procedural defects is the extent of the defects. While Federal Reserve Chairman Bernanke has announced that federal bank regulators are looking into the issue and will issue a report this month, I do not believe that it is

Brief of Antonio Ibanez, Defendant-Appellee, US Bank Nat'l Assn, as Trustee for the Structured Asset Securities Corporation Mortgage Pass-Through Certificates, Series 2006-Z v. Ibanez; Wells Fargo Bank, N.A. as Trustee for ABFC 2005-Opt 1 Trust, ABFC Asset Backed Certificates Series 2005-OPT 1, No 10694, (Mass. Sept. 20, 2010), at 10 (detailing 3 different "certified true copies" of a note allonge and of an assignment of a mortgage); <http://4closurefraud.org/2010/04/27/foreclosure-fraud-of-the-week-two-original-wet-ink-notes-submitted-in-the-same-case-by-the-florida-default-law-group-and-jpmorgan-chase/> (detailing a foreclosure file with two different "original" wet ink notes for the same loan).

⁷⁴ <http://4closurefraud.org/2010/04/08/foreclosure-fraud-of-the-week-poor-photoshop-skills/>.

⁷⁵ See WSTB.com, at <http://www.wsbtv.com/video/25764145/index.html>.

⁷⁶ Deposition of Cheryl Samons, Deutsche Bank Nat'l Trust Co., as Trustee for Morgan Stanley ABS Capital 1 Inc. Trust 2006-HE4 v. Pierre, No. 50-2008-CA-028558-XXXX-MB (15th Judicial Circuit, Florida, May 20, 2009, available at <http://mattweidnerlaw.com/blog/wp-content/uploads/2010/03/depositionsammons.pdf>.

⁷⁷ <http://www.nassauclerk.com/clerk/publicrecords/oncoreweb/showdetails.aspx?id=809395&rn=0&pi=0&ref=search>.

within the ability of federal bank regulators to gauge the extent of procedural defects in foreclosure cases. To do so would require, at the very least, an extensive sampling of actual foreclosure filings and their examination by appropriately trained personnel. I am unaware of federal bank regulators undertaking an examination of actual foreclosure filings, much less having a sufficient cadre of appropriately trained personnel. Bank examiners lack the experience or training to evaluate legal documents like foreclosure filings. Therefore, any statement put forth by federal regulators on the scope of procedural defects is at best a guess and at worse a parroting of the “nothing to see here folks” line that has come from mortgage servicers.

I would urge the Committee to inquire with federal regulators as to exactly what steps they are taking to examine foreclosure irregularities and how they can be sure that those steps will uncover the extent of the problem. Similarly, I would urge the Committee to ask the servicer witnesses what specific irregularities they examined during their self-imposed moratoria and by what process. It defies credulity that a thorough investigation of all the potential problems in foreclosure paperwork could be completed in a month or two, much less by servicers that have taken so long to do a small number of loan modifications.

III. CHAIN OF TITLE PROBLEMS

A second problem and potentially more serious problem relating to standing to foreclose is the issue of chain of title in mortgage securitizations.⁷⁸ As explained above, securitization involves a series of transfers of both the note and the mortgage from originator to sponsor to depositor to trust. This particular chain of transfers is necessary to ensure that the loans are “bankruptcy remote” once they have been placed in the trust, meaning that if any of the upstream transferors were to file for bankruptcy, the bankruptcy estate could not lay claim to the loans in the trust by arguing that the transaction was not a true sale, but actually a secured loan.⁷⁹ Bankruptcy remoteness is an essential component of private-label mortgage securitization deals, as investors want to assume the credit risk solely of the mortgages, not of the mortgages’ originators or securitization sponsors. Absent bankruptcy remoteness, the economics of mortgage securitization do not work in most cases.

Recently, arguments have been raised in foreclosure litigation about whether the notes and mortgages were in fact properly transferred to the securitization trusts. This is a critical issue because the trust has standing to foreclose if, and only if it is the mortgagee. If the notes and mortgages were not transferred to the trust, then the trust lacks standing to foreclose. There are several different theories about the defects in the transfer process; I do not attempt to do justice to any of them in this testimony.

⁷⁸ Chain of title problems appear to be primarily a problem for private-label securitization, not for agency securitization because even if title were not properly transferred for Agency securities, it would have little consequence. Investors would not have incurred a loss as the result of an ineffective transfer, as their MBS are guaranteed by the GSEs or Ginnie Mae, and when a loan in an Agency pool defaults, it is removed from the pool and the owned by the GSE or Ginnie Mae, which is then has standing to foreclose.

⁷⁹ Bankruptcy remote has a second meaning, namely that the trust cannot or will not file of bankruptcy. This testimony uses bankruptcy remote solely in the sense of whether the trust’s assets could be clawed back into a bankruptcy estate via an equity of redemption. The Uniform Commercial Code permits a debtor to redeem collateral at face value of the debt owed. If a pool of loans bore a now-above-market interest rate, the pool’s value could be above the face value of the debt owed, making redemption economically attractive.

It can be very difficult to distinguish true sales from secured loans. For example, a sale and repurchase agreement (a repo) is economically identical to a secured loan from the repo buyer to the repo seller, secured by the assets being sold.

While the chain of title issue has arisen first in foreclosure defense cases, it also has profound implications for MBS investors. If the notes and mortgages were not properly transferred to the trusts, then the mortgage-backed securities that the investors' purchased were in fact *non-mortgage-backed securities*. In such a case, investors would have a claim for the rescission of the MBS,⁸⁰ meaning that the securitization would be unwound, with investors receiving back their original payments at par (possibly with interest at the judgment rate). Rescission would mean that the securitization sponsor would have the notes and mortgages on its books, meaning that the losses on the loans would be the securitization sponsor's, not the MBS investors, and that the securitization sponsor would have to have risk-weighted capital for the mortgages. If this problem exists on a wide-scale, there is not the capital in the financial system to pay for the rescission claims; the rescission claims would be in the trillions of dollars, making the major banking institutions in the United States would be insolvent.

The key questions for evaluating chain of title are what method of transferring notes and mortgages is actually supposed to be used in securitization and whether that method is legally sufficient both as a generic matter and as applied. There is a surprising degree of legal uncertainty over these issues, even among banks' attorneys; different arguments appear in different litigation. The following section outlines the potential methods of transfer and some of the issues that arise regarding specific methods. It is critical to emphasize that the law is not settled on most of the issues regarding securitization transfers; instead, these issues are just starting to be litigated.

A. TRANSFERS OF NOTES AND MORTGAGES

As a generic matter, a note can be transferred in one of four methods:

- (1) the note can be sold via a contract of sale, which would be governed by the common law of contracts.
- (2) if the note is a negotiable instrument, it could be negotiated, meaning that it would be transferred via endorsement and delivery, with the process governed by Article 3 of the Uniform Commercial Code (UCC). The endorsement
- (3) the note could be converted into an electronic note and transferred according to the provisions of the federal E-SIGN Act.⁸¹
- (4) The note could be sold pursuant to UCC Article 9. In 49 states (South Carolina being the exception), Article 9 provides a method for selling a promissory note, which requires that there be an authenticated (signed) agreement, value given, and that the seller have rights in the property being transferred.⁸² This process is very similar to a common law sale.

⁸⁰ This claim would not be a putback claim necessarily, but could be brought as a general contract claim. It could not be brought as a securities law claim under section 11 of the Securities Act of 1933 because the statute of limitations for rescission has expired on all PLS.

⁸¹ 15 U.S.C. § 7021.

⁸² UCC 9-203. The language of Article 9 is abstruse, but UCC Revised Article 1 defines "security interest" to include the interest of a buyer of a promissory note. UCC 1-201(b)(35). Article 9's definition of "debtor" includes a seller of a promissory note, UCC 9-102(a)(28)(B), and "secured party" includes a buyer of a promissory note, UCC 9-102(a)(72)(D). Therefore UCC 9-203, which would initially appear to address the attachment (enforceability) of a security interest also covers the sale of a promissory note. South Carolina has not adopted the revised Article 1 definition of security interest necessary to make Article 9 apply to sales of promissory notes.

There is general agreement that as a generic method, any of these methods of transfer would work to effectuate a transfer of the note. No method is mandatory. Whether or not the chosen process was observed in practice, is another matter, however.⁸³

There are also several conceivable ways to transfer mortgages, but there are serious doubts about the validity of some of the methods:

- (1) the mortgage could be assigned through the traditional common law process, which would require a document of assignment.
 - a. There is general consensus that this process works.
- (2) the mortgage could be negotiated.
 - a. This method of transfer is of questionable effectiveness. A mortgage is not a negotiable instrument, and concepts of negotiability do not fit well with mortgages. For example, if a mortgage were negotiated in blank, it should become a “bearer mortgage,” but this concept is utterly foreign to the law, not least as the thief of a bearer mortgage would have the ability to enforce the mortgage (absent equitable considerations). Similarly, with a bearer mortgage, a homeowner could never figure out who would be required to grant a release of the mortgage upon payoff. And, in many states (so-called title theory states), a mortgage is considered actual ownership of real property, and real property must have a definite owner (not least for taxation purposes).
- (3) the mortgage could “follow the note” per common law.
 - a. Common law is not settled on this point. There are several instances where the mortgage clearly does not follow the note. For example, the basic concept of a deed of trust is that the security instrument and the note are separated; the deed of trust trustee holds the security, while the beneficiary holds the note. Likewise, the mortgage follows the note concept would imply that the theft of a note also constitutes theft of a mortgage, thereby giving to a thief more than the thief was able to actually steal. Another situation would be where a mortgage is given to a guarantor of a debt. The mortgage would not follow the debt, but would (at best) follow the guarantee. And finally, the use of MERS, a recording utility, as original mortgage (a/k/a MOM) splits the note and the mortgage. MERS has no claim to the note, but MERS is the mortgagee. If taken seriously, MOM means that the mortgage does not follow the note. While MERS might claim that MOM just means that the beneficial interest in the mortgage follows the note, a transfer of the legal title would violate a bankruptcy stay and would constitute a voidable preference if done before bankruptcy.
- (4) the mortgage could “follow the note” if it is an Article 9 transfer.⁸⁴

⁸³ Note that common law sales and Article 9 sales do not affect the enforceability of the note against the obligor on the note. UCC 9-308, Cmt.6, Ex. 3 (“Under this Article, attachment and perfection of a security interest in a secured right to payment do not of themselves affect the obligation to pay. For example, if the obligation is evidenced by a negotiable note, then Article 3 dictates the person to whom the maker must pay to discharge the note and any lien security it.”). UCC Article 3 negotiation and E-SIGN do affect enforceability as they enable a buyer for value in good faith to be a holder in due course and thereby cut off some of the obligor’s defenses that could be raised against the seller. UCC 3-305, 3-306; 15 U.S.C. § 7021(d).

⁸⁴ UCC 9-203(g). If the transfer is not an Article 9 transfer, then the Article 9 provision providing that the mortgage follows the note would not apply.

- a. There is consensus that this process would work *if* Article 9 governs the transfer of the note.

Ultimately, there is lack of consensus as to the method of transfer that is actually employed in securitization transactions. In theory, the proper method should be UCC Article 9 transfer process was adopted as part of the 2001 revision of Article 9 with the apparent goal of facilitating securitization transactions. Parties are free, however, to contract around the UCC.⁸⁵ That is precisely what pooling and servicing agreements (PSAs) appear to do. PSAs provide a recital of a transfer of the notes and loans to the trust and then they further require that the as they set forth specific requirements regarding the transfer of the notes and mortgages, namely that there be a complete chain of endorsements followed by either a specific endorsement to the trustee or an endorsement in blank.⁸⁶ The reason for this additional requirement is to provide a clear evidentiary basis for all of the transfers in the chain of title in order to remove any doubts about the bankruptcy remoteness of the assets transferred to the trust. Absent a complete chain of endorsements, it could be argued that the trust assets were transferred directly from the originator to the trust, raising the concern that if the originator filed for bankruptcy, the trust assets could be pulled back into the originator's bankruptcy estate.

As PSAs are trust documents, they must be followed punctiliously. Moreover, most RMBS are issued by New York common law trusts, and well-established New York law provides that a transaction that does not accord with the trust documents is void.⁸⁷ Therefore, the key question is whether transfers to the trusts complied with PSAs. It appears that in recent years mortgage securitizers started to cut corners in order to deal with the increased deal volume they faced during the housing bubble, and they ceased to comply with the PSA requirements in many cases. Thus, in many cases, the notes contain either a single endorsement in blank or no endorsement whatsoever, rather than the chain of endorsements required by the PSA and critical for ensuring the trust's assets' bankruptcy remoteness.

It bears emphasis that the validity of transfers to the trusts is an unsettled legal issue. But if the transfers were invalid, they cannot likely be corrected because of various timeliness requirements in the PSAs.

IV. YES, BUT WHO CARES? THESE ARE ALL DEADBEATS

A common response from banks about the problems in the securitization and foreclosure process is that it doesn't matter as the borrower still owes on the loan and has defaulted. This "No Harm, No Foul" argument is that homeowners being foreclosed on are all a bunch of deadbeats, so who really cares about due process? As JPMorganChase's CEO Jamie Dimon put it "for the most part by the time you get to the end of the process we're not evicting people who deserve to stay in their house."⁸⁸

Mr. Dimon's logic condones vigilante foreclosures: so long as the debtor is delinquent, it does not matter who evicts him or how. But that is not how the legal system works. A

⁸⁵ UCC 1-203.

⁸⁶ This provision is general found in section 2.01 of PSAs.

⁸⁷ NY E.P.T.L. § 7-2.4.

⁸⁸ Tamara Keith & Renee Montaigne, *Sorting Out the Banks' Foreclosure Mess*, NPR, Oct. 15, 2010.

homeowner who defaults on a mortgage doesn't have a right to stay in the home if the proper mortgagee forecloses, but any old stranger cannot take the law into his own hands and kick a family out of its home. That right is reserved solely for the proven mortgagee.

Irrespective of whether a debt is owed, there are rules about who can collect that debt and how. The rules of real estate transfers and foreclosures have some of the oldest pedigrees of any laws. They are the product of centuries of common law wisdom, balancing equities between borrowers and lenders, ensuring procedural fairness and protecting against fraud.

The most basic rule of real estate law is that only the mortgagee may foreclose. Evidence and process in foreclosures are not mere technicalities nor are they just symbols of rule of law. They are a paid-for part of the bargain between banks and homeowners. Mortgages in states with judicial foreclosures cost more than mortgages in states without judicial oversight of the foreclosure process.⁸⁹ This means that homeowners in judicial foreclosure states are buying procedural protection along with their homes, and the banks are being compensated for it with higher interest rates. Banks and homeowners bargained for legal process, and rule of law, which is the bedrock upon which markets are built function, demands that the deal be honored.

Ultimately the “No Harm, No Foul,” argument is a claim that rule of law should yield to banks' convenience. To argue that problems in the foreclosure process are irrelevant because the homeowner owes *someone* a debt is to declare that the banks are above the law.

V. CONCLUSION

The foreclosure process is beset with problems ranging from procedural defects that can be readily cured to outright fraud to the potential failure of the entire private label mortgage securitization system.

In the best case scenario, the problems in the mortgage market are procedural defects and they will be remedied within reasonably quickly (perhaps taking around a year). Remedying them will extend the time that properties are in foreclosure and increase the shadow housing inventory, thereby driving down home prices. The costs of remedying these procedural defects will also likely be passed along to future mortgage borrowers, thereby frustrating attempts to revive the housing market and the economy through easy monetary policy.

In the worst case scenario, there is systemic risk, as there could be a complete failure of loan transfers in private-label securitization deals in recent years, resulting in trillions of dollars of rescission claims against major financial institutions. This would trigger a wholesale financial crisis.

Perhaps the most important lesson from 2008 is the need to be ahead of the ball of systemic risk. This means (1) ensuring that federal regulators do a serious investigation as discussed in this testimony above and (2) considering the possible legislative response to a crisis. The sensible course of action here is to avoid gambling on unsettled legal issues that could have systemic consequences. Instead, we should recognize that stabilizing the housing market is the

⁸⁹ See Karen Pence, *Foreclosing on Opportunity: State Laws and Mortgage Credit*, 88 REV. ECON. & STAT. 177 (2006) (noting that the availability—and hence the cost—of mortgages in states with judicial foreclosure proceedings is greater than in states with non-judicial foreclosures).

key toward economic recovery, and that it is impossible to fix the housing market unless the number of foreclosures is drastically reduced, thereby reducing the excess inventory that drives down housing prices and begets more foreclosures. Unless we fix the housing market, consumer spending will remain depressed, and as long as consumer spending remains depressed, high unemployment will remain and the US economy will continue in a doldrums that it can ill-afford given the impending demographics of retirement.

This suggests that the best course of action is a global settlement on mortgage issues, the key elements of which must be (1) a triage between homeowners who can and cannot pay with principal reduction and meaningful modifications for homeowners with an ability to pay and speedier foreclosures for those who cannot, (2) a quieting of title on securitized properties, and (3) a restructuring of bank balance sheets in accordance with loss recognition.

I recognize that for many, the preferred course of action is not to deal with a problem until it materializes. But if we pursue that route, we may be confronted with an unmanageable crisis. We cannot rebuild the US housing finance system until we deal with the legacy problems from our old system, and these are problems that are best addressed sooner, before an acute crisis, then when it is too late.